Tending to Brexit wounds. **Keeping a stiff upper lip while the Brits bid "Cheerio!"**

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Barely a week after the **U.K. referendum on leaving the European Union**, most markets settled into somewhat predictable patterns. The **British pound was the biggest casualty of the initial turmoil**, down roughly 11% from pre-vote levels. Sovereign bond yields pushed to record lows, and gold and the US dollar rose. Other than European banks and various U.K.-centric names, **equities for the most part recouped their knee jerk losses**. Both the **S&P/TSX and the S&P 500 dipped less than 1% net in the five days** following the vote, while the UK's FTSE 100, which comprises mostly global companies, **actually rose +2.6% for the week**.

The political earthquake that has rocked Britain has been felt in markets around the world, but little is certain other than we have entered a period of heightened uncertainty. Global markets were whipsawed in the days immediately after the vote as investors looked uneasily for an appropriate analogy to provide some guidance as to the severity of the potential economic impact of the U.K. (presumably) leaving the E.U., and its ripple effects on markets. But no obvious comparison presented itself and the questions seemed to mount rather than dissipate.

It is clear that some of the key questions will not be resolved for several years. The corollary of uncertainty is volatility, so expect capital markets to remain unsettled. The Brexit vote has opened a Pandora's Box of issues to broader and more intense public debate, and in some

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respects all issues are at the end of the day, to some degree, capital markets issues. What follows is an attempt to capture and summarize the aspects of Brexit most relevant to Canadian investors.

Why Leave the E.U.? The Pros and Cons of Brexit.

What does Britain stand to gain from exiting the European Union? Although the vote may have been determined in the final weeks by anti-immigrant xenophobia or frustration at perceived bureaucratic over-reach by Brussels, the E.U. is at heart an economic union and most of the benefits and the costs of leaving it have been framed in economic terms. Here are some highlights.

Budget

+ After Leaving the E.U. Britain will no longer contribute to the E.U. budget. In 2015, this was a net contribution of £8.5 billion (about 0.5% of British GDP or about 1.1% of government spending). This represents a notional contribution of £18bn, less an instant discount or rebate of £5bn, and roughly £4.5bn coming back as E.U. spending on the U.K. (mostly payments to farmers and poorer regions).

+ Brexit campaigners argue Britain could devise its own farm subsidies more efficiently rather than participating in the E.U.'s Common Agricultural Policy which accounts for 38% of the E.U. budget. Pro-Brexiters have also suggested the money could be redirected to health care or schools.

- Remain campaigners claim benefits of E.U. membership are worth approximately £3000 per year per household, compared to a net payment of only £340 annually per household.

- E.U. migrants are net contributors to U.K. public finances. Fewer immigrants means lower tax revenues and lower economic growth.

Goods Trade

+ Leave campaigners argued the U.K. will gain the freedom to negotiate its own bilateral trade agreements with other countries, and that being a member of a block like the E.U. is less important today than in decades past due to 40 years of global trade liberalization.

- On its own, the U.K. will be in a much weaker negotiating position. Furthermore, negotiating countless new agreements will take a long time. The recently completed (but not yet fully ratified) Canada-E.U. Comprehensive Economic & Trade Agreement (CETA) took ten years to negotiate.

- If Britain wants full access to the E.U.'s single market, it will still have to conform to E.U. product rules but have no influence in setting them.

- Currently 45% of British exports go to the E.U. Manufacturers wanting to retain access to the E.U. market, not to mention avoiding the potential proliferation of export tariffs and red tape, may shift operations out of the U.K.

Services Trade

+ As the E.U. has moved toward tighter financial and fiscal integration, Britain has had to fight constantly against regulation that could disadvantage London's financial services sector.

+ Leave supporters argued that London's attraction as a financial center was not harmed by staying out of the Euro currency block, and that outside the E.U. it may even thrive as an offshore center similar to Singapore or Switzerland.

- As with goods trade, Britain will still have to conform to E.U. regulations, without influence, to retain E.U. access.

- U.K.-based financial services will lose their "passport" to operate in E.U. markets. International firms such as J.P. Morgan and MSCI have already talked of relocating some operations to other centers as a response.

Regulation

+ More control over employment law, health and safety, etc.

