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Global View

Early Investment Implications of the Brexit Brouhaha

Neil Dwane
Global Strategist

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.

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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Perspective on Europe

What If the ECB Runs Out of Bonds to Buy?

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After 17 months of sovereign-bond purchases by the European Central Bank (ECB) – not to mention negative deposit rates and heightened Brexit-related political uncertainty – more than half of the euro zone's government bonds are currently carrying a negative nominal yield.

This has put the concept of "scarcity scares" back on the agenda, with investors asking themselves what would happen if the euro area's central banks ran out of bonds to buy. Markets worry that the ECB's self-imposed purchasing constraints, particularly its deposit-rate restriction, increase the likelihood of this scenario.*

The good news is that on the aggregate level, the scarcity problem might not come to pass for a while. For the euro zone as a whole, the currently available supply of assets eligible for the public sector purchase programme (PSPP) is still exceeding the ECB's expected demand until the end of March 2017. Still, Germany's Bundesbank could be the first national central bank that runs out of eligible bonds to purchase. Of course, this supply shortage would be even more pressing if any quantitative easing (QE) were to be extended beyond March.

To address these scarcity issues, the ECB's Governing Council will likely try to implement technical solutions (such as dropping the deposit-rate floor) instead of political ones (such as adjusting its "capital key" rules).

The ECB's capital key says that sovereign-bond purchases must be split across countries according to the respective country's share in the total population and GDP of the region (for example, 25.6 per cent for Germany and 20.1 per cent for France). However, there is no legal requirement to buy assets in line with the capital key, and substitute purchases – such as bonds issued by supranational institutions – are already allowed.

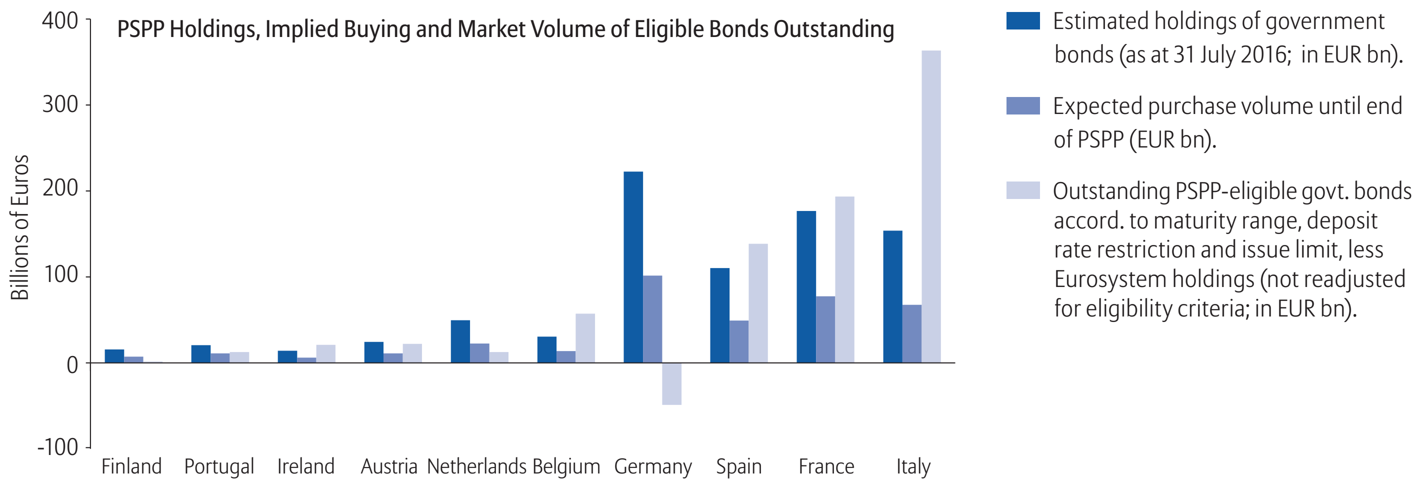
One option for the ECB is to waive this rule, which would likely result in the central bank buying a higher proportion of the bonds from more indebted member states. This would open up the ECB to criticism that it is heading toward monetary financing.

