Q3 2016

Investment View

Brexit: A risky divorce

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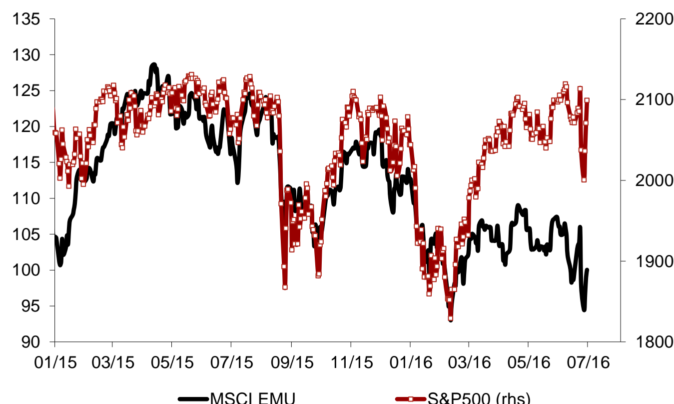
Global View

- **The 'Leave' vote in the British EU referendum on June 23 has unsettled financial markets, triggering a slide in equities and global yields alike. Politically and economically, the decision is a huge step into unchartered territory.**
- **The damage to the British economy will prove sizeable. The impact for the rest of Europe and financial markets hinges on the reaction of political stakeholders and sentiment effects among businesses and financial markets.**
- **In a scenario of a moderate fallout, a period of financial market stress is likely to be followed by a return to growth and financial market relief.**
- **In case of a strong sentiment impact on European businesses and an indecisive response by policy makers, a prolonged period of financial market stress with a more protracted fall in yields would be on the cards.**
- **In the near term, we favor a prudent tactical allocation stance. Core yields and equities are likely to remain under pressure amid ongoing high uncertainties about the consequences of the historical decision by British voters.**

Financial markets reacted strongly to the 'Leave' decision by British voters

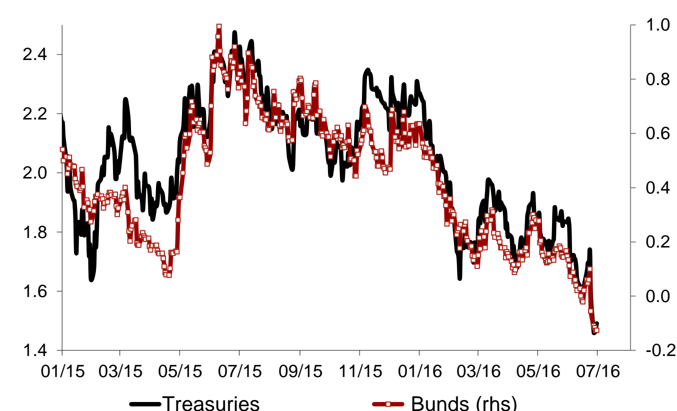
The EU referendum in the UK had cast a long shadow on global financial markets over the whole past quarter, with swings in poll results moving financial markets and the exchange rate of sterling in particular. However, when the outcome in favor of Brexit ultimately became clear, markets reacted with a steep fall in core government yields, a drop in sterling to a 30-year low against the US dollar and a sell-off in equities on the day after the referendum. Strikingly, while core bond yields alongside sterling extended their decline over subsequent days, stocks pared some of the losses while spreads on Southern European debt re-tightened markedly close to levels prevailing ahead of the vote.

EURO AREA AND US EQUITIES



Graph 1

GOVERNMENT BOND YIELDS



Graph 2;10-year maturities, in %

Brexit fallout: the bad or the ugly

Politically and economically, the decision is a huge step into unchartered territory. After decades of expansion of the EU, the UK is the first country that may leave the Union. At the same time, given the economic and population size of the UK and its political influence at the international level, a Brexit will mean a turning point in the composition of the EU. In Britain, the decision likely heralds a longer period of deep political uncertainties. Not only has Prime Minister David Cameron declared to step down; the UK may also face another referendum of Scottish independence, which has now has a greater chance of approval by the EU friendly Scottish population. Meanwhile, British voters and parties themselves are hugely divided after a fierce and of-

fensive referendum campaign. And just days after the referendum, even the possibility of an exit from the Brexit cannot be completely dismissed.

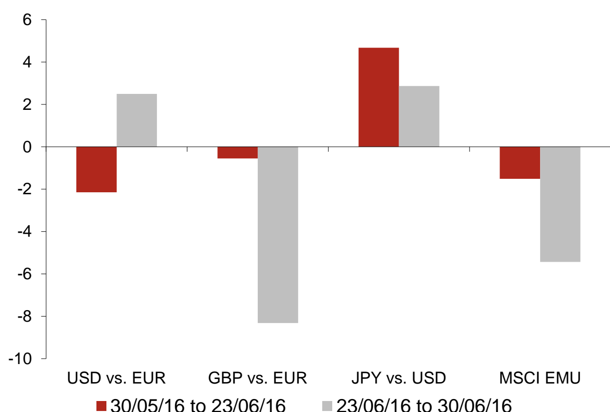
UK to suffer from a drop in investment activity already short term

During the period of up to two years of negotiations between the UK and the EU, Britain will remain part of the EU with all its rights and duties. However, the resulting political and economic uncertainties about future trade relationships will start to hurt the economy short term via a drop in investment activity. Quantitative estimates are subject to large uncertainties, but we anticipate the damage to British GDP growth by between 1.5 to 2.5 pp by the end of next year compared to a 'Remain' scenario.

Biggest risks to rest of Europe arise from political uncertainties and a drop in business sentiment

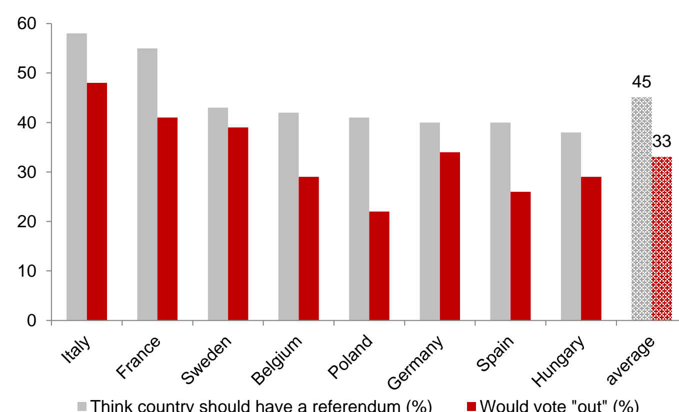
The economic fallout on Europe and global financial markets will depend on factors which are hard to predict. The direct impact on external demand will be limited, given that euro area exports to the UK amount to less than 3% of GDP. The much greater impact may arise from sentiment effects on growing political uncertainty and financial market volatility. If the response by the policy makers from the remainder of the EU turns out weak, growing fears about accelerated disintegration, including exit referenda in other countries can harm business and consumer sentiment more meaningfully. Similarly, a lasting sharp increase in financial market volatility may dampen the economic outlook and trigger a decline in investment.

FX AND EQUITY PERFORMANCE PRE AND AFTER BREXIT VOTE



Graph 3; change in %

SENTIMENT TOWARDS THE EU



Graph 4; in %, Source: Ipsos Public Affairs 05/2016

In a moderate scenario, short-term financial markets strains may be followed by a recovery of economic sentiment and financial markets from earlier losses

Due to these hard-to-predict political repercussions on sentiment, scenario-thinking is key in the current environment. In a projection of a moderate fallout, the damage in sentiment and economic activity will be largely confined to the British economy. The political response by European politicians will be reassuring enough to dismiss markets fears of domino effects from the Brexit vote and speculation about 'who is next' in the European Union. While financial market volatility remain elevated for somewhat longer on lingering uncertainties, more reassuring economic data and the support announced by central banks will suffice to keep the increase in market risk premia limited. Visibility of the damage of the Brexit vote to the economy and political stability in the UK would help to contain demands for similar referenda elsewhere. Further out, with market fears abating and business confidence recovering, financial markets can escape the risk-off mode, with core bond yields and risky assets recovering.

In a less benign scenario of persistent stress, the fallout would be larger and last for longer. In particular, there is an elevated risk of a vicious cycle feeding on itself for some time. Rising support to eurosceptic parties in other EU countries would raise the risk of domino effects, with the public debate focusing on the question 'who is next'

In a less benign scenario, contagion to the rest of Europe and financial markets will prove profound

for an EU referendum. Doubts about the stability of the EU and the euro area would harm business confidence, with investment plans put on hold, inducing an economic slowdown. Despite further ECB measures, the risk premia on Southern European sovereign debt would rise, adding to doubts about the sustainability of public debt. Slowing economic momentum and spreading uncertainties could just add to the rise in eurosceptic mood. As a result, the economic slowdown and financial market stress also outside the UK would prove deep and protracted, providing little ground for a marked recovery over the coming quarters.

