

After the Brexit...

It will take some time before the full economic, financial, and political ramifications of the "Brexit" play out. Judging by the financial markets' reaction, the shock to the global economic and financial system should be both measured and contained, but the tail end of risk distribution might have been fattened by the Brexit, with financial and geopolitical ramifications to be felt over the long run.

Market Reactions

Global equities—the barometer for global economic growth—have had a brief but measured selloff to Brexit, with the total loss in the MSCI World Index¹ slightly less than 7% between June 23 and July 11. Currently, all of the loss has been erased, with global stocks having waged a sharp rebound in recent weeks.

Nevertheless, equity market performance on a regional/country basis is very uneven.

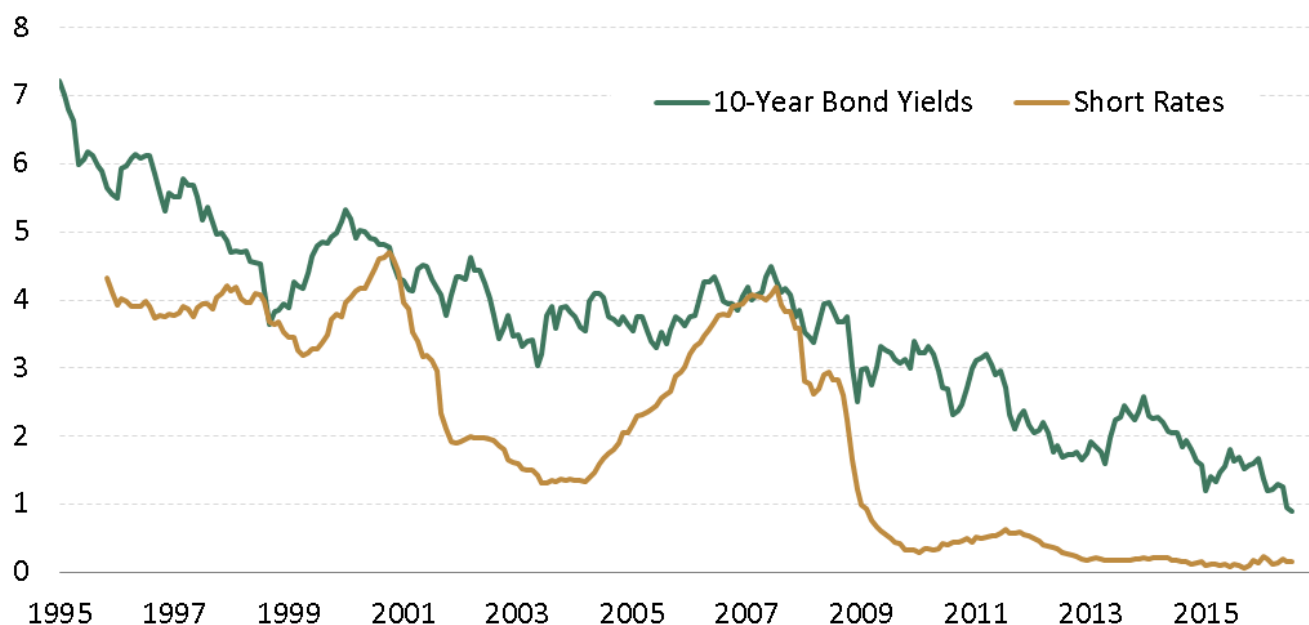
The FTSE 250²; is still off by more than 13% in U.S. dollar terms, while the DAX³ and Euro Stoxx indices are still down by about 4% and 5% in dollar terms, respectively. On the other hand, the S&P 500 has broken out to fresh highs since the Brexit. Similarly, the Nikkei⁴ is also higher than its June 23 level, when adjusted for yen appreciation. Most impressively, the MSCI Emerging Market Index has been significantly higher since the Brexit.

Global currency markets have experienced extremely volatile adjustments. Shocked by the referendum result, sterling collapsed 13% versus the dollar. The speed of the decline is only matched by the 2008 collapse in the British currency. At the other end of the spectrum, the Brazilian real appreciated nearly 5% since June 23, marking it as the strongest currency post-Brexit referendum.

