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Living in a Post-Brexit World

Much has been written and said about Great Britain's historic referendum to leave the European Union (EU). In this month's *Capital Market Notes* we take our guesses like everyone else about what's to come (more on this below). We also revisit our overall macro and market views in light of Brexit and looking to the second half of 2016.

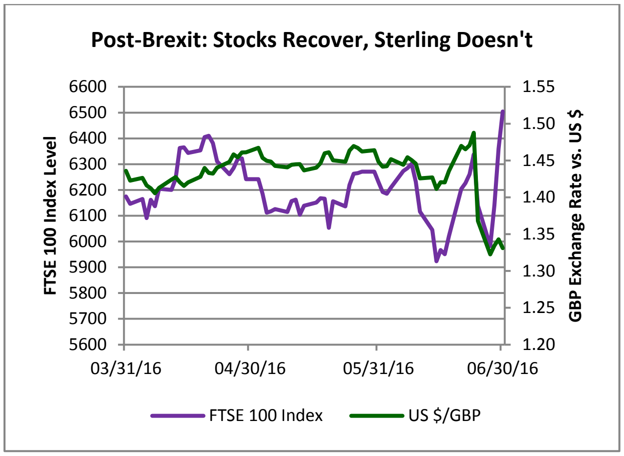
First, it's important to understand that the effects of the Brexit vote are complex, wide-ranging, and interconnected. The decision tree representing the UK's withdrawal from the EU is a nightmare, with each branch leading to a myriad of potential outcomes. On the political front the decision points include the UK's new leadership post-Cameron, implications for Scotland and Northern Ireland, the Article 50 withdrawal process, and perhaps greater implications for the future of the EU itself. On the economic side, uncertainty about what a new UK/EU relationship will look like creates instability across equities and currencies while driving down safe-haven bond yields. Adding to all this complexity is the "risk" that it might not even happen! By our count, there are about a half dozen (low probability) scenarios whereby the UK doesn't actually exit the EU in spite of the referendum. That is to say, we are all guessing.

What Do We Know?

Given the political and economic complexities, what do we really know in the wake of Brexit? Or to be more precise, what do we really *think* we know?

First, businesses and consumers across the UK will have a difficult time handicapping the variables in question. What legal framework will prevail? How difficult will the new terms of trade be with the EU and other nations? Will businesses have to relocate? How will cross-channel labor be affected? How will EU budget contributions be redeployed? What about the loss of EU subsidies? How will the pound fluctuate relative to the euro and other currencies? Anecdotally, we're already hearing that some businesses are deferring expansion plans, postponing hiring, and reassessing locations. Perhaps in the long run, a Britain free of the EU's bureaucracy could be more dynamic and innovative, but in the near term these uncertainties will be a headwind to growth. What's unclear is whether this headwind will be enough to push either the UK or EU into an actual recession.

Second, we know the potential outcomes of the referendum are varied and complex. The ramifications are uncertain, and investors don't like uncertainty. As a result, markets will discount asset prices as appropriate. In simple terms, the uncertainty of Brexit will be a drag on the price of risk assets tied to the UK and EU. (No surprise there.) While UK stocks have rallied back to their pre-vote highs, we don't believe this is an "all-clear" signal.



Source: Bloomberg, Natixis Investment Strategies Group (Natixis ISG) (3/31/16 – 6/30/16)

Third, and most importantly, businesses, consumers, and policy-makers will adapt to the changes that Brexit may bring. While we recognize the challenges, it's key to remember that economic agents are flexible. Businesses will continue to produce goods, employ workers, and seek profits. Consumers will shop and spend. Central banks will provide liquidity and act as a firewall against further contagion. Change doesn't occur in a vacuum. While we expect Brexit to weigh on markets in the coming months (after the initial sell-off and rebound), it shouldn't be seen as a catastrophic event.