To avoid this scenario, the ECB might not waive the capital key rule entirely. Instead, the Governing Council could try several approaches to adjust the QE parameters, including increasing the issue limit for government bonds issued without collective action clauses (CACs); lowering the deposit rate or dropping the rate floor; changing the eligible maturity range; and/or broadening the eligible asset universe.

No matter what the ECB decides to do with the capital key, one thing seems to be clear: Given today's market conditions, the ECB will almost certainly need to adjust its QE parameters in the months ahead.

'Scarcity Scares' Are Back on the Agenda

Germany's Bundesbank could be hardest-hit by self-imposed constraints.



Source: Bloomberg, ECB, AllianzGI Global Capital Markets & Thematic Research as at 3 August 2016 (unless otherwise stated). Past performance is not a reliable indicator of future results.

*Additional information about the ECB's purchasing constraints: 1) Maturity range: The remaining maturity of the bonds must be between two years and less than 31 years. 2) Deposit-rate restriction: The ECB only acquires government bonds whose yield is above the ECB's deposit facility rate (currently -0.40 per cent per annum). 3) Issuer/issue limit: As part of the PSPP, the ECB purchases a maximum of 33 per cent of the outstanding bonds of an issuer and of each single issue, except for bonds with CACs, where the issue-share limit is 25 per cent (subject to a case-by-case verification).

Viewpoint

The BOJ Is Feeling the Heat to Sync Up with Abe

Stefan Scheurer
Senior Investment Strategist

After winning Japan's Upper House election and establishing a two-thirds majority in the senate, the governing coalition led by Prime Minister Shinzo Abe seems to have found strong support for its "Abenomics 2.0" measures. This should allow for increased fiscal spending measures to match up with greater monetary easing, which in turn should help speed up Japan's exit from deflation.

With fiscal stimulus, the devil's in the details

Abe recently unveiled the government's plans for an economic stimulus package worth JPY 28.1 trillion – 5.6 per cent of Japan's GDP – to show support for the economy and to inflate the value of supplementary budgets. However, while the scale of the stimulus package looks good on paper, the devil is in the details. Even though the JPY 13.5 trillion in fiscal spending that was shouldered directly by the government was higher than expected, only JPY 7.5 trillion appears to be "fresh water" – and some of that may ultimately be parceled out over several years. That would not have an immediate impact on growth, especially as the timing of actual spending is uncertain.

With new fiscal stimulus measures under way, the Bank of Japan (BOJ) is feeling pressure to join the government in supporting Japan's economy, and anticipation was rising in advance of its 28-29 July monetary policy meeting (MPM). For the markets, the issue is that economic activity remains weak and price pressures are moderating; inflation expectations even fell further recently. Additionally, a stronger yen is weighing on profits and lowering firms' willingness to lift wages. All in all, there is a clear case to be made for more easing, and markets have been expecting swift and determined action to counter the idea that the BOJ is running out of ammunition.

A high bar for the BOJ to clear

However, the BOJ was not able to pull a rabbit out of its hat at its July meeting: It decided not to expand its overall pace of asset purchases, and not to lower its policy rate below -0.1 per cent. Yet the bank did announce plans to almost double its purchases of Japanese ETFs, to JPY 6 trillion annually, and announced that it intends to expand its dollar lending program for overseas investment, to USD 24 billion. Additionally, the BOJ will establish a new facility to lend Japanese government bonds to banks, which should cushion the drag on the banks' profits and provide more collateral – a particularly helpful program given today's negative interest rates.

The BOJ also recently noted that when it holds its next MPM on 20-21 September, it will conduct a comprehensive assessment of the effects of its current policy. This suggests that policymakers will wait until next month to consider further policy actions, which means that uncertainty about additional easing could linger until then. Nevertheless, this pause may give the BOJ the time to assess the government's fiscal stimulus plan. Given Kuroda's penchant for surprising markets, policymakers could use this time to explore other easing options that are currently not on the table.

Overall, the Bank of Japan is in a tough position: It has not used all three dimensions of its monetary policy tools (interest rates, quantity and quality), and the market is questioning the effectiveness of QQE (qualitative and quantitative easing). At the same time, standing firm and doing nothing could increase the market's doubts about the effectiveness of the BOJ's monetary tool box.

