insightpaper

AMP CAPITAL

BREXIT:

Medium Term Perspectives and Global Insights

28 JUNE 2016

With Britain having voted narrowly in favour of leaving European Union (EU) on 24 June, there has been some initial, aggressive price reaction from investment markets.

KEY POINTS

- **Currency moves** were substantial, particularly weakness in Sterling (GBP), while the United States Dollar index (USD) strengthened about 4% and the Japanese Yen also strengthened. The NZ dollar (NZD) declined 3% following the UK's leave decision on Friday but has since steadied around 70 US cents. The NZD remains a little higher for the year to date, both against the USD and a broader trade weighted basis. Many initial currency moves were retraced over the course of the European and US sessions on Friday.
- Apart from GBP, many of the falls in markets have reflected **retracements in the rally** of the previous week when 'Remain' was the widely expected outcome, or retracements to the lows seen in January and February, 2016.
- There is a **high degree of uncertainty** about the future, as the sustainability of the EU is being questioned and further referendums in the EU are probable. Scotland, which voted aggressively in favour of 'Remain,' appears to be laying the groundwork for another Scottish referendum on independence, soon. This uncertainty could serve to undermine growth. However, for Eurozone countries, the hurdle to leave the Eurozone is higher than Britain leaving the EU as this involves adopting a new currency, paying higher interest rates etc.
- There is a **risk of recession in the UK**. However, we will be closely watching the data and monitoring developments in our ongoing assessment of the risks to growth. UK assets appear to have priced in this uncertain future environment. It's important to note that the UK economy represents only 2.4% of global GDP, so the economic impact of weaker UK growth on the global economy is unlikely to be significant.
- Contagion risks: financial stress on **European banks** (particularly Italian banks) could be the mechanism that causes the transmission of this event to go from a UK event with a global hiccup to a global recession.
- Investors should continue to **gather information** and **assess the medium term implications**.
- **AMP Capital's investment teams located in London** have been providing on-the-ground insights and as developments unfold we will continue to draw on their perspectives for the benefit of our clients.
- Markets can overreact when presented with increased uncertainty, which can create dislocations and heightened volatility in the short-term. There will be investment opportunities in this environment as some markets become oversold, and we will continue to carefully **consider portfolio strategy and medium term opportunities**.

We have summarised the immediate market response of each key asset class as at the end of trading on Friday. While markets were generally not expecting this result and much uncertainty still remains around the mechanics and detail of the exit, AMP Capital's investment teams have provided their insights on the possible medium term implications of Britain's exit of the EU (Brexit).

NEW ZEALAND FIXED INCOME PERSPECTIVES

GRANT HASSELL
MD & Co-head of NZ Fixed Income

VICKY HYDE-SMITH
Co-head of NZ Fixed Income

Global fixed income markets reacted quickly to the surprise outcome, taking most countries' long-term rates lower by around 25 bps. The weekend has provided a sufficient 'cooling-off' period so that this rally has not continued into this week. New Zealand rates fell by around 10 bps for 2-year bonds and 20 bps for 10-year bonds, with the yield curve flattening.

The NZ fixed income portfolio returned nearly 1% overnight on the back of these falls and while our portfolio has no direct exposure to the UK, the interdependencies in global markets is quite evident in times of stress. Assets which are not of the highest quality will not perform as strongly as government bonds. This has already been seen in global markets where credit spreads are around 25% wider. We are keeping portfolios over-exposed to duration (we are longer) in order to hedge any underperformance of these assets.

PUTTING THE MARKET MOVES INTO CONTEXT

While a significant one day move, it will require additional events to trigger a further fall in rates. So for the moment the impact represents just one of the market moves you expect to see at least once a year. More interesting, however, is the potential impact on the European region, especially the banking system, which would be the fastest way to transmit what is currently a local issue into either a regional one (European), or even a global one. For the time being, New Zealand is relatively well insulated from offshore volatility, but should the cost of borrowing for European banks increase dramatically, then this will raise the cost of borrowing for New Zealand banks.