- For businesses still operating in Europe, additional red tape may hamper business.

Labour Mobility

+ More control. Brexiters argue the U.K. can cherry pick the best global talent rather than accommodate unrestricted E.U. immigration. Less strain on public services, infrastructure. Less downward pressure on wages.

- If the U.K. pursues a deal for access to E.U. markets, it will have to accept free movement of labour and no change to immigration.

- If immigration is restricted, skill shortages are likely as domestic workforce is shrinking.

Capital Mobility

- The E.U. is moving toward a Capital Markets Union. Outside the union the U.K. risks losing foreign investment if it is no longer an access platform to the single market.

- U.K. companies will have to deal with multiple frameworks for raising capital and investing across jurisdictions.

How long until this is settled? Will Brexit even happen?

Uncertainty is the root of volatility, and uncertainty is going to be with us for a while, as the details of the exit process are worked out, and the terms of a new relationship between Britain and the E.U. are established. But before even those questions are addressed, there is first the question of whether the U.K. acts on the directive of the referendum at all. 'Bregret' and 'Bremorse' at the outcome of the vote is being widely expressed and leading many to ask if there is a way out of following through. Former Prime Minister Cameron has already nixed the idea of a "re-do", a second referendum, after millions of signatures were collected immediately after the vote. Such a move would have had the potential to dangerously exacerbate tensions and would be of dubious legality.

There are however other routes by which Brexit may be blocked. All are highly improbable, but the odds are not zero. (*Our thanks to Roberto Perli of Cornerstone Macro for the following list.*)

Blocking Brexit?

- **The U.K. Parliament votes against Brexit.** The referendum was only advisory in nature and Parliament is not legally bound to follow through. The current makeup of Members is dominated by "Remain" supporters who could choose to ignore the referendum directive. But the referendum results have rendered the current Parliament somewhat illegitimate and it is unlikely to disregard the public will.

- **The E.U. makes concessions to a new prime minister.** In this scenario the E.U. offers concessions to avoid political, economic, and social risk. Even minor concessions could provide cover for Parliament to accept. But the E.U. has a strong desire to nip in the bud similar populist sentiment nascent in other member countries. Not wanting to encourage others to follow Britain's lead, E.U. leaders have already taken a firm stand against concessions.

- **A new prime minister calls for a new general election.** If two-thirds of parliament supports holding a snap election (or the government loses a confidence vote) a campaign could be run clearly along Exit/Remain lines, effectively serving as a referendum do-over. Of the 'Brexit-blocking" options this is perhaps the most palatable and most likely. However all the major political parties were split on the issue during the Brexit campaign, so this scenario would require significant coalescing of party positions.

- **Scotland and Northern Ireland block it.** Some legal scholars are suggesting that with the dissolution of powers, the Parliaments of Scotland, Northern Ireland and Wales would need to approve an E.U. exit. Scotland and Northern Ireland would almost certainly not do so. A heated constitutional debate may be in the making.

Assuming Brexit proceeds, what is the time line? Two years? Ten years?

Everyone who never heard of "Article 50" before surely has now. The section of the E.U. treaty that provides for the departure of a member state sets a two year timetable for negotiation of terms once formal notice is given. But the timing of that notice itself is up in the air. European politicians are calling for the divorce to be made effective as quickly as possible, so as to allow the E.U. to get on with life without Britain (and also to send as quickly as possible a harsh warning to other members thinking of exit.) But the treaty allows the U.K. to set the pace and the British government is unlikely to want to start the clock until they have settled the question of who will do the negotiating.

Furthermore, a new prime minister may call for a new general election, as outlined above. An election campaign will add at least a couple of months to the process, followed by further time for Parliament to debate and authorize the invoking of Article 50.

No one expects a break from the E.U. to be cleanly negotiated in the two years provided for in the treaty. There are just too many details over trade, immigration, financial transfers and subsidies, and other laws to work out. In the absence of a negotiated agreement after two years, the default position is the nullification of the treaty terms with respect to Britain and the U.K. will immediately be treated by the same terms as other non-members until it can re-establish specific agreements and relationships. This process will take many more years. As well, Britain's terms of international relations and trade with other non-E.U. nations such as Canada and the United States, formerly governed by the E.U. relationship, will have to be renegotiated. Some have suggested this process may take as long as a decade.