For distinguishing the odds of both scenarios, the coming weeks will be key. First reactions by European leaders have been more on the reassuring side. And also on financial markets there has so far been little indication of a turmoil that has the potential to derail the moderate European recovery. Over the coming weeks, timely sentiment indicators like purchasing manager indices may give some first indications to what extent broader economic sentiment has been hit by the vote outcome.

MACRO OUTLOOK FOR A MODERATE BREXIT FALLOUT

	Growth			Inflation		
	2015	2016f	2017f	2015	2016f	2017f
US	2.3	1.5	1.8	0.1	1.3	1.8
Euro Area	1.6	1.3	0.9	0.0	0.3	1.3
- Germany	1.4	1.4	1.2	0.1	0.4	1.3
- France	1.2	1.3	1.1	0.1	0.3	1.2
- Italy	0.6	0.8	0.4	0.1	0.0	0.9
UK	2.2	1.3	1.0	0.0	2.7	3.1
Japan	0.5	0.3	0.5	0.8	0.1	0.4
Asia ex Japan	5.8	5.5	5.6	2.2	2.5	2.6
- China	6.9	6.3	5.9	1.4	1.9	2.0
CEE	0.3	1.5	2.4	8.9	5.0	4.7
Latin America	-0.6	-0.9	1.5	13.6	23.5	16.6
World	**2.6**	**2.3**	**2.6**	**1.6**	**2.5**	**2.6**

Table 1; annual changes, in %

FINANCIAL MARKETS FORECASTS

10-Year Bond Yields	**Current***	**3M**	**6M**	**12M**
US	1.48	1.45	1.50	1.60
Germany	-0.12	-0.20	-0.10	0.00
Italy	1.32	1.35	1.30	1.25
Japan	-0.23	-0.30	-0.20	-0.10
Forex	**Current***	**3M**	**6M**	**12M**
USD/EUR	1.11	1.07	1.08	1.10
JPY/USD	103	100	102	104
GPB/EUR	0.83	0.88	0.86	0.85
Equities	**Current***	**3M**	**6M**	**12M**
S&P500	2069	2005	2040	2040
MSCI EMU	98.5	95.0	97.0	99.0

Table 2; *current as of June 30, 3-day average

Prudent allocation stance until the dust settles

Prudent tactical allocation stance appropriate with weeks of political and economic uncertainties ahead

With further weeks of economic and political uncertainties ahead, we favor a prudent tactical allocation stance over the coming weeks. Equities are likely to remain vulnerable to further setbacks amid ongoing high uncertainties about the fallout of the historical decision by British voters. Similarly, with major central banks ramping up their monetary policy support and inflation expectations low, core bond yields are likely to fall even somewhat further. Meanwhile, the risk premia on Southern European sovereign debt, which have largely pared their initial increase just after the referendum, are unlikely to tighten further. In this regard, uncertainties about the outcome of the constitutional referendum in Italy (scheduled for October) and the ordered re-run of presidential elections in Austria will come stronger into the focus of investors. Among risky assets, non-financial investment-grade corporate bonds in the euro area are likely to prove most resilient. This is largely due to the intervention by the ECB, which has just started to buy non-bank papers on June 8 by a sizeable amount. Finally, on the currency side, the British pound has more leeway to the downside, while the fallout on the EUR/USD is likely to prove more limited going forward.

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Macroeconomic Outlook

- **The Brexit decision will dampen economic activity in the months to come. This concerns first of all the UK which will suffer from an investment-led recession. Spillovers will also be felt in the euro area and to a lesser degree in the US.**
- **On top of the lower demand from the UK and the depreciation of the British pound, uncertainty about the future relation with the UK and – given Eurosceptic movement also in other countries – concerns about an additional political fallout will weigh on economic confidence. While we deem the recovery strong enough to weather the Brexit shock, we expect the ECB to err on the side of caution and to extend QE beyond March 2017.**
- **In the US, the Fed is likely to maintain its very cautious approach and postpone the second rate hike into the next year.**
- **Regarding China, we expect structural weaknesses to come to the fore again in H2.**

Brexit will likely elicit an investment recession

Last week, British voters decided in a referendum with a majority of 51.9% to leave the European Union. This shocked not only the UK and continental Europe, but markets around the globe. The decision has started a period of high political and economic uncertainty, including a possible break-up with Scotland and Northern Ireland. PM Cameron already announced to step down by September. However, he handed over invoking Article 50 of the Lisbon Treaty – the formal begin of exit negotiations with the EU – to his successor. Under this Article, there will be a negotiation period of up to two years, in which the current legal and institutional arrangements continue to be binding. This is an important macroeconomic backstop as it gives all involved economies time to adjust. However, the high uncertainty will most likely have also a short-term negative impact on the UK economy especially on investment. Business capex has already slowed down over the last quarters for cyclical reasons. In addition, expenditures for dwelling also turned around. Other parts of the economy – most notably retail sales – have been more resilient so far. In addition, the labor market continued to add jobs, albeit on a relatively low level. Looking ahead, we see investment to be hit most and expect the past slowing to turn into an outright in-vestment recession. The depreciation of the pound will also drive up inflation, eliciting a negative effect on private consumption while benefiting exports. In sum, we expect the economy to stagnate in the second half of this year, while growth in 2017 is likely to recede to 1%, instead of about 2% in the non-Brexit case. Substantial risks are to the downside. In a stress scenario, markets and sentiment could enter a negative feedback loop. Moreover, we expect inflation to rise markedly, given the depreciation of the pound. Slowing growth and rising inflation puts the (inflation-targeting) BoE into a stagflation dilemma, thereby limiting its room for maneuver. However, BoE Governor Carney sent a strong message recently that monetary policy would ease in summer. We currently expect a cut by 25 bps combined with some non-standard mesures.

Euro area activity dampened by Brexit fallout

Degree and length of uncertainty key for impact of Brexit on activity

The exit of a country as a member of the EU is unprecedented and has implications beyond economics. The euro area runs a trade surplus with the UK (+ 1.1% of GDP in 2015) and its goods exports to the UK amount to 2.6% of GDP. A marked slowing of the UK and the depreciation of the British pound will drag on exports. Moreover, firms will face a considerable amount of uncertainty about future relations between the UK and the EU, until a new arrangement is found. On the political level, the Brexit has the potential to foster disintegration and separatist forces, raising doubts about the stability of the EU. All these factors will contribute to a significantly higher than unusual degree of uncertainty. The Brexit hits the euro area economy when the recovery is strenghthening with domestic activity the main driver of growth. Indicators suggest that GDP expanded by 0.3% qoq in Q2. There are signs that the labor market continues to improve. Employment kept on rising (+0.3% qoq in Q1) and employment indicators in business surveys suggest that job creation will continue. The unemployment

rate has come down to 10.2% in April (peak: 12.1% in 2013) but is still above the equilibrium level of 9.7%. This implies that there will be hardly any upward pressure on wages for now. Likewise, the fundamentals for investment activity are solid. Production expectations as well as capacity utilization are above average, the financing conditions are favorable, capital goods orders are expanding and also the latest Bank Lending Survey as well as loan growth data suggest that investment keeps expanding.

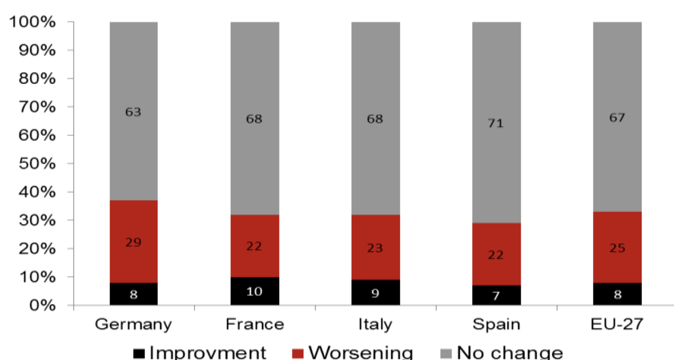
ECB to extent and adjust its QE program

Looking ahead, the recovery will continue to be supported by the highly accommodative monetary policy. However, following an exceptional boost from fiscal policy due to refugee-related expenditures, such a further push to activity will ebb. Likewise, the help to consumption activity from falling oil prices will peter out. With the global environment remaining muted, domestic activity will continue to set the tone. For the growth outlook, it will be decisive how strong the Brexit will weigh on confidence. In a moderate case which we deem slightly more likely than the stress case, we see growth at 1.3% in 2016 (down from 1.4%) and 0.9% in 2017 (down from 1.2%). If the headwinds from the Brexit are stronger and more lasting, we see growth weakening to 1.2% in 2016 and 0.4% in 2017. While headline inflation will inch higher due to fading base effects from energy prices, underlying inflation will hardly trend up. Persistently low inflation expectations will also worry the ECB. Given the Brexit decision, we expect the ECB to extent its QE program beyond March 2017 by at least six months. However, this as well as the latest market development warrants an adjustment in the program as government bonds will increasingly become scarce, especially Bunds. We therefore expect measures like a change in the issuer limit, an extension of maturities, the abandoning of the lower bound or even a further shift of purchases to other asset classes to be increasingly discussed and finally announced in the months to come.