Overall, performance of the EM currency index has been steady. Contrary to EM currencies' traditional label as a risk asset, the MSCI Emerging Market Currency Index has actually been flat during this risk-off period. Nevertheless, regional/country variance has been large within the EM currencies universe: while the poor performers are concentrated in central Europe, the stronger EM currencies are clustered in commodity-producing countries.

Global government bond yields have melted in the wake of the Brexit, with "risk-free" rates in Germany and Japan falling deeper into negative territory. Treasury yields have also made a dramatic move lower since June 23, with both 10- and 30-year yields touching historic lows before the recent rebound. Currently, the average G7 10-year bonds yield a mere 0.86%. Yield curves have further flattened across the G7 world.

Chart 1: Meltdown in G7 Interest Rates %, Weighted by GDP; As of 7/13/2016



Source: Thomson Datastream

Messages from "Mr. Market"

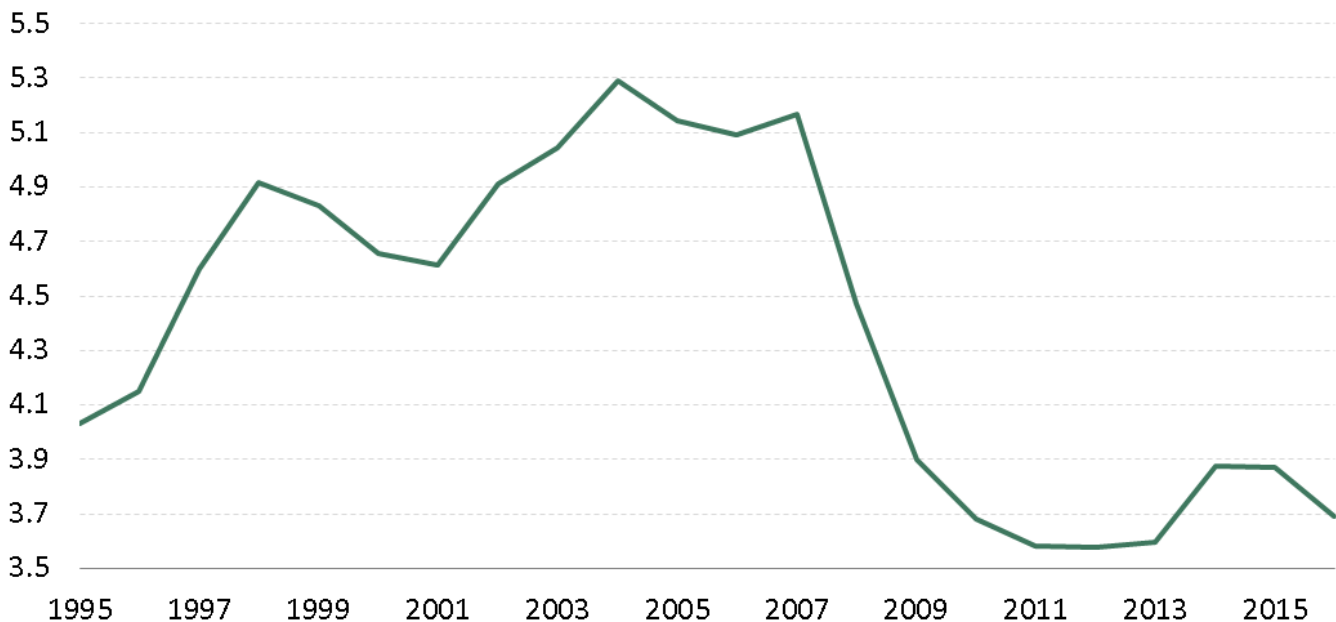
The Brexit shock remains fresh and many ripples are still being made and felt. A few observations can be made from the very early market reactions:

- ▣ Although Brexit represents a negative shock that has intensified anxiety and trepidation over the global economy, I believe the actual contagion to global growth will be limited. The steady advance in the MSCI World Index since June 23 suggests that the shock may not be big enough to cause a significant slowdown to the world economy.
- ▣ There have been four times when sterling declined close to or more than 20%, with each episode preceding a recession. Sterling has declined by more than 24% versus the dollar since 2014, with half of the loss incurred after the Brexit referendum. Using historical correlation as a reference point, the likelihood of a growth slump in the U.K. economy is high. A brief technical recession is not impossible.
- ▣ I believe the steep plunge in European bank stocks is a clear warning that a slow burning crisis in the Italian banking system has the potential to become a full-fledged systemic event. The European authorities must act quickly and decisively to stem any systemic risk. In the end, the European Central Bank (ECB) holds the key to the financial stability of the eurozone banking system. In my view, the central bank will do whatever it takes to safeguard financial stability in the wake of Brexit. Hence, the odds of another major flare up in the form of a eurozone debt crisis is not high in my opinion.
- ▣ Brexit is a deflationary shock, which is a key reason why global bond yields have moved significantly lower. I believe that the collapse in sterling and weakness in the euro will push deflation in Europe into the rest of the world. In this sense, the Brexit shock has quickened the convergence of global bond yields by compressing higher-yielding markets such as the U.S. treasury market.

Putting the Shock in Proper Perspective

It is important to put the Brexit shock in proper context. The U.K. economy has been shrinking in relative size for years, as has its importance in the world economy. Though still ranked as the fifth largest economy in the world, its gross domestic product (GDP) as a share of the world total has fallen to 3.7%. The U.K.'s trade share in the global total is trivial, accounting for 2.8% in world exports and about 4% in global imports.

Chart 2: U.K. GDP as % of World *Estimated 2016 GDP as of 7/5/16*



Source: Thomson Datastream

However, the U.K. external sector has been dominated by trade with the European Union (EU). Exports from the U.K. to the EU accounts for 47% of the country's total exports, while 55% of U.K. imports are coming from the EU. The U.K.'s trade deficit with the EU accounts for over 75% of the country's overall trade deficit. This highlights the importance of a smooth transition for the U.K. to exit the EU.

Finally, although the U.K. economy has shrunk in size, sterling remains a very important reserve currency; it accounts for 11% of the International Monetary Fund's Standard Drawing Rights (SDR) basket. It is generally accepted that the SDR weights reflect the average composition of the reserve currencies in the global financial system. This means that the importance of sterling in international finance and trade dwarfs the role of the U.K. economy by several fold. For instance, the Chinese yuan is now loosely pegged to a currency basket with sterling taking up a significant weight. With sterling having broken down, the Chinese yuan will have to manage noticeable depreciation against other key currencies in the basket.

What to Look For?

Although Brexit has occupied the headline news, it is the Federal Reserve (Fed) that dictates global monetary conditions and China that determines the marginal changes to the world economy. Both hold the key for the performance of global financial markets.