> Year-end seems a likely target for taking action, **leading to an exit by 2019**, but even Brexit campaign leaders such as **Boris Johnson** (perhaps ironically) are already **suggesting there is no rush**.

Political Implications

The not-so-United Kingdom

The British government is in turmoil for the immediate future. Prime Minister Cameron's announced intention to step down had put the leadership of the Conservative Party into play, an issue recently resolved with the confirmation of Theresa May as Conservative Party leader and prime minister. Discontent within the Labour Party over Jeremy Corbyn's stewardship has led to mass resignations from the shadow cabinet. Labour has a planned convention in late September, where it too may emerge with a new leader. UKIP leader Nigel Farage has also stepped down. Considering how viciously the split over Brexit carved through the major parties, it is not inconceivable that a major shakeup of political alliances, positioning and platforms emerges.

The vote result revealed significant philosophical differences along demographic, social, and geographic lines as well. Most worrying is the potential for trouble for England's relationship with Scotland and Northern Ireland. Scottish First Minister Nicola Sturgeon wasted no time following the Brexit vote to declare a second independence referendum for Scotland was "on the table." In Northern Ireland, which also voted heavily in favour of "Remain", the prospect of its southern border with the Republic of Ireland becoming a proper frontier between a non-E.U. United Kingdom and an E.U. Irish Republic, conjures images of families once again torn apart and a possible resumption of the infamous "troubles". Republican group Sinn Féin has called for a vote on Irish reunification if the U.K. goes through with Brexit.

The European Union

If the grand experiment of the European Union is to proceed, the E.U. needs not only to take a firm stand in its dealings with Britain to discourage others from leaving, it needs to quickly come up with a credible plan for deepening commitment to the remaining union. Far right leaders in other member states such as France's Marine Le Pen and the Netherlands' Geert Wilders, emboldened by the U.K. result, were quick to call for their own referendums.

As things stand, referenda in other countries are highly unlikely. No sitting government wants one and the E.U. is putting on enormous pressure for it not to happen. So the danger lies in the possibility of extremist or populist victories upsetting existing governments. In this regard it was somewhat reassuring to see a relatively stable result in the Spanish national elections the weekend following the Brexit vote. Perhaps disenchanted voters thought twice about casting protest votes when they saw the chaos emerging in Britain.

Dates to watch include

- **October 2016** – Italian constitutional referendum by this date. Populist victories in municipal votes, including in Rome, are raising concern.
- **February 2017** – German Presidential election
- **March 2017** – Dutch general election
- **April – June 2017** – French elections (Note the E.U. is less popular in France than it was in the U.K. leading into the Brexit vote.)
- **September 2017** – German general election

> At first glance the Brexit result is a **warning that Trump's chances of victory are higher than widely believed**. Many of the issues driving the Brexit result are the same issues that have been the foundation of Trump's success so far: **voters upset about immigration** and **rapid cultural change**, **economic dislocation**, and the **dysfunction of the political system**.

Donald Trump

Beyond serving as a warning not to underestimate Trump, the Brexit vote will actually help Trump if it leads to a noticeable economic slowdown in the United States. The Democrats own the state of the economy as an issue, and a renewed slowdown under Obama's watch will taint the Clinton campaign. Furthermore, the economy is one issue in polls where voters say they trust Trump more than Clinton. Brexit is not a game-changer in the U.S., but it does have the potential to change the dynamics of the contest.

The global populist backlash

As many pundits have said in recent days, the Brexit vote is a warning shot heard round the world. Populist backlash against political and business elites is a global phenomenon. To the extent that risk of regime change is elevated in any jurisdiction, policy uncertainty will discourage investment and lead to prolonged weakness in growth.

Economic Implications

Britain to quickly enter recession

The markets rendered a verdict on the implications for Britain before the counting of ballots had even finished. The pound plunged on currency markets, crumbling to 30-year lows in short order *(See Figure 1)*. When equity and fixed income markets opened, banks got clobbered as investors forecast their U.K. and European business shrinking badly, losses on real estate portfolios and business loans, increased costs associated with restructuring for a Britain/E.U. split, and even their U.K. operations moving elsewhere. U.K. Real Estate Investment Trusts (REITs) plunged 26% the day after the vote.