Solid US growth

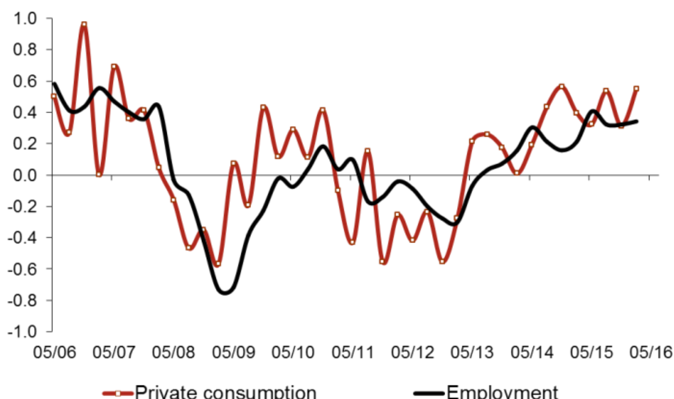
In the US, we expect the fallout from the Brexit to remain limited as trade links to the UK are rather small. More important would be lasting financial market volatility and the appreciation of the US-dollar. US GDP growth had already disappointed in Q1 with a rate of 1.1% qoq annualized. Private consumption proved again to be the main driver of growth, while investment and net exports remained a drag. Against this background, a very weak payroll figure in May of only 38K (compared to a Q1 average of about 195K) unsettled financial markets, raising doubts about the solidity of consumer demand. However, apart from this single payroll figure, the labor market appears to be in a good shape as shown by a record number of hirings, the large availability of jobs and low initial jobless claims. The unemployment rate has fallen to 4.7%. Thus, we

EUROPE: EFFECTS OF A BREXIT ON THE OWN COUNTRY



Graph1; Bertelsmann Foundation, conducted in April 2016

EURO AREA: EMPLOYMENT AND CONSUMPTION



Graph 2; % qoq

consider the latest payroll slump to be a one-off effect and expect job creation to rebound, albeit not any more to the high levels before. The ongoing labor market tightening will likely result in higher wages, providing – together with low interest rates and a sizeable deleveraging of households – the basis for ongoing consumption expansion. However, overall, recent indicators remained mixed, with PMIs increasing slightly, core retail sales up of late but durable goods orders again soft. While the housing market is expected to stay solid, a lasting US upturn will depend on rising investment. The past slowdown in capex was dominated by the energy sector. Nevertheless, given solid domestic demand and favorable financing conditions against the background of a higher oil prices, we may face some temporary but no lasting weakness in investment. GDP is likely to expand by 1.5% this and 1.8% in the next year. Apart from negative spillovers from the Brexit decision, we also consider a possible election of Donald Trump as US President a risk factor to political stability. Regarding consumer prices, rising unit labor costs will increasingly underpin inflation that we expect to average 1.3% this year and 1.9% in the next. Current uncertainties have also resulted in a very reluctant monetary policy stance. We see the FOMC to postpone is next Fed Funds target rate increase into next year. The Brexit fall-out poses downside risks.

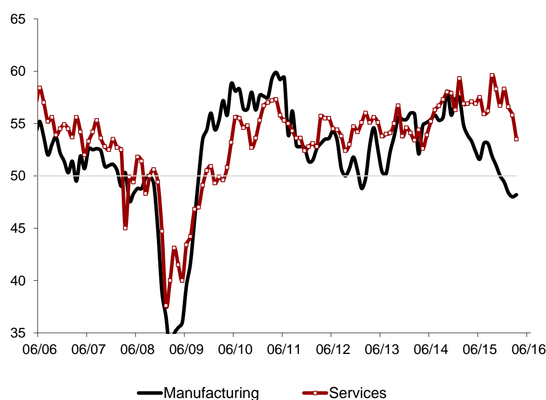
Fed to continue its very cautious monetary stance

China's structural weaknesses to come to the fore again in H2

Growth in China has tended to stabilize in H1 but we do not expect that to last

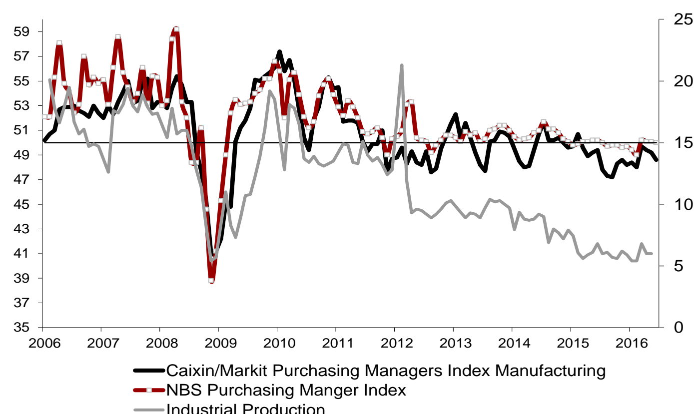
Regarding China, Beijing's economic policy continues to face the ongoing dilemma of working through past excesses (overcapacities in mining, steel, real estate and related sectors, high credit-to-GDP ratio), while not letting growth slip below a certain "comfort" level. Over the last years, China has handled the problem by a stop-and-go policy, most visible in the short-term cyclical development of the Caixin manufacturing PMI. Recently, China has provided increased stabilization measures with an extraordinary strong credit impulse as well as more government investment in infrastructure. Investment growth improved in parts of the economy (SOEs, real estate) while private capex weakened. The real estate sector is likely to contribute positively to growth, going forward. Against this background, an "authorative" press article in June called already for more attention to be paid to credit risks as well as to implement supply-side reforms. Given the recent relative stabilization of macroeconomic data, we se that as a sign that policy will likely turn less accommodative again in H2. Accordingly, this will bring structural weaknesses again to the fore. However, growth is likely to come in at 6.3% in 2016 while monetary policy is likely to help only late 2016.

US: ACTIVITY INDICATORS



Graph 3; index points

CHINA: MANUFACTURING PMI AND INDUSTRIAL PRODUCTION



Graph 4; index points, in %

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Fixed Income

- **Even before the Brexit vote government bond yields trended further down in Q2. While long-dated US yields are still above the historical low, 10-year Bund yields fell to a new trough and are currently even trading in negative territory.**
- **Assuming the fallout after the Brexit vote remains contained, we do not expect US yields to fall further in the weeks to come taking into account the already very cautious stance of financial markets. In contrast, on top of the risk-off mode the scarcity issue due to the ECB'S QE program is expected to trigger a further downtrend in 10-year Bund yields.**
- **Peripheral bond spreads widened in the course of Q2. Despite the relative attractive yield level and the well advanced issuance activity, we sound a note of caution. Looming political risks and the general risk-off mode are forecast to prevent a lasting spread tightening in the months to come.**

New historical yield lows in many countries around the world in Q2 2016

Yields across all maturities trended lower globally in Q2. In many cases new historical lows were marked. This downshift was triggered both by lower real yields and by a decrease in inflation expectations. Meanwhile, in almost all developed countries real long-dated yields are in negative territory. Strikingly, inflation expectations fell as well although commodity prices have rebounded in recent months.

While more dovish central banks, lackluster global growth and the looming risk of a Brexit (and eventually the surprising exit vote) contributed to this development, it is hard to explain it from a fundamental point of view. World growth is meagre, but a worldwide recession is clearly not imminent. Moreover, low inflation expectations are to a certain degree driven by low headline inflation. But, due to the rebound in commodity prices this will peter out in H2 and headline inflation rates are seen to rise considerably in the months to come.

Future yield development path dependent

The future development of core government bond yields on both sides of the Atlantic will substantially be influenced by the further evolvement of the Brexit crisis. In case a moderate scenario prevails and the economic fallout remains contained government yields will be higher than in the stress case. This stress case is characterized by a lasting damage to the global economy and an ongoing risk-off mode on financial markets.