MEDIUM TERM IMPLICATIONS: DIRECT AND INDIRECT

We expect markets to trade around current levels, but remain jumpy and sensitive to new information which may include further central bank accommodation. In New Zealand there are two principal factors which might induce further Official Cash Rate reductions. First, the currency remains significantly above our estimate of fair value, in part due to revisions of when the US Federal Reserve will begin to raise rates and also the increased chance of Reserve Bank of Australia cuts. Second, should bank funding costs increase then mortgage rates will increase, all things being equal.

At its core, the Brexit outcome and the performance of Trump in the US are the result of the same phenomenon: real income growth in middle class, developed nations has been nil for the past 30 years. Unless this begins to change (and even then it will be slow), political and thus market volatility will be the norm.

GLOBAL FIXED INCOME PERSPECTIVES

SIMON WARNER
Global Head of Fixed Income

The initial market reaction can be described as a flight to safety, which saw global government bond yields rally by 25bp. There was a 25% widening in credit spreads.

Most fixed income markets remain well within their ranges for the year and are flashing orange on the risk of broader economic and market dislocation. Markets have priced in recession for the UK, only.

The Australian economy has only small direct exposure to the UK and the economic impact should be small. Australian bonds retained their safe haven properties on Friday and prices rose significantly. The index would have returned approximately 1% on the day (highly uncertain estimate). Australian with its positive yield continues to attract significant international interest from investors seeking defence, AAA ratings and some yield.

PUTTING THE MARKET MOVES INTO CONTEXT:

We are watching the European banking system closely as the route by which UK stress could spread to the rest of the region. Specifically we are monitoring bank credit spreads and Italian banks especially. The moves in these variables on Friday were large but not excessive and currently do not indicate an economic impact.

The other route for Australia to be impacted is through commodity prices, which fell modestly on Friday.

Our models suggest that the AUD is close to fair value at present. There is a risk that the AUD strengthens on the perception that Australia is far removed from the immediate economic fall-out and that its high real rates support currency valuations. If this scenario eventuates the RBA is likely to respond with rate cuts.

We were expecting another rate cut this year from the RBA, and are now more highly convicted of this view.

MEDIUM TERM IMPLICATIONS: DIRECT AND INDIRECT

The implications are highly uncertain, however, we are assuming that a recession and rate cuts in the UK are likely to now ensue. The broader consequences are likely to be determined by the reaction of markets and the potential hit to confidence.

For wider impact, we will be watching European banks and Italy in particular. The European banking system is still weak and is vulnerable to wider sovereign spreads, wider credit spreads, and lower equity prices. Policy makers have limited room to move if there is spreading contagion.

In addition, we are closely watching USD performance. If there is a flight to quality, that pushes the USD higher, emerging markets may come under renewed pressure.

We see the events in the UK as part of a broader pattern of heightened political risk. There has been a rise of anti-establishment parties in many counties around the world and Europe, in particular. This raises uncertainty and should result in markets pricing higher risk premiums. These forces may depress economic activity and we are watching economic confidence measures closely in coming weeks.

AUSTRALIAN EQUITIES PERSPECTIVES

MICHAEL PRICE
Head of Fundamental Equities

The ASX200 Index weakened -3.2% on Friday to finish the week down -0.9%. Financials and Resources were the sectors that underperformed after the Brexit result was known. Defensive yield sectors outperformed. The relative sector performance reflected expectations of lower global growth and bond yields going forward.

MEDIUM TERM IMPLICATIONS: DIRECT AND INDIRECT

We anticipate that lower global growth and bond yields will lead to resurgence in the

yield trade. The Australian market has rallied for three years without earnings growth and could be considered expensive and vulnerable to a loss of global confidence.

It remains unclear whether Australia will be regarded as a safe haven or a vulnerable economy. The Australian index underperformed the FTSE by around 3% for the week.

GLOBAL EQUITIES PERSPECTIVES

TRENT LOI
Portfolio Manager

History now shows that investors were too complacent with their positioning into the 'Brexit/Bremain' vote. Most equities markets rose days prior to the vote, even though several polls suggested that the race leading up to the referendum was tight. The UK's decision to leave EU was clearly a shock to many. Most of the major markets have endured a sell-off once the result was clear. As the market entered a 'risk off' mode, defensive sectors such as consumer staples, utilities and health care have fared better than cyclical sectors. Financials, and banks in particular, were sold off.