Within days, credit agencies were downgrading Britain's AAA rating as they predicted policy paralysis until a new government was in place in the fall. Economists predicting lower business investment due to elevated uncertainty, tighter financial conditions, and lower permanent income issued forecasts of a quick descent into recession.

The global economy

The key issue is the degree to which Brexit undermines confidence. Will uncertainty increase enough that business investment elsewhere retrenches and takes another turn for the worse? Most economists and strategists are anticipating a hit to global Gross Domestic Product (GDP) of perhaps -0.5%, since the U.K. represents only 2-3% of global GDP. Furthermore, the European big five (U.K., Germany, France, Italy, Spain) accounted for only 6% of global net growth 2013-2015.

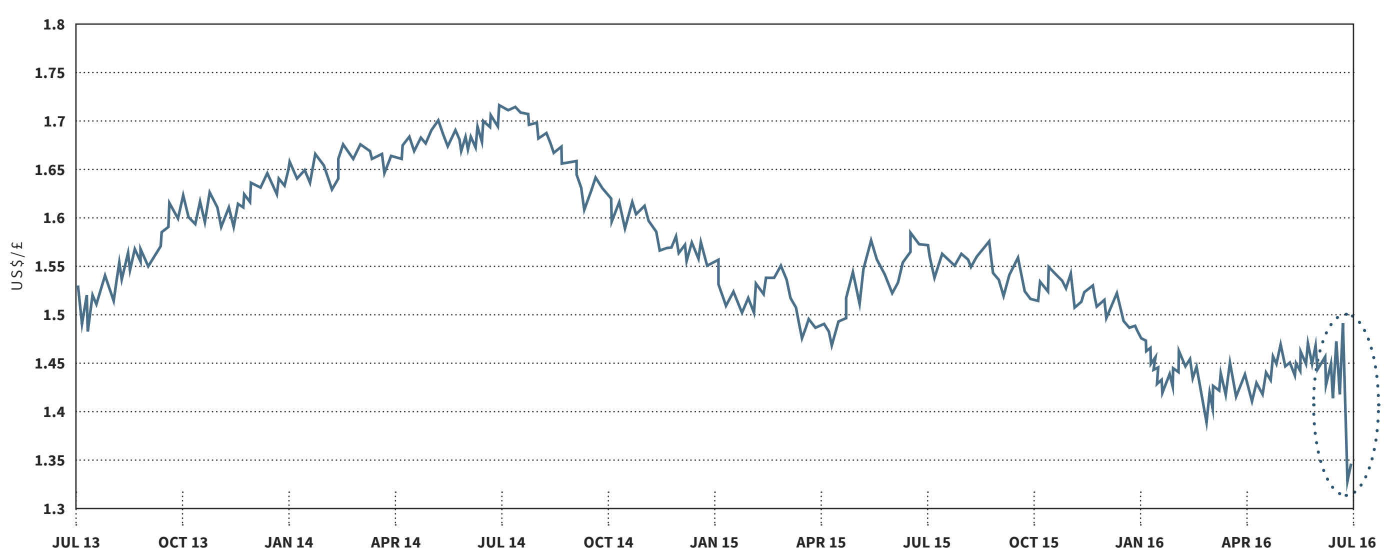
Canada and the U.S.

If the U.K. is less than 3% of global GDP, the impact in both Canada and the United States of a slowdown is probably quite limited. Even a severe contraction in the U.K. will likely have a negligible impact on North America as only 4% of U.S. exports go to the U.K., and only 15% to the E.U. It is even possible that the negative effects in North America will be more than offset by boosts to the consumer and housing sectors brought on by lower mortgage rates as monetary policy and bond market action take rates even lower.