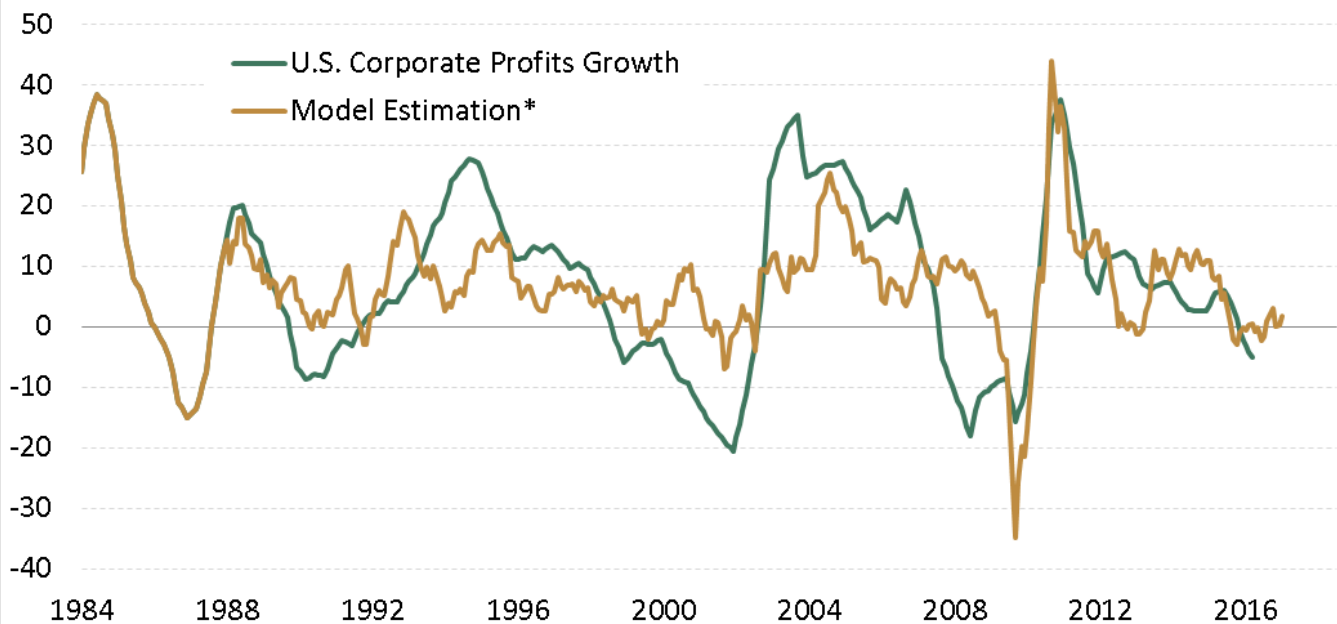
The sharp fall in long-term U.S. bond yields and the much delayed Fed rate hike are culminating in a dose of stimulant-propelling domestic borrowing and spending. This is akin to the late 1990s when the crises in Asia and Long-Term Capital Management drove down U.S. bond yields, which in turn pushed up U.S. domestic

spending and accelerated the advance in U.S. equity prices. We may be seeing a replay of a similar story with the rise in the S&P 500 turning parabolic.

As for China, it is hard to imagine how the economy is seriously impacted by Brexit. Signs of growth stabilization in China continue to accumulate. China's service economy is doing fine and pain in the manufacturing business is easing. Judging by the easing Producer Price Index deflation and public sector spending, China's GDP growth will likely be a tad stronger 3-6 months out.

The combination of a better Chinese economy and a dovish turn for the Fed means that the sweet spot for risk assets can be extended. It is possible that the U.S. labor market will become a tad weaker, but corporate profits growth may become stronger. Our corporate profit model—which is based on the weighted impact of the dollar, corporate spread and Institute for Supply Management—suggests that the U.S. corporate sector profit recession is passing.

Chart 3: U.S. Corporate Profits and Model Estimate *Annual % Change; As of 3/31/2016*