PUTTING THE MARKET MOVES INTO CONTEXT

The Core Global Share Fund has adopted a more defensive posture for some time now, including overweighting Hexavest, our defensively positioned manager. While 'Brexit' was not our key thesis, we are managing the portfolio with a view to having modestly protective characteristics in down markets. At the overall portfolio level, the Fund's overweight to the more defensive sectors has delivered a healthy relative outperformance compared to the index month-to-date. The overweight exposure to gold miners generated handsome rewards in the current risk-off environment. Our underlying managers will undoubtedly see the recent sell-off as an attractive opportunity.

MEDIUM TERM IMPLICATIONS: DIRECT AND INDIRECT

The immediate question is whether 'Brexit' will derail current tepid global growth and send the world into recession. While we do not rule this out completely, we assign a low probability to this.It is in everybody's interest to make sure that Brexit doesn't destabilise economies and financial systems, so we would expect central banks and governments of the UK, EU and the world to pull their efforts together to calm the situation down. However, it is likely that the investors will remain hypersensitive to the news on the European Union's dealing with UK, future of Scotland and Northern Ireland, the rise of the Left in European countries, etc. There are more questions than answers from Brexit. Subsequently, macro news is likely to continue to dominate the headlines and to drive the market sentiment, and therefore the volatility.

EMERGING MARKETS EQUITIES PERSPECTIVES

DUY TO
Portfolio Manager

The main transmission mechanism for Brexit to the emerging markets is through the currency market rather than direct trade linkages. With a flight to safety, the US dollar (USD) is expected to rally placing pressure on emerging market currencies and the potential for devaluations. Countries with current account deficits are expected to be most affected, thus favouring Asia over EMEA (Europe, the Middle East and Africa) and Latin America. In addition, a strong USD tends to cause downward pressure on commodity prices and trade volumes, adding to the recent volatility of commodity exporting countries.

From an investor sentiment perspective, despite relatively attractive valuations, emerging market sentiment has been negative over the past three to five years. The market volatility arising from Brexit adds to existing poor sentiment and the aversion to higher risk assets.

PUTTING THE MARKET MOVES INTO CONTEXT

The Emerging Markets Fund is structured to be core across investment styles and have a strong awareness to country/currency risk. In terms of underlying managers, Schroders actively hedge their currency risk, Investec limit their active country exposures and Lazard employ a country neutral approach. As a result, the macro impacts of Brexit are expected to be minimal. The increase in market volatility often results in overreactions relative to fundamentals which can lead to opportunities at the stock level for our managers.

ASIAN EQUITIES PERSPECTIVES

PATRICK HO
Head of Asian Equities

Asian share markets weakened -2% to -5%. Overall, the regional index weakened by 3% in local terms (A-share was down about 1%).

Asian currencies depreciated -2% to -3% against USD, although the Chinese Yuan (CNY) depreciated less than -1%. By contrast, the Japanese Yen (JPY) appreciated 3% against USD.

PUTTING THE MARKET MOVES INTO CONTEXT

The move reflected the change in the sentiment and increased uncertainty about the global economy post Brexit.

MEDIUM TERM IMPLICATIONS: DIRECT AND INDIRECT

We anticipate further weakening in GBP against USD, potential weakening in the Euro (EUR) against USD and JPY strengthening against USD.

We may see weaker demand of Chinese exports to the Eurozone, including the UK. There is also the possibility of further delays to rate hikes in the United States and earlier monetary easing (for example: reserve rate ratio cut or interest rate cuts) in China.

GLOBAL LISTED INFRASTRUCTURE PERSPECTIVES

TIM HUMPHREYS
Global Head of Listed Infrastructure

The initial reaction of global listed infrastructure was negative, with the Dow Jones Global Infrastructure Index losing approximately 3% on Friday (as of 3.30pm UK time). Global listed infrastructure slightly outperformed global equity markets, in-line with the defensive characteristics of the sector.

PUTTING THE MARKET MOVES INTO CONTEXT

Within the global listed infrastructure sector, stock performance was quite differentiated, depending on the region with US and the UK relatively outperforming (led by a flight to safety) and Europe relatively underperforming (risk-off in peripheral Europe).