FIGURE 1

British Pound Spot Price

SOURCE: IGIM., BLOOMBERG



The most immediate threat to Canadian growth is likely to be the impact of renewed US dollar strength driving back down the price of oil. Similar to the situation earlier in 2016 when oil dipped below $30 a barrel, Canada's energy sector would be hurt by renewed weakness. The lower loonie that will assuredly accompany this scenario may help offset the pain by making Canadian manufacturing exports more attractive to the U.S. market. But in a similar vein, Canadian exports will become more challenged in regions sporting even weaker currencies, namely Britain and Europe. The U.K. is the third largest buyer of our manufactured goods after the U.S. and China.

In the event of a British exit from the E.U., many Canadian businesses will face difficult times as they adjust to new regulations and terms of trade. Many have complicated supply chains that straddle the E.U. and U.K. Questions will arise about the future of facilities in Britain potentially disadvantaged versus the E.U. going forward. Magna has nine manufacturing facilities in England. Bombardier makes many aerospace components in Northern Ireland.

In the long run, the bigger threat to Canada comes from potential rising protectionism in Europe, the U.S., or elsewhere. Our growth has always been export dependent. And if Canadian businesses are unsure of finding receptive markets, whether due to foreign protectionism or slowing global growth, they will hesitate before making investments. Furthermore, political upheaval in Europe may jeopardize Canada's recently negotiated free trade agreement with Europe that still awaits all the necessary approvals.

Central Banks' response

Assurances from central banks around the world began well before the actual Brexit vote. In the U.S., Janet Yellin's testimony in preceding months indicated that the Federal Reserve was well aware of, and well prepared for, the risks to the fledgling economic recovery in the U.S. if European growth slowed or Brexit unsettled markets. Brexit was specifically mentioned as a contributing factor in deliberations about possible rate hikes this year. Mark Carney announced before the vote that the Bank of England stood ready to offer liquidity and other monetary policy measures if needed.

Since the Brexit vote global central banks have made it clear they will move to cushion any significant fall in asset prices if necessary and the G7 has indicated preparation for co-ordinated action if currency markets become dysfunctional.

In the days immediately following the referendum we saw

- BofE offer liquidity to the tune of $345 billion
- ECB's Mario Draghe calling for global policy co-ordination
- Italy propose a $44 billion bank injection
- Japan's Prime Minister Abe instruct his finance minister to do whatever is necessary
- China's Premier Li say China won't allow a market "roller coaster" after Brexit

Given the perceived ineffectiveness of monetary policy in reigniting growth since the 2008 crisis, and the limitations of traditional tools when rates are already close to the zero lower bound, we should not be surprised to see more extreme monetary experimentation in coming months.

The Fed and the Bank of Canada

The days following the U.K. referendum have seen an upending of market expectations for North American interest rates. Going into the vote, markets were still pricing in the likelihood of a Fed rate hike by December 2016. That forecast has been turned on its head, with expectations now indicating a small likelihood of a rate cut.

In Canada, events are now expected to keep the Bank of Canada at least on hold as well, possibly until the end of 2017.

Investment Implications

Summary

Fixed Income – Rates lower for longer. The search for yield becomes ever more difficult. G7 sovereign yields take another leg down. Yields in peripheral Europe rise on fears of contagion, anaemic growth and weak government finances. Corporate spreads widen, junk bond yields rise.

Equities – Slowing economic growth pressures revenues and profits. Economic uncertainty compresses multiples, while lower rate environment adds some support to valuations. Dividend stocks continue to attract attention. Once we are past the shock of a slowdown, lower for longer should provide an enduring tailwind for North American equities.

Currencies – US dollar strength against ALL other currencies as chief beneficiary of safe haven flows. Other safe haven plays include Swiss Franc and Japanese Yen. Continued pound and Euro weakness. Canadian dollar weak versus US dollar, but appreciates versus pound and Euro. Yuan slides further.

Commodities – Gold continues to strengthen on safe haven flows. Oil and other commodities come under renewed pressure as US dollar strengthens.