Big Picture

Our summary view of the UK referendum is neither optimistic nor overly pessimistic. The dominant theme in global markets today is the longer-term stagnation caused by poor demographics, labor force dynamics, and low productivity. With a few exceptions, growth is positive, but sub-par in most of the largest economies. The impacts of the Brexit vote are nothing more than additional friction in this already slow growth environment. Our belief is that this drag will not pull the global economy into recession, but that possibility has to be recognized as a potential risk scenario.

Stocks Remain Challenged

We remain cautious on global equities for two reasons: earnings growth is constrained by the macro environment and valuations are elevated, limiting the hope for P/E expansion. The macro headwinds of Brexit simply reinforce our view that earnings growth will be even more challenged. This may be partially offset in the UK and Europe by a moderately weaker British pound and euro relative to the U.S. dollar and Japanese yen. We remain largely indifferent between U.S. and non-U.S. equities, as growth favors the U.S. but valuation is somewhat more reasonable outside the states. In emerging markets, measures of activity appear to have bottomed. Valuations still reflect some major worries which we believe the market has already discounted, including the slowdown in China, the commodity rout, and a U.S. dollar funding crisis. After 3+ years of relative underperformance, and in spite of Brexit, we still see EM as an opportunity for investors with some patience.

Emerging Markets: Are the fears already priced in?

EM Headwinds	Current Status
Slowing China	Chinese growth appears to be stabilizing
Recessionary Pressures	Country activity metrics have bottomed
Commodity Reliance	Commodity prices stable/rising
U.S. Dollar Strength	Dollar debt funding crisis overplayed

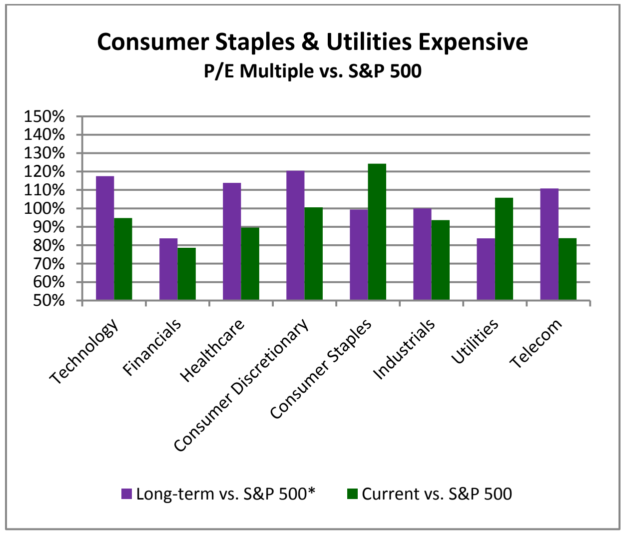
Source: Natixis ISG

Bonds Bifurcation Continues

Brexit has done little to change our views across fixed-income. The bond market remains bifurcated between high quality / interest rate risk and lower quality / credit risk. Through the post-vote gyrations, the sentiment remains largely risk-off with sovereign yields materially lower. Relative to pre-Brexit levels, investors are now exposed to even more interest rate risk for less yield compensation. Within the corporate sectors of the bond market, relative values have improved modestly thanks to lower prices in some cases (e.g., high yield) and because treasuries have “rallied away” from the spread sectors. In this regard, Brexit has only reinforced the existing trend as expensive sectors have gotten more expensive and cheaper sectors have gotten slightly cheaper.

The Risk of Safety

Aside from the UK referendum, portfolio allocations and asset valuations imply a dangerous and one-sided view of the world. The preponderance of investors are overweight safety as illustrated by minuscule sovereign yields, large cash positions, excessive valuations in non-cyclical sectors like utilities and consumer staples, and the strength in gold, the U.S. dollar, and the Japanese yen.



Source: Bloomberg, Natixis ISG (As of June 29, 2016)
*Long-term P/E ratio is January 1990 – May 2016

Given this positioning, the risk to most investors today is not that the global economy will deteriorate toward recession, but that it regains some strength. Having too much exposure to safety could actually be the biggest risk to portfolios.

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