MEDIUM TERM IMPLICATIONS: DIRECT AND INDIRECT

The direct implications on infrastructure stocks of Brexit are likely to be quite small.

Listed infrastructure companies in the UK (largely regulated utilities) have very little exposure to the economy, largely protected against inflation and have access to long term funding. Outside of the UK some companies, like Eurotunnel, and European airports are exposed to the UK economy via trade and tourism flows, but we expect any impacts from these linkages to be small and short-lived.

The UK will now likely go through an extended period of uncertainty as they negotiate their exit from the EU and how their future relationship with the economic area will look. The potential for a second Scottish referendum on independence will add to the uncertainty. During this period, those companies with less exposure to the negative implications and with more defensive attributes, like the UK regulated utilities mentioned above, should be perform relatively well.

However, in the meantime there will be pressure on governments to also announce referendums on their continued involvement in the economic area. This uncertainty will clearly not be good for markets or the economy and a risk for those companies directly exposed. How this will be addressed and resolved will depend on the response from policymakers, both with response to fiscal and monetary policy, and will be watched closely by markets.

For listed infrastructure companies, the exposure to economic developments varies, but generally speaking they are very well-capitalised and benefit from stable regulation or long term contracts. In fact, most companies have benefited from policy interventions at the EU level to date, such as the ECB's CSPP and the European Fund for Strategic Investments (i.e. Juncker Plan), and could be a focus of further initiatives going forward.

Although the direction of markets remains uncertain given the backdrop of Brexit, we expect the global listed infrastructure sector to continue to demonstrate its defensive characteristics and perform well relative to broader equity markets.

We will continue to monitor developments very closely and take advantage of market dislocation, whilst focussing on the output of our investment process. In the medium term, we see the most attractive risk-adjusted returns in Continental Europe, which represent our largest overweight position, partially offset by an underweight to the UK.

GLOBAL LISTED REAL ESTATE PERSPECTIVES

MATHEW HOULT
Co-head of Global Listed Real Estate

JAMES MAYDEW
Co-head of Global Listed Real Estate

The resulting market movement has been dramatic, with the listed real estate sector down around 2% (as measured by FTSE EPRA/NAREIT Developed Europe Index). In-line with its typically defensive characteristics, global REITs outperformed the broader equity market.

PUTTING THE MARKET MOVES INTO CONTEXT

All risk assets, including global REITs have experienced substantial price declines as equity risk premiums have risen in response to heightened political turmoil and an uncertain economic future for the UK and the European Union. Currently, UK listed property is the weakest subsector despite lower leverage and sound direct property fundamentals. This reflects the substantial capitalisation rate compression we've seen since 2012 and the dramatic reversal of implied valuations with recent price movements.

Taking price reactions at face value, the clear implication is that property demand in London and the UK broadly is likely to diminish considerably, particularly as key financial and technical tenants look to relocate to the continent. This may indicate an overreaction, as London was a financial centre long before the European Economic Committee even existed, but at the margin it is certainly fair. Interestingly, with the concurrent selloff in property names in Europe, the implication goes beyond demand forecasts as for every tenant that leaves London you would expect some offsetting, increased demand in Paris, Frankfurt or elsewhere. Extending this around the world, it is increasingly clear that the selloff has less to do with demand forecasts in London and the UK, but with Brexit acting as a catalyst for a long feared market correction.

MEDIUM-TERM IMPLICATIONS: DIRECT AND INDIRECT

It is important to remember that over the medium to long term, listed property returns are far more correlated with direct real estate than stock markets. Dislocations such as these where the long term fundamental qualities of a company have not changed are a stock pickers best opportunity to generate long term alpha. Furthermore, we think that it is unlikely that Britain voting to leave the European Union will lead to a globally coordinated economic recession and we will be able to reallocate capital away from Europe and into other regions.

Notwithstanding the current market volatility, our investment process attempts to capture the returns that can be achieved through listed property ownership throughout a real estate cycle. The benefits of being global allow us to rotate capital out of underperforming regions and into regions that offer superior risk-adjusted returns. We do believe that there will be heightened political risk in Europe in the foreseeable future