Corporate Earnings Outlook

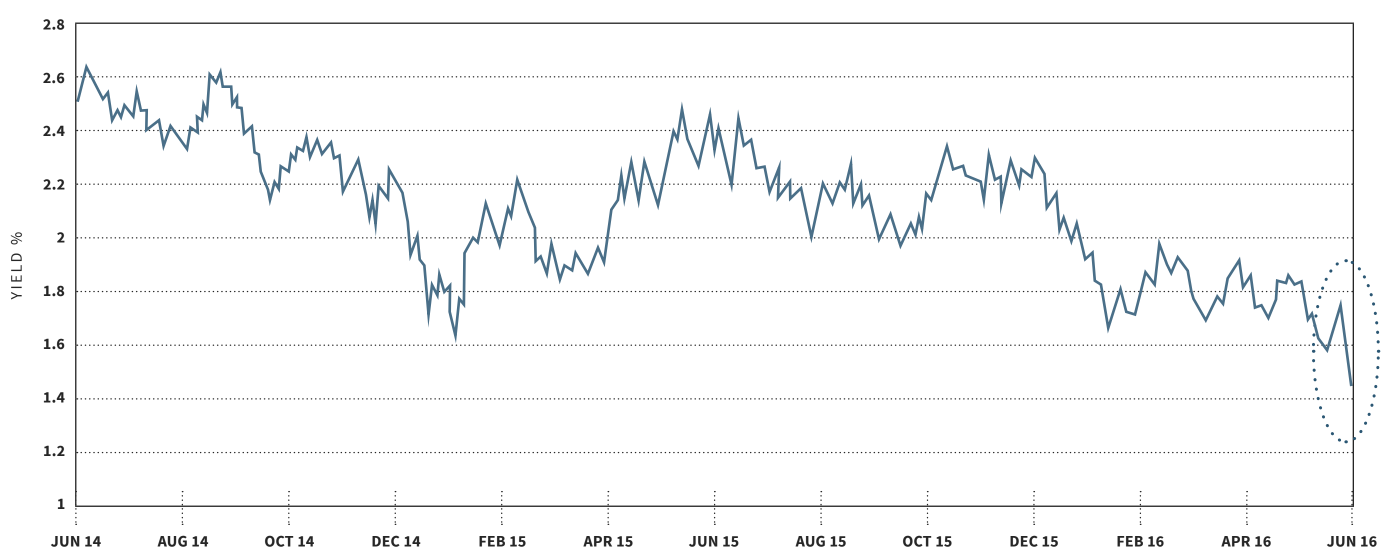
Going into the Brexit campaign, S&P earnings had just started to climb again after a period a weakness through year-end. If global GDP takes a hit, earnings estimates in both the U.S. and Canada are going to come down. This will be especially true for global S&P companies if the US dollar stays strong. The uncertainty surrounding the coming quarters is likely to be reflected in a cautious tone from most management teams as Q2 earnings results are reported through July, putting pressure on earnings forecasts and price multiples.

The earnings decline last year was driven primarily by the surge in the US dollar, the plunge in oil prices, and the slowdown in Chinese economic growth. Together these factors led to increasing fears of recession in Q1 2016 and sent the markets into a short-lived but significant slide. It is hard not to worry that, substituting a European

FIGURE 2

U.S. 10 Yr Treasury Bond

SOURCE: IGIM., BLOOMBERG



slowdown for a Chinese one, this list of adverse factors looks remarkably familiar.

Lower for longer

As investors position for a longer period of weak growth and continued low inflation, government bond yields are probably going to reach new lows. The flight to quality has already pushed 10 year government bonds yields below 1% in Canada and may soon do the same in the U.S. *(See Figures 2 and 3)*.