ECB's QE program in combination with the low yield environment to bring scarcity issue of Bunds to the fore again

However, even in the moderate case the leeway for higher Bund yields appears limited. Particularly in the weeks to come, the uncertainty will remain high and risk aversion is expected to last. Hence, some safe haven flows are likely even in this case. Moreover, the ECB's QE program is expected to come in the focus of markets again. At current yield levels more than half of the German Bunds are no longer eligible for the central bank's purchase program. This is due to the restriction that the ECB buys only bonds with a yield to maturity above the deposit rate (currently -0.4%) which effectively excludes bonds up to 7 years from the program. Applying the issuer limit of 33% to the remaining bonds and taking into account that the ECB has bought already part of these issuances, the ECB can continue at most until the end of the year. At latest then, the ECB has no further material to buy. This scarcity issue is an important backstop for long-dated Bund yields and is likely to prevent any meaningful increase in yields. Accordingly, we expect the friendly bond market environment to prevail and the Bund yield curve to flatten a bit more in the months to come.

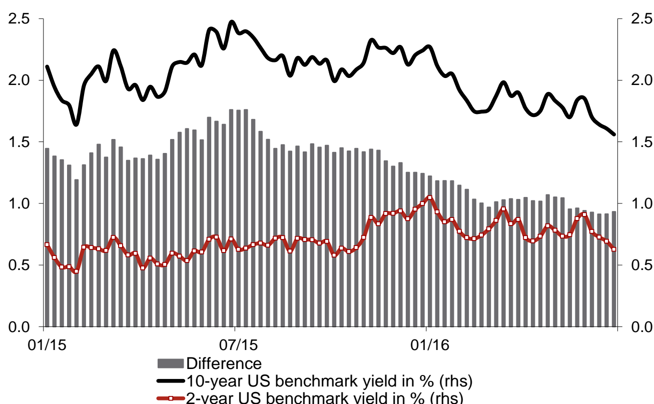
In contrast, US yields are unlikely to fall much further from already low levels. Beside the robust US economy and the limited fallout from the Brexit, we base this mainly on the too cautious assessment of financial markets regarding future Fed key rate hikes. A first hike is only priced for 2018 and for the end of this year even a rate cut is expected with a likelihood of nearly one quarter. While we expect the Fed to postpone a

second hike due to the current turmoil on financial markets, in this moderate scenario we see up to four key rate hikes until the end of 2018. Hence, our forecast is about in the middle of financial market expectations and the so-called Fed dots, which assume key rate increases of accumulated 200 bps until the end of 2018. Accordingly, Treasury yields are forecast to trend sideways in Q3 and to creep upwards afterwards. Consequently, the 10-year transatlantic yield spread is likely to widen moderately.

In a stress scenario even US yields can fall significantly further and mark new historical lows

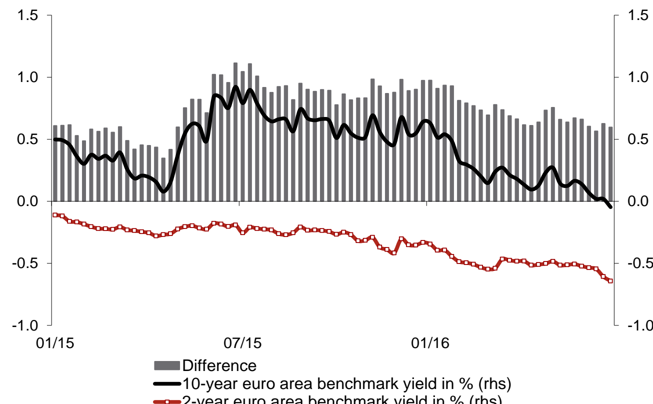
In the somewhat less likely stress scenario the drop in Bund yields is forecast to be even more pronounced and a stabilization even on a 12-month horizon is unlikely. New historical lows will be marked and the ECB is expected to shift to an even more aggressive policy stance. In this environment US Treasuries will not be able to evade the market sentiment and US yields will fall with 10-year Treasury yields marking new historical lows.

US: SHORT- AND LONG-DATED GOVERNMENT BOND YIELDS



Graph1

EURO AREA: SHORT- AND LONG-DATED GOVERNMENT BOND YIELDS



Graph 2

Peripheral bonds to remain under pressure in the short term

The looming Brexit vote had burdened Southern European bonds at latest since the end of May. In a knee-jerk reaction after the surprising "Leave" result spreads jumped to the highest level since summer 2014. However, in recent days peripheral bonds were able to recover some lost ground, but spreads finished the second quarter still well above the level at the end of Q1.

Despite relative attractiveness peripheral bonds are seen to be burdened by the increased risk aversion and looming political events

In this low yield environment, peripheral bonds are generally very attractive as they provide a certain pick-up for investors searching for a higher current income. Currently, the 10-year peripheral yield level is seven times the core yield level. Moreover, in a turbulent market environment any spread widening is at least partly balanced by a drop in the underlying yield. This reduces the volatility significantly. In addition, the issuance activity is already well advanced. Adding the purchases by the ECB all peripheral countries will have a negative net issuance in H2.

However, in light of the expected risk-off mode we do not recommend an investment in peripheral bonds. The forecast bouts of political and economic uncertainty are expected to burden peripheral bonds. In addition, particularly the large issuers (Italy and Spain) have a political agenda filled with potentially adverse news in the months to come. The agreement on the forthcoming constitutional vote in Italy is far from certain and although the likelihood of a successful government formation has increased after the second election in Spain, lengthy and difficult negotiations will have to follow.

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Corporate Bonds

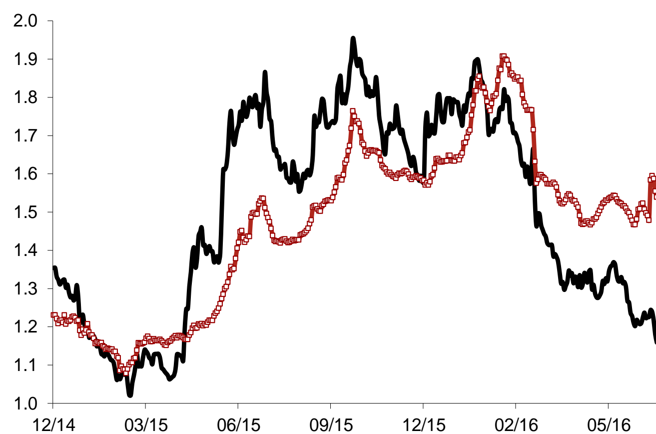
- **Supported by dovish central banks and rising commodity prices, corporate bond spreads tightened in the course of Q2. However, the surprising UK "Leave" vote burdened corporates towards the end of the period under review.**
- **Despite an expected high risk aversion, non-financial bonds are likely to perform well in the months to come. Beside sound fundamentals, particularly the ECB's Corporate Sector Purchase Program (CSPP) will support non-financials.**
- **Financial corporate bonds continued to underperform. The uncertainty linked to the Brexit process and stretched banks' profitability will keep harming Financials, but plentiful liquidity will prevent excessive spread widening.**

Very solid performance of euro area IG corporate bonds in Q2 – Weathering the surprising Brexit vote overall well

Over the course of the second quarter, a positive sentiment regarding corporate bonds prevailed. Both, in the US and in the euro area, Investment Grade (IG) spreads tightened on the back of rising commodity prices and a dovish shift by central banks. Since the start of May the increased uncertainty regarding the forthcoming "Brexit" vote had taken its toll and the surprising "Leave" vote triggered a significant spread widening. However, in recent days markets have taken back a significant part of the initial widening already. On balance, euro area duration adjusted IG corporate spreads have tightened slightly from 168 bps to 165 bps since the end of March. The underperformance of financials continued in Q2. Accordingly, the total return of non-financials year-to-date is already 5.3% compared to 2.5% for financial corporates.

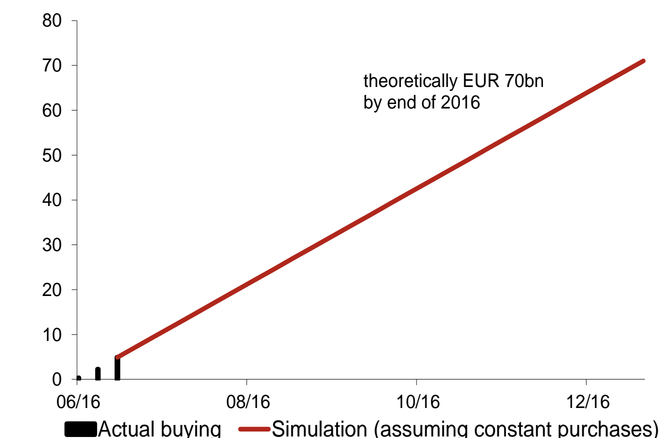
While US and euro area IG corporates marched in step in Q2, we expect euro area IG corporates to outperform US ones going forward. While euro area defaults are on a low level and are forecast to remain below the long-term average in the months to come, defaults of US corporates are on a rather high level and are expected to rise further going forward. This is also reflected in the rating drift which is much more benign in the euro area compared to the US. This mirrors a better fundamental position of euro area corporates which benefit from a very accommodative policy stance of the ECB and a more cautious approach with respect to M&A.

