Early Investment Implications of the Brexit Brouhaha

August 2016

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Now that the initial volatility has passed, the UK is in a better post-Brexit position than Europe – at least for now. But an overall feeling of uncertainty will make the hunt for income a key theme for the rest of 2016.

Key takeaways

- Global uncertainty, which was already high given ongoing financial repression, grew worse following major geopolitical events in France, Turkey and beyond.
- The UK's economy is facing big headwinds, but it should benefit from more BOE stimulus, more fiscal spending and a weaker currency.
- Political uncertainty abounds in Europe, which is already very sensitive to the dull global growth environment.
- A global flight to safety has boosted bonds at the expense of equities, which now seem "cheap for a reason" in the UK and Europe.
- Asia has been less affected by Brexit; positive trends are developing in China, India and Japan. Meanwhile, the US has become the world's default "safe haven".

Global markets have been regaining some much-needed poise in recent weeks as the volatility of the unexpected Brexit decision has begun to subside, with regions around the world responding to their own particular rhythms while singing a similar overall tune. At the same time, global economic uncertainty – which, in keeping with our financial repression theme, was already high – has been exacerbated by a range of factors beyond Brexit, including terror attacks in Europe and an attempted coup in Turkey.

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It would therefore seem prudent to expect more political uncertainty on the horizon, especially given Europe's upcoming referendums and November's US elections. Factor in this uncertainty with dull economic growth globally, and it becomes clear why investor attention is shifting toward the stability that income generation can provide. This "hunt for income" is a long-term trend that should primarily benefit assets in the US and Asia for the rest of the year.

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Europe and the UK

As we expected, Brexit has been affecting Europe more than the UK, which is regaining its balance as it puts a new government in place. Britain's new leaders have a clear mandate to leave Europe as smoothly as possible while, for the first time in 40 years, engaging more constructively with the rest of the world. With the pound sterling moving lower in a post-Brexit world, the UK's economy will face headwinds, yet it should also benefit from additional proactive monetary stimulus measures and investments from the central government. Sterling's downward trend has given solace to UK-based international corporations, which has helped the UK outperform Europe so far.

Europe, meanwhile, faces a period of political uncertainty as Brexit takes its toll, but the region should be less affected economically by any serious consequences even as it remains very sensitive to the dull global growth environment.

Both markets have experienced a flight to safety as investors reallocated toward sovereign bonds, which were already moving higher in Europe thanks to the European Central Bank's policies. This boost for bonds comes at the expense of equities, with financial companies in particular hurt by the uncertainties that Brexit has created for regulation, "passporting" and economic growth. Overall, it appears that equities in the UK and Europe look undervalued in a global context, but they are also now "cheap for a reason". This environment may last for a few years, unless or until negative interest rates force Europe's cash and bond holders to seek higher equity yields.

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Asia Pacific

Now that the initial shock has subsided, Asia has been generally unaffected by Brexit; instead, more significant local situations have been developing:

- China continues to stabilize as it enacts its next five-year plan.
- Prime Minister Modi of India is continuing to make positive legislative progress; he is also recovering from the impacts of a poor start to the monsoon season and the loss of the Reserve Bank of India's governor.
- Japan has re-elected Prime Minister Abe, who now seems ready to move to "Abenomics 2.0", although it is unclear if this shift will include actual structural reforms rather than just more QQE from the Bank of Japan and more fiscal stimulus from the government.

At the same time, Asia remains very sensitive to the strength of the US dollar and to global trade activity, which remains in the doldrums. With Europe still clouded by uncertainty, Asia and emerging markets now offer a combination of alluring factors:

- For equity investors, Asia has undervalued markets that also provide the potential for some earnings growth.
- For investors who feel unwilling or unable to take equity risk, Asia offers high-yielding local and hard-currency sovereign bond investments.

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US

The US has become the post-Brexit world's default "safe haven", with the US dollar getting stronger and global buyers of US Treasuries driving yields lower. Hard-currency high-yield bonds are still attractive and, despite the United States' dull but solid economic progress, the US Federal Reserve still wants to move US interest rates higher. As a result, while US equity valuations are stretched and earnings expectations are still muted, the US has become the safest place to take a moderate amount of risk in exchange for modest return potential.

Of course, political risks are clearly rising in the US, and that will add to the overall market volatility that we anticipate will peak in November. Nevertheless, when compared with ongoing difficulties in Europe, the challenges the US is facing may begin to seem increasingly manageable to a growing number of investors.

About the Author

Neil Dwane is the Global Strategist for Allianz Global Investors and part of the Equity Investment Management Group. He coordinates and chairs AllianzGI's Global Policy Committee, which formulates the Allianz Global Investors house view, as well as leads and directs the agenda setting for the bi-annual Investment Forums. Neil still manages some European equity portfolios, and thought leadership articles written by Neil are published regularly.

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