**Estimation range 1988-current*

Source: Thomson Datastream

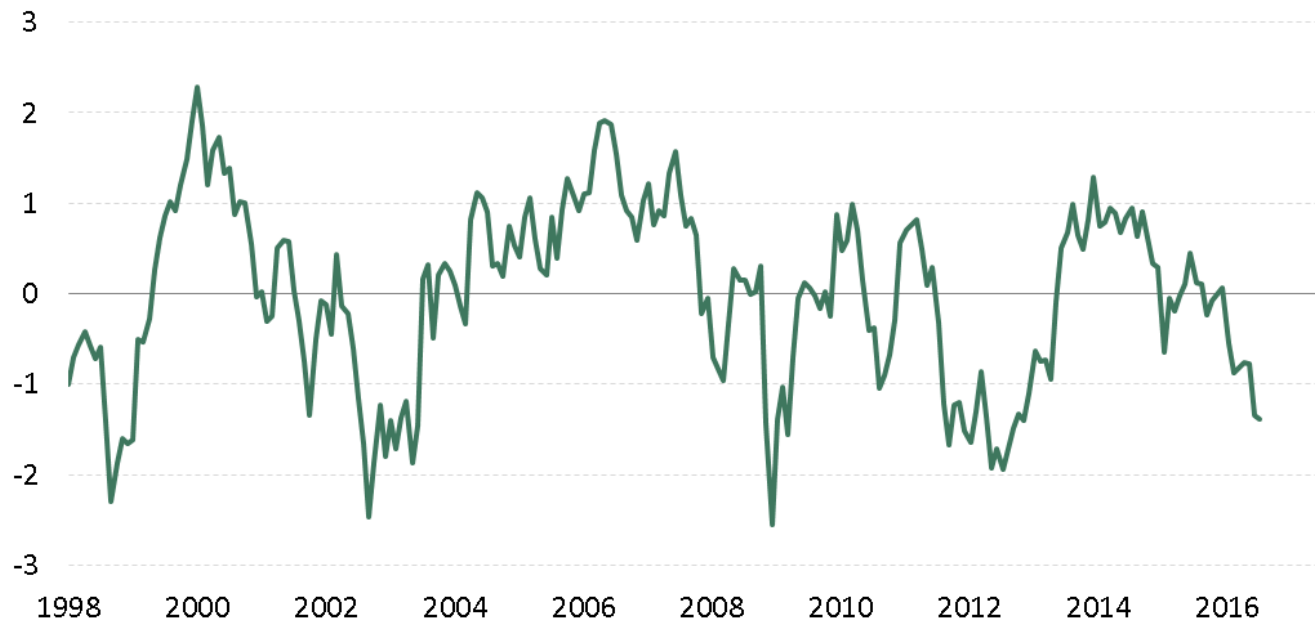
The resilience of EM equity and currency indices in the wake of Brexit suggests that investors may have sniffed out improving global economic and monetary conditions. Nevertheless, any further advance in EM assets would require continued improvement in China's economy, stability in commodity prices, dovishness from the Fed, and weakness in the dollar.

The U.K. economy is prone to boom-bust cycles and tends to recover quickly from a slump or recession, especially after a large and sustained currency devaluation. There is no question that the U.K. is a service-oriented economy with imports chronically exceeding exports. Nevertheless, as a global hub for finance, a significantly cheapened sterling, and a substantially reduced cost base will likely attract renewed capital inflows into the U.K. once uncertainty dies down and the economy recovers from the Brexit shock.

The dramatic surge in U.S. Treasury bond prices has set the stage for a corrective phase. It is unlikely that the secular trend in long-term bond yields in the U.S. will turn up at any time soon, but the recent fall in yields represents a 1.5 sigma undershoot. I believe a sizable price correction is inevitable and may be already underway.

Chart 4: U.S. 10-Year Treasury Yield: Deviation from Fair Value Estimate

Standardized Residual; As of 7/13/2016



*Estimation interval 1998-present

Source: Thomson Datastream

The extraordinary surge in the sterling-dollar volatility index suggests that the selling power in the sterling market is being exhausted. The sterling market has discounted a fairly pessimistic outcome, but valuation, momentum, and sentiment have all suggested that the opportunities will mainly exist on the long side. In my opinion in 6-12 months, sterling will likely be significantly higher than it is today.

Last but not least, Brexit is more of a political crisis than an economic one. Much like the Trump phenomenon in the U.S., Brexit can be regarded as a popular revolt against the political establishment. This sentiment poses several serious political challenges and questions for western democracies going forward.

Will the Brexit solidify EU unity or eventually destroy it? Is Brexit a harbinger of a Trump presidency in the U.S.? Very rarely have financial markets so mispriced risk as they did with Brexit because "Mr. Market" always assumes that self-interests will ensure rational behavior prevails. Brexit suggests that this assumption could be easily wrong in the age of widespread populist anger and discontent. Does this mean that politics and policy—after swinging toward free-market capitalism and supply-side reforms for thirty years—are beginning to swing the other way? Should protectionism ever gain momentum, a period of stagflation will inevitably follow. If so, the path of least resistance for both bonds and stocks will be down.

1. The MSCI World Index captures large- and mid-cap equities across 23 developed countries.
2. The FTSE 250 is a market-capitalization-weighted index consisting of 101-350th largest companies by market cap listed on the London Stock Exchange.
3. The Deutscher Aktienindex (DAX) is a German equity index consisting of 30 German companies trading on the Frankfurt Stock Exchange.
4. The Nikkei 225 is a stock market index for the Tokyo Stock Exchange.

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