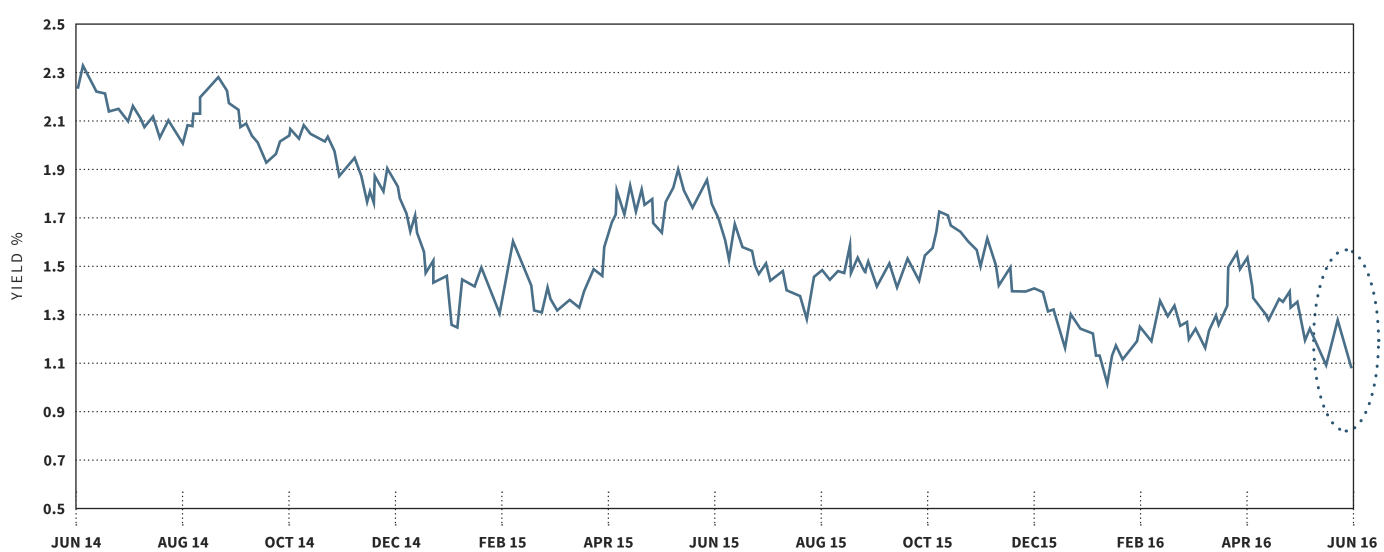
The prospect of an even lower interest rate environment for the foreseeable future suggests a renewed look at some investment considerations first outlined in our April article, *"Negative interest rates: Implications for investors"*, namely:

- **Gold.** Gold has always had zero yield and sometimes incurs costs in the way of storage fees, etc. As other "safe-haven" assets begin to offer lower or even negative yields, zero-yield looks more and more attractive!
- **High-Yield Bonds.** If you believe the world is *not headed* for recession, but also that interest rates are not going to rise materially any time soon, then the high rates offered by some corporate and high-yield ("Junk") bonds can be interesting.
- **Low or Negative Yield Bonds.** If you believe *recession is imminent* and want a refuge. Perhaps you are betting on inflation. Or perhaps you suspect rates will drop even lower and you will be able to sell at a profit.
- **Inflation-Indexed Bonds.** To the extent that these instruments are priced for low inflation and perhaps lower than they otherwise would be due to global rate pressures, there is a profit opportunity for investors if economic growth is stronger and inflation higher than expected.
- **Equities.** Stocks still provide opportunities, particularly those of higher quality companies that not are subject to macro growth concerns. If recession is not in the cards, equities depressed by economic uncertainty could see a rebound rally.

FIGURE 3

Government of Canada 10 Yr Bond

SOURCE: IGIM., BLOOMBERG



- **Financials** (especially European financials). The pressure on interest margins and the weak economic outlook have depressed valuations across most of the sector. Relatively cheap now, Financials could be an opportunity for value investors.

- **Dividend stocks.** The yield on 10 year U.S. Treasuries has fallen below 1.5%, while the yield on the S&P 500 has been rising (currently at 2.25% - June 28, 2016). While dividends are not "guaranteed" the way interest payments are, it should be noted that the dividend payout ratio for the S&P 500 as percent of profits is still less than 40%, providing investors with a big cushion against possible dividend cuts.

The need to be careful and selective: leave it to the pros.

Bank and other financial institution stocks were hit hard on the Brexit news. European bank shares suffered their worst two day drop ever (Barclays share price fell almost 50%!). But there is a vast spectrum of differing vulnerabilities that may offer opportunities to astute investors.

As with any market shock, there are winners and losers. Opportunities will be created in select securities as markets overreact to short-term noise. And long-term effects of the economic disruption on individual companies will vary greatly, requiring careful analysis of revenue exposures, cost structures, and a myriad of other considerations.

Investors Group's investment team of experts, including portfolio managers and analysts based close to the action in Dublin, are continuously monitoring developments in this evolving situation and are already taking advantage of attractive valuations in select markets and stocks.