IBOXX EURO AREA CORPORATES



Graph1

ECB: CSPP HOLDINGS



Graph 2; in bn EUR, weekly data

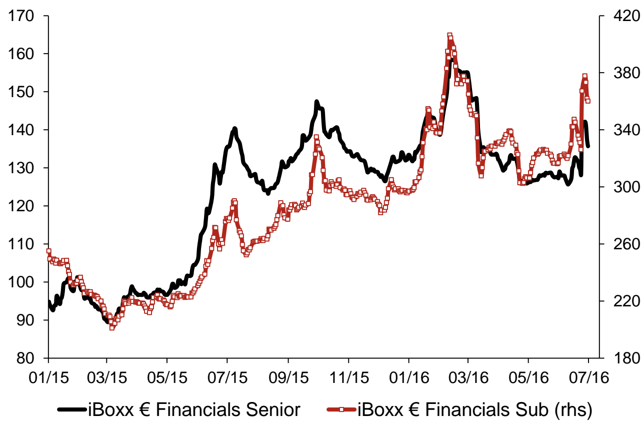
Non-financials to weather turbulent times well thanks to the ECB

Not least due to the announced start of the CSPP, non-financials performed very well in Q2. The duration adjusted spread tightened by 8 bps. Moreover, due to the decrease in underlying yields the non-financial yield level fell 30 bps to 1.02%. This is close to the historical low marked in March 2016.

Inflows and the CSPP to support non-financials in Q3 and to trigger a further spread tightening in the months to come

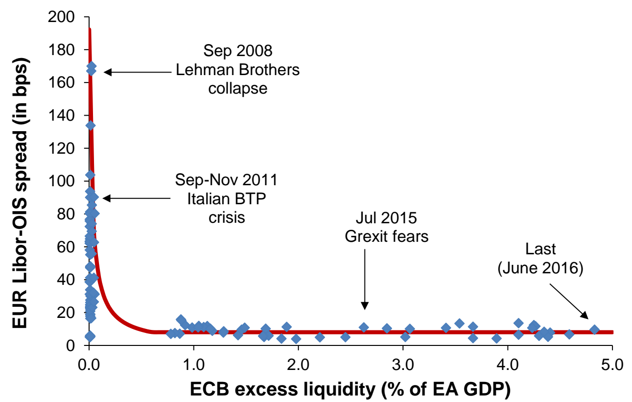
Despite the low yield level and the forecast high volatility, we expect non-financials to perform well going forward. On the one hand, the technical picture is still sound as the high return has triggered inflows into this asset class over the last months. This is expected to continue as investors appreciate the rather stable development of non-financial bonds. On the other hand, the CSPP is an important backstop. In addition to the displacement effect by the government bond purchases, the ECB has started to buy non-bank IG bonds since June. According to first data, monthly purchases can sum up to an amount of up to €10 bn. The emergence of a new buyer with deep pockets constitutes an important backstop for non-financials and should shield non-financials against a lasting spread widening.

IBOXX EURO AREA FINANCIAL CORPORATES



Graph3; Spread vs German Bund (duration adj), in bps

EUR LIBOR-OIS SPREAD AND EXCESS LIQUDITY



Graph 4; Data period: 01/2007 - 06/2016, in bps

Financials to keep underperforming following the Brexit

Financial corporate bonds continued to underperform non-financial peers during the second quarter, although the decline in the underlying Bund yield led to a positive performance with a total return of +1.26%. The spread on the iBoxx IG Senior Financials widened 4 bps to 136 bps, after hitting a 3-month high at 142 bps following the victory of the 'Leave' camp in the Brexit referendum. The widening in Subordinated Financials was more severe (+30 bps to 360 bps in Q2).

Financials are more exposed to the consequences of the Brexit, but plentiful central banks' liquidity will prevent excessive widening in spreads

Financial bonds are the segment of the IG credit market more exposed to the Brexit shock. First, the negotiations between the UK and the EU will keep uncertainty high for a very prolonged period, weighing on risky assets. Second, central banks will adopt a more dovish stance to tame the negative spillovers of the Brexit, leading to even lower yields and harming the already stretched banks' profitability. Third, weaker economic activity could depress lending volumes and impact credit quality, again weighing on banks' profits. Finally, heightened political risks could push sovereign bond spreads higher and this will negatively impact on Financials given their still large exposure in terms of sovereign securities (especially in peripheral countries). That said, we do not anticipate a major widening in financial corporate bond spreads thanks to the abundant liquidity in the system. This contributes to keep the interbank lending risk (Libor-OIS spread) at very low levels, thus preventing any excessive widening in IG Senior Financials' risk premia.

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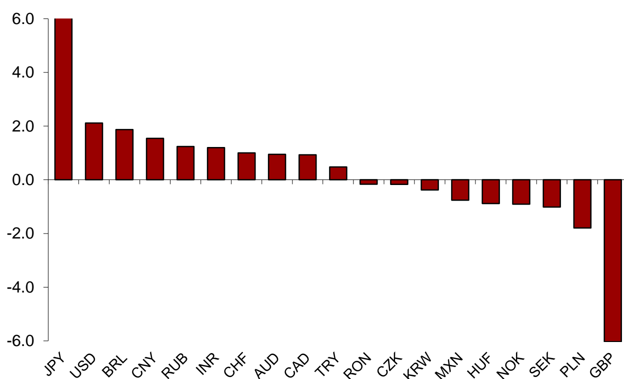
Currencies

- **The 'Leave' vote in the British referendum pushed the British pound to a 30-year low against the US dollar. The impact on the EUR/USD was more muted, while the yen and the Swiss franc surged.**
- **Looking ahead, we anticipate a further fall of sterling, given the UK's large current account deficit and the huge uncertainties about the country's future in Europe.**
- **The EUR/USD is likely to decline further, too, even though the expected rise in the risk premium on the single currency will be partially offset by unwinding US rate expectations and a rise in global risk aversion.**
- **The Brexit fallout on EM currencies is likely to prove limited, owing to small trade linkages to the UK and the supportive effects from a more accommodative stance of central banks in the US, the euro area and Japan.**
- **The Chinese yuan is likely to weaken gradually, but a large devaluation by Chinese authorities remains unlikely.**

Sterling slumped after the British 'Leave' vote while the yen soared

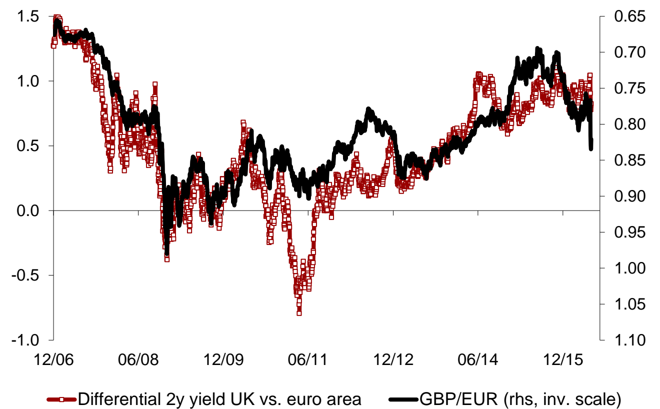
The decision by British voters to leave the EU sent the British pound sliding. Global financial markets were taken wrong-footed by the referendum outcome, after particular bookmakers' odds had clearly seen the 'Remain' camp in the lead shortly before the vote. Against the US dollar, sterling slumped 8% on the day after the vote to 1.36 USD/GBP, the lowest reading in more than 30 years. The Japanese yen soared sharply by 6% against the euro amid the sharp rise in risk aversion, while the reaction by the EUR/USD fell 2%.

FX PERFORMANCE AFTER BREXIT REFERENDUM



Graph 1; vs. euro, in % (June 24 vs 23)

YIELD DIFFERENTIAL AND GBP/EUR



Graph 2

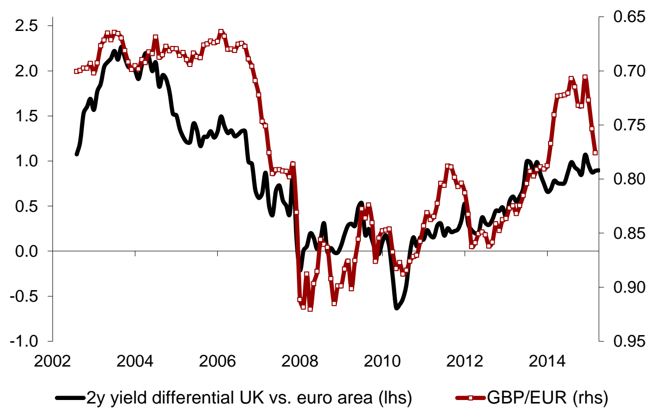
Pressures on sterling to persist

Looking ahead, the fallout of the Leave decision will continue to be a key driver on FX markets. Most importantly, despite the undershooting compared to yield differentials, we see further downside for sterling given the large political and economic uncertainties. The large British current account deficit, which amounted to £ 32.6 bn or 6.9% of GDP in the first quarter of the year, makes the pound particularly vulnerable to a deceleration in capital inflows. This holds in particular if the remaining 27 EU member will stick to the hard stance towards the UK regarding the trade conditions, which has been indicated at the recent EU summit for the negotiations over the time after the Brexit.

With worries about the future of the European Union to rank high over the coming weeks, also the EUR/USD is likely to suffer. However, the degree of euro weakness

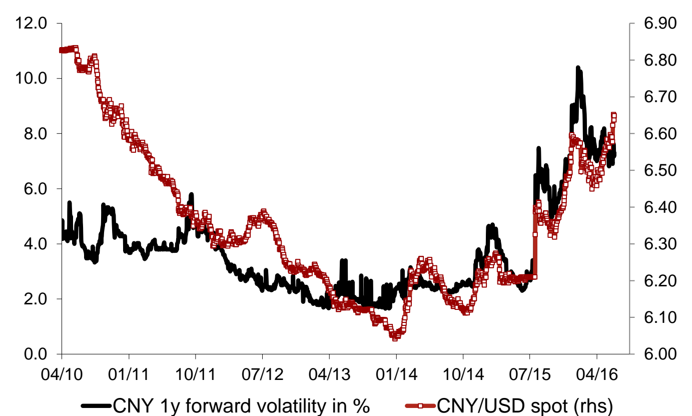
will hinge on the credibility of policy makers' response to the crisis. If the European leaders and the ECB achieve to dismiss fears of an accelerated European disintegration, the fallout on the EUR/USD should prove limited. Moreover, the impact is dampened by the unwinding of US rate expectations in the wake of the Brexit decision. Similarly, the rise in global risk aversion also tends to partially offset the rising risk premium on the euro, which has been serving as a global funding currency since introduction of negative European rates last year. On a three-month view, we thus anticipate the EUR/USD to weaken slightly in the moderate scenario, while in a less benign stress scenario levels below last year's trough of 1.05 USD/EUR seem feasible.

YIELD DIFFERENTIAL AND GBP/EUR



Graph 3

CHINESE YUAN AND DEVALUATION UNCERTAINTIES



Graph 4

EM currencies resilient on Brexit

Low trade exposure to the UK and improved current account balances limit the vulnerability to the Brexit strains

Emerging market (EM) currencies have weakened on the UK's Brexit vote, with CEE currencies most affected. Overall, however, the fallout was moderated, with most currencies paring their initial losses over subsequent days. While currencies in CEE will remain exposed to further weakness on worries about disintegration worries, we expect currencies in Latin America and Asia to prove more resilient. For one, this is because the trade exposure to the UK is generally small. Furthermore, most EMs have achieved to improve their current account balances over the past years, making them less vulnerable to receding capital inflows. Also, most EMs are endowed with sizeable FX reserves to counter temporary pressures on their exchange rates. Finally, pressures on EM currencies are partially offset by an unwinding of US rate expectation after the Brexit referendum, which are keeping a lid on USD strength.

A gradually weaker yuan will also weign on other EM currencies vs. the US dollar

The Chinese yuan (CNY) weakened on the Brexit vote, falling by 1.5% against the US dollar to levels around 6.65 CNY/USD. Importantly, however, this weakness was not associated with market worries about a looming sharper devaluation of the yuan. In contrast to the spells of yuan weakness in August last year and at the start of this year, the implied volatility of 1-year forward options was very resilient (see Graph 4 above). Looking ahead, we anticipate some further, albeit gradual depreciation of the yuan against the US dollar on easing intervention by the Chinese central bank (PBOC). Given the heavy weight of China as a trading partner for EMs more generally, a weaker yuan and a more visible structural deceleration of growth in China will likely weigh moderately on EM currencies over the coming months.

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Equities

- **After Brexit, our view on equities remains cautious for the next 3 months, in particular for the Euro area (EA).**
- **As political uncertainty stays high, the risk premium could overshoot, pushing markets to attractive oversold levels.**
- **We favor US, SMI, FTSE100 and prefer defensive names, dividend strategies and global themes like oils, materials and EM: they could be relatively "insulated" in comparison to the epicenter of this crisis which is Europe.**
- **In the EM space we favor India and Korea.**

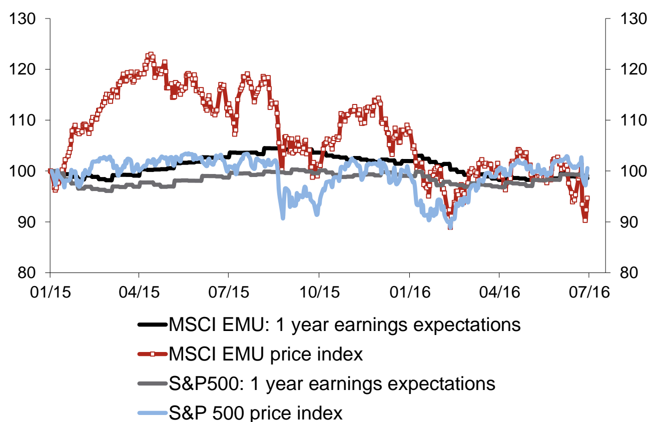
In a moderate scenario after Brexit, we forecast a flat-to-slightly positive total return for equities on a 12-month horizon. But we see the next months to be at risk due to a persistent high risk premium amid poor political confidence and decreasing profits estimates, especially in the EA. Lower yields will sustain valuations through a very low cost of debt which will keep equities attractive again on pronounced set-backs.

Risk of overshooting amid Brexit fallout

EA equities remain vulnerable short term as valuation discount is limted while the politics and earnings estimates would represent a risk. The US is more defensive but remains expensive

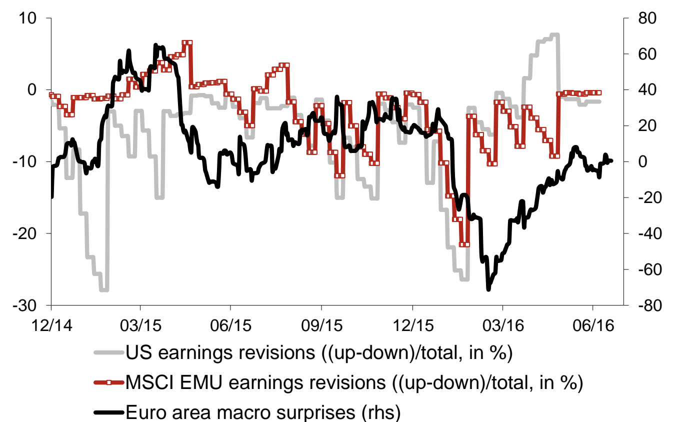
The MSCI EMU lost 6% since March. Defensive markets (US, UK and the SMI) outperformed while EA periphery severely underperformed. Earnings revisions, core inflation trends in the US and the EA, the oil price, the macro news flow, and the price component of global trade gave positive signs of stabilization before the referendum outcome. But in the short term, EA earnings revisions could experience renewed downside pressures. The level of PE in the EA looks slightly low given the current level of the macro surprise index and the EA market multiples are at a limited discount versus their historical average (-4%). In the US, on the contrary, they look expensive (+9.6%) and both higher wages and lower productivity will continue to put pressure on corporate margins. Brexit should maintain the equity risk premia high, possibly overshooting in the short term. At that point, persising low yields should help equity valuations and make EA dividends very attractive to investors. We expect earnings estimates to decrease, following future reductions of real GDP forecasts. The rule of thumb for the EA is 8% earnings decrease for every 1% cut of real GDP. Under a stress scenario we expect earnings downgrades for the EA to reach -8% cumulated in 2016-2017, excluding recession. UK apart, Spain and Italy add to the political risk in the next months. Monetary response should be aggressive, but it is too early to assess its effectiveness and the EU political response is lagging.

PRICE AND EARNINGS PERFORMANCE



Graph 1; (01/01/2015 = 100)

MSCI EMU: EARNINGS REVISIONS



Graph 2

For both US and EA markets, 2017 earnings estimates are at risk. A higher risk premium could bring about a drop of 20% for the EA from May-highs

We see the MSCI EMU to decline by 12% (moderate scenario) to 20% (stress scenario) from the recent May highs. The US, the UK and the SMI indices should suffer less. We analyzed the risk premium behavior around periods of spiking risk aversion. In order to be prudent, we increased the risk premium's delta to be applied to the current environment (Brexit) compared to what we observed, for example, last year (Greece and China-induced fears). We thus get the following results: For the moderate scenario, we consider a risk premium's delta of 1.5X standard deviations (SD) and 2.5X SD for the stress one. We take the end of May as a starting point. Since then the market started appreciating a possible negative event from the referendum. The implicit possible fall for the MSCI EMU is -12.5% since end-May (-6% from current levels). In the stress scenario we forecast -20% (-14% from current levels), from 13.9X forward PE at the end of May to 11X. In the stress scenario we exclude recession. The latter would cause a bigger earnings fall (15-20%) and a lower targeted PE (10X).