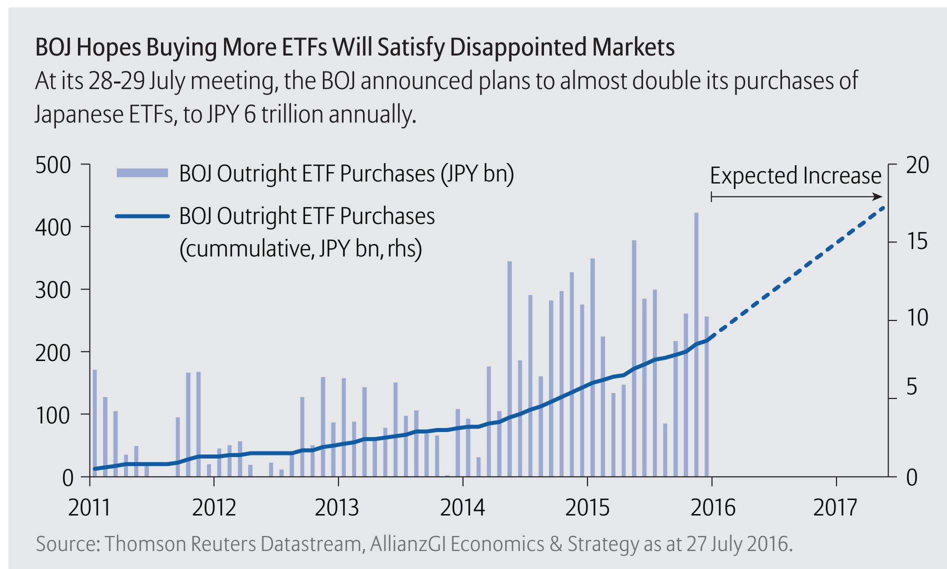
Talk of 'helicopter money' could subside temporarily

Given the fading impact of standalone fiscal and monetary easing measures, the BOJ and Japan's government should be expected to more closely coordinate their efforts in the future – especially with the central bank's inflation goal at growing risk of slipping out of reach.

With so many factors are occupying the market's attention, we believe the sometimes intense discussions about helicopter money in Japan may quiet down – at least for now. Still, if the yen were to break the critical mark of 100 JPY/USD, the BOJ may again find itself under increasing pressure to decide what additional easing it is willing to deploy long before its September meeting.

BOJ Hopes Buying More ETFs Will Satisfy Disappointed Markets

At its 28-29 July meeting, the BOJ announced plans to almost double its purchases of Japanese ETFs, to JPY 6 trillion annually.



Source: Thomson Reuters Datastream, AllianzGI Economics & Strategy as at 27 July 2016.

Soundbites from Research

Europe's Property Sector Provides Much More than Shelter

Dr Dirk Becker
Sector Head, European Financials

While banks and insurers are among the many financial institutions struggling to cope with today's ultra-low interest-rate environment, there is one subsector of the financial industry that actually benefits from low rates: real estate. This strength is clearly reflected in the stockmarket, where property stocks have recently been major outperformers.

Cheaper debt boosts earnings and cash flow

So why are low rates such a boon to real estate companies? The primary reason is that low rates decrease financing costs. Most real estate companies operate with leverage levels of between 40 per cent and 60 per cent, and their debt has historically cost 5 per cent or more. Today, however, the cost of debt has fallen to between 2 per cent and 3 per cent, and new financing can even be obtained for 1 per cent or less. These low debt-servicing costs are massive drivers for earnings and cash flows.

Low rates push up valuations

In addition to making debt cheaper for real estate companies, low rates also drive up their asset valuations. Market prices for real estate are usually linked to the risk-free rate plus a risk premium of around 200 basis points. In normal times, a typical capitalization rate for real estate is 6 per cent (or 17 times the annual rental income). Low rates have driven the capitalization rate down, which has driven up the valuation multiples for real estate transactions to 20, 25 or in some cases even 33 times annual rental income. This has enabled many real estate companies to write up the value of their portfolios, which pushes the per-share net asset value up accordingly – which usually means higher share prices.