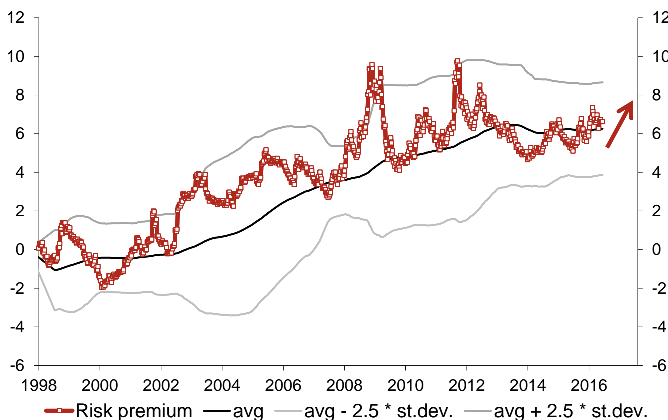
Regional markets: overweight defensive and global themes

The relative performance of markets should be driven first by the relative risk profile: A lower beta factor will represent a premium as risk aversion stays high. The US has a defensive sector structure and lower earnings sensitivity to GDP versus the EA. We stay underweight the EA, for the time being. The Japanese profits are even more vulnerable as indicated by our regression models. For all markets, the 2017 and 2018 earnings growth estimates are higher than 10%, which is too high according to our models (not including the Brexit effect). Among European sectors we underweight financials, “value” names (vs. growth and global ones), peripheral countries, the Topix in local currency and Europe vs. US. We overweight the US, SMI and FTSE 100 in local currency and Nordics.

Among sectors in the short-term, we favor IT, the relatively expensive food, households and pharma and stay neutral on TLC. We hold a "global/commodity-link" exposure through the energy and material sectors, and our favorite names in the EM space: India and Korea. All should be relatively insulated from the current European-centric crisis of confidence. Oils could enjoy the improved commodity momentum so far. Assuming stable commodity prices (a moderate “leave” scenario), the oils and materials could offer some shield which is worth a neutral stance (not overexposed as they are volatile).

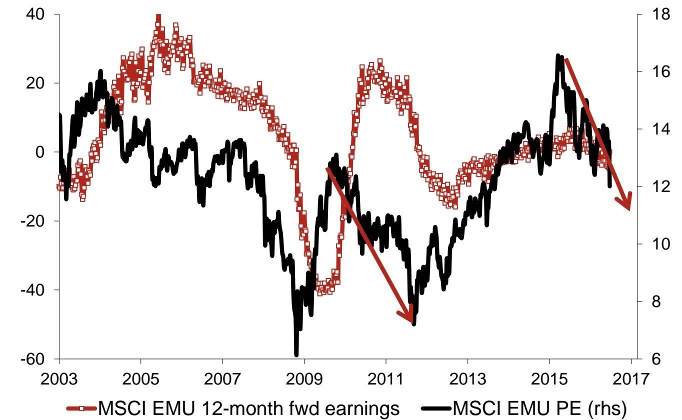
Banks, on the contrary, have a high (1.4) and statistically significant beta and represent a "value" theme, and thus are at risk in the short term after the UK referendum, notwithstanding depressed relative valuations. As GDP decelerates and yields stay

EA RISK PREMIUM: MSCI EMU INDEX



Graph 3

MSCI EMU: PROFITS AND PRICE EARNINGS RATIO



Graph 4

low, the pressure on their earnings can accelerate. The same seems true for insurances. Real estate is more defensive. In the environment of low yields and declining growth estimates, the extreme undervaluation of "value" names can linger for some time: we postpone our bet on the "value" theme short term. We prefer defensive sectors with decent earnings revisions, which could outperform in a weak macro context: Food, household, pharma and IT. We are overweight transportation and professional services and neutral on capital goods (global themes). The TLC sector (neutral) deserves an interesting upbeat price component.

We overweight US, SMI, UK in local currency, defensive sectors and the names with a higher global exposure: oils, materials and EA stocks with a higher sales weight to EMs

EM: stabilizing macro conditions support EM earnings

Over the last three months Emerging markets (EM) stock markets have slightly increased, outperforming the MSCI World by 1 pp. In our view the EMs are to benefit further from increased oil (WTI is +85% from mid-February) and commodity prices, a range-bounded US dollar, and stabilizing world trade pricing. The Brexit should have more limited effect on these factors (compared to the effects on Europe per se), which would contribute to higher EM resiliency (exports to EU are around 4% of EM GDP). CEE countries could be more at risk in relative terms due to a weaker Euro and EU economy. A more accommodative policy from ECB / BoE and a delayed Fed move - off the table till the rest of the year - provide EM central banks with a leeway to cut rates or to be less hawkish than before.

EM can come out relatively resilient in comparison to the EA. We favor India and Korea

From a valuation point of view, the Chinese market seems to be relatively cheap according to a number of measures (price/earnings, price/book, price/cash flows, dividend yield, cyclically adjusted PEs), with an average discount of around 11% versus its own history, which is not much lower than discounts for other Emerging Markets. But China's industrial profit growth continues to slow, with other sectors' earnings potentially following. It remains to be seen if the yuan can be kept stable. Our short-term models also indicate a negative possible return over three months and only a limited earnings growth of 5% in 2017, while analysts' consensus is higher at 14.3%. On the other hand, India and Korea are characterized by a positive earnings revisions and a good momentum. Yen appreciation vs KRW would additionally help Korea's competitiveness. Within the EM space, we favor India and Korea, while for the time being suspending our call on smaller CEE countries.

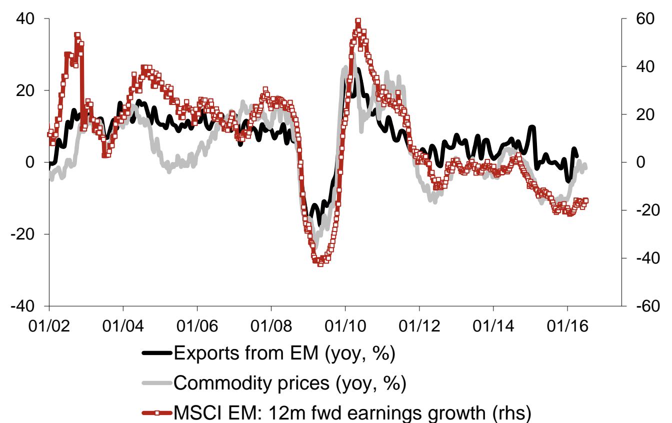
EQUITY MARKETS VALUATION DASHBOARD

Markets / Indices	Market multiples avg. discount	PEG adj. by ROE and cost of equity	PE (12-month forward)	DY - 10Y	M1 trend (yoy)	Price Gap vs. M1 trend
USA	9.6	1.8	16.7	0.7%	↓	→
JAPAN	-30.4	2.0	12.4	2.7%	→	↑
UK	9.5	2.2	16.4	3.3%	↗	↑
SWITZERLAND	1.5	2.4	16.3	4.1%	→	→
EMU	-3.9	2.3	12.9	3.3%	↘	↑
EM ($)	-6.4	1.9	11.9	-1.9%	→	↑
BRAZIL	-11.1	3.1	11.3	-8.2%	→	↓
CHINA	-10.8	1.7	10.8	-0.2%	↑	↑
SHANGHAI	-12.5	2.5	12.4	-0.3%	↑	↑
INDIA	6.5	2.0	17.6	-5.8%	↗	↑
KOREA	-14.6	1.7	10.2	0.5%	↘	↑
MEXICO	13.1	2.2	18.2	-3.8%	↓	↑
RUSSIA	-29.4	3.2	6.0	-3.7%	↗	↘
Global Average	**-2.6**	**-0.5**	**13.5**	**-0.9%**		

Note: the first four markets are represented by major local indices, the rest is from MSCI.
PEG is PE divided by long-term growth. COE = risk-free + 6% x Beta. (Beta: vs. MSCI World)
Monetary gap is relative to price changes.
Discount in % to long-run norm; Multiples used: PE, PB, PCF, and DY.
Blue and negative numbers = undervaluation. Red and pos. numbers = overvaluation

Table 1

EM: EXPORTS VS. FORWARD EARNINGS



Graph 5

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Asset Allocation

- **By its Brexit vote the UK did not at all relieve markets of the uncertainties prevailing over the past weeks in the run-up to the referendum.**
- **Against this backdrop, we deem markets likely to remain in the current risk-off mode.**
- **High quality non-financial corporate bonds will be promoted by still decent fundamentals and the strong technical support from ECB bond purchases.**
- **For the time being, this argues for a defensive allocation stance, characterized by a moderate underweight in equities mostly in favor of non-financial corporate bonds.**

Unclear consequences of Brexit to burden financial markets

Over the next months to come, we consider financial markets to be primarily burdened by the uncertainties resulting from the UK's Brexit vote. They are expected to continue particularly weighing on risky assets and yields of core government bonds.

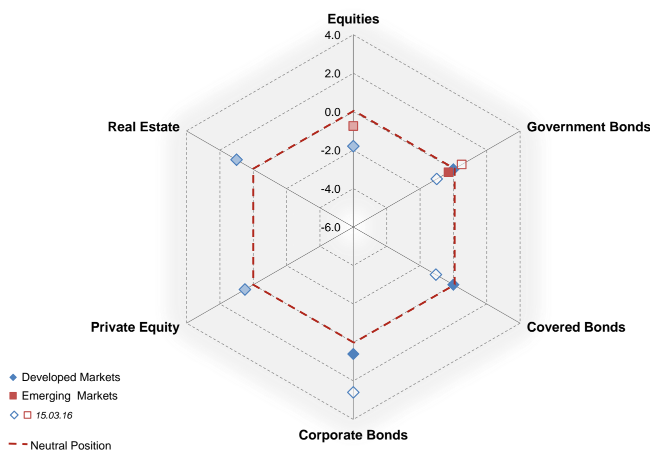
Financial markets to stay in risk-off mode

The picture drawn by the recent macroeconomic data flow has been heterogeneous. Solid data and indicators for you euro area are contrasted with weaker/mixed figures from the US and China raising concerns about the resilience of these economies. Against this backdrop, we deem markets likely to remain in the current risk-off mode. A flight to quality should, flanked by the ECB's purchasing program should in particular favor euro area core government bonds and non-financial corporate bonds.

Defensive allocation stance for the time being

Compared to last quarter, this argues for a slightly less aggressive tactical alignment of the model portfolio in a sense that exposure is essentially shifted from peripheral government bonds to core government bonds and from reducing exposure to senior financial corporates.

MODELPORTFOLIO: TAA – RADAR SCREEN



Graph1; active positions in percentage points

Non-financial corporate bonds likely to become most attractive

With the ECB enhancing its purchasing program to non-financial corporate bonds, we expect this asset class to be the most attractive one in our investment universe for the time being. In that sense they represent the only "risky asset class" to be overweighted in the coming months.

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Forecasts

GROWTH

	2014	2015	2016f	2017f
US	2.4	2.3	1.5	1.8
Euro Area	0.9	1.6	1.3	0.9
- Germany	1.6	1.4	1.4	1.2
- France	0.7	1.2	1.3	1.1
- Italy	- 0.3	0.6	0.8	0.4
Non-EMU	2.6	2.3	1.6	1.3
- UK	2.8	2.2	1.3	1.0
- Switzerland	1.9	0.9	0.9	1.4
Japan	- 0.1	0.5	0.3	0.5
Asia ex Japan	6.2	5.8	5.5	5.6
- China	7.4	6.9	6.3	5.9
Central/Eastern Europe	1.9	0.3	1.5	2.4
Latin America	1.0	- 0.6	- 0.9	1.5
World	**2.8**	**2.6**	**2.3**	**2.6**

INFLATION

	2014	2015	2016f	2017f
US	1.6	0.1	1.3	1.8
Euro Area	0.4	0.0	0.3	1.3
- Germany	0.8	0.1	0.4	1.3
- France	0.6	0.1	0.3	1.2
- Italy	0.2	0.1	0.0	0.9
Non-EMU	1.0	0.1	2.1	2.4
- UK	1.5	0.0	2.7	3.1
- Switzerland	0.0	- 1.1	- 0.8	0.2
Japan	2.7	0.8	0.1	0.4
Asia ex Japan	3.3	2.2	2.5	2.6
- China	2.0	1.4	1.9	2.0
Central/Eastern Europe	5.6	8.9	5.0	4.7
Latin America	10.4	13.6	23.5	16.6
World	**2.3**	**1.6**	**2.5**	**2.6**

FINANCIAL MARKETS

3-month Money Market	**Current**	**3M**	**6M**	**12M**
US	0.63	0.65	0.70	0.70
Euro-Area	-0.29	-0.30	-0.40	-0.40
Japan	-0.03	-0.05	-0.10	-0.15
UK	0.55	0.35	0.30	0.40
Switzerland	-0.79	-0.75	-0.80	-0.80
10Y Government Bonds	**Current**	**3M**	**6M**	**12M**
US	1.48	1.45	1.50	1.60
Euro-Area	-0.12	-0.20	-0.10	0.00
France	0.22	0.15	0.20	0.30
Italy	1.32	1.35	1.30	1.25
Japan	-0.23	-0.30	-0.20	-0.10
UK	0.93	0.75	0.80	0.80
Switzerland	-0.51	-0.60	-0.50	-0.35
10Y Spreads	**Current**	**3M**	**6M**	**12M**
Covered Bonds	73	75	70	65
GIIPS	150	160	155	145
EM Gvt. Bonds Spreads	**Current**	**3M**	**6M**	**12M**
Latin America	530	545	560	570
Asia ex Japan	234	248	260	250
CEE	189	195	188	174
Corporate Bond Spreads	**Current**	**3M**	**6M**	**12M**
IBOXX Non-Financial	150	145	135	125
IBOXX Sen-Financial	138	145	140	135
Forex	**Current**	**3M**	**6M**	**12M**
USD/EUR	1.11	1.07	1.08	1.10
JPY/USD	103	100	102	104
JPY/EUR	114	107	110	114
USD/GBP	1.34	1.22	1.26	1.29
GBP/EUR	0.83	0.88	0.86	0.85
CHF/EUR	1.08	1.05	1.07	1.08
Equities	**Current**	**3M**	**6M**	**12M**
S&P500	2069	2005	2040	2040
MSCI EMU	98.5	95.0	97.0	99.0
TOPIX	1239	1200	1220	1240
FTSE	6335	6175	6260	6300
SMI	7924	7740	7845	7900

As of 30.06.16 (3-Day-Average)

FORECAST-INTERVAL* – 3-MONTHS HORIZON

Group	Asset	Low	Mid	High
Government Bonds (10Y)	US	1.26	1.45	1.64
	Germany	-0.21	-0.20	-0.19
	UK	0.63	0.75	0.87
	Switzerland	-0.67	-0.60	-0.53
Spreads	10Y-GIIPS Spread	134	160	186
	EUR Covered Bond Spread	65	75	85
	EM Latin America Spread	468	545	622
	EM Asia Spread	209	248	287
	EM Europe Spread	163	195	227
	Euro Corporate Spread (Non-Fin)	127	145	163
	Euro Corporate Spread (Sen-Fin)	128	145	162
Forex	USD/EUR	1.03	1.07	1.11
	JPY/USD	96	100	104
	GBP/EUR	0.85	0.88	0.91
	CHF/EUR	1.02	1.05	1.08
Equities	S&P500	1,901	2,005	2,109
	MSCI EMU	88	95	102
	TOPIX	1,096	1,200	1,304
	FTSE 100	5,867	6,175	6,483
	SMI	7,322	7,740	8,158

FORECAST-INTERVAL* – 12-MONTHS HORIZON

Group	Asset	Low	Mid	High
Government Bonds (10Y)	US	1.19	1.60	2.01
	Germany	-0.03	0.00	0.03
	UK	0.55	0.80	1.05
	Switzerland	-0.50	-0.35	-0.20
Spreads	10Y-GIIPS Spread	92	145	198
	EUR Covered Bond Spread	45	65	85
	EM Latin America Spread	401	570	739
	EM Asia Spread	153	250	347
	EM Europe Spread	99	174	249
	Euro Corporate Spread (Non-Fin)	87	125	163
	Euro Corporate Spread (Sen-Fin)	96	135	174
Forex	USD/EUR	1.03	1.10	1.17
	JPY/USD	96	104	112
	GBP/EUR	0.81	0.85	0.89
	CHF/EUR	1.01	1.08	1.15
Equities	S&P500	1,831	2,040	2,249
	MSCI EMU	84	99	114
	TOPIX	1,028	1,240	1,452
	FTSE 100	5,664	6,300	6,936
	SMI	6,976	7,900	8,824

* The forecast range for the assets is predetermined by their historical volatility. The volatility calculation is based on a 5 year history of percentage changes, equally weighted in the case of the 12-month forecast and exponentially weighted in the case of the 1 month forecast. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

Imprint

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