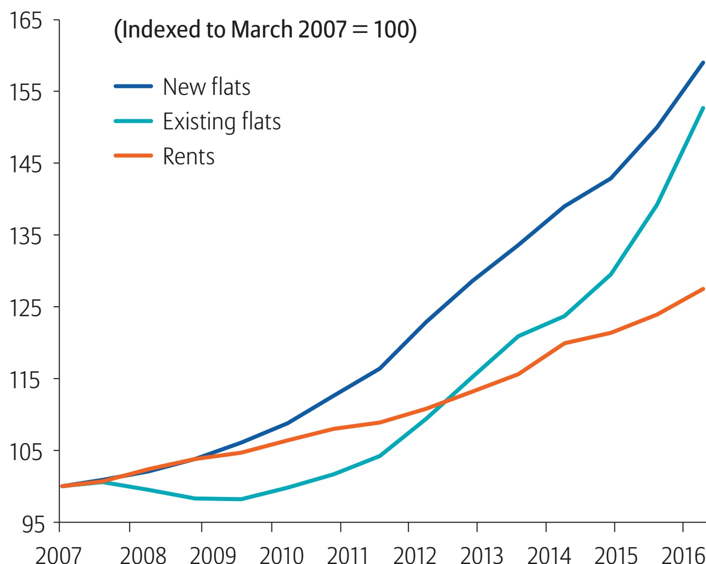
Europe set to outperform; Germany leads the way

While many investors view the entire real estate sector in Europe as a safe haven – except for the UK, given the Brexit vote – we find residential property companies in Germany to be particularly attractive. These companies are serving an essential need for affordable housing, and they are also receiving a boost from a range of macro factors currently at work in Germany: an inflow of refugees, a strong economy, low vacancy rates and a supply shortage. Although property prices and rent levels in Germany have been rising in recent years, they are still reasonable when compared with many other countries.

All told, while the European real estate sector in general has a good chance of further outperforming the rest of the market, residential property companies in Germany should excel.

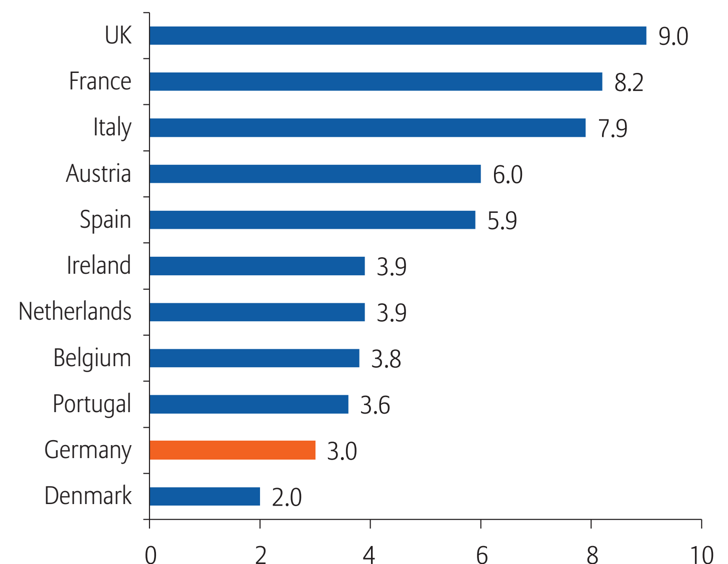
The European real estate sector has a good chance to outperform the rest of the market, with German residential property companies expected to excel

German Property Firms Have Been Helped by Higher Prices ...
Since the financial crisis, German residential property prices have steadily increased over time.



Source: Immobilienscout24 as at July 2016.

... And High Prices Are Still More Affordable in Germany
Germany is a great place to buy a 70m² apartment, requiring only 3.0 times the average annual gross salary of a purchaser.



Source: KeplerCheuvreux, Allianz Global Investors as at July 2016.

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Global View

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 ECB'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.

Equities in the UK and Europe look undervalued, but they are also now "cheap for a reason"

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.

With Europe clouded by uncertainty, Asia and emerging markets offer a combination of alluring factors

The United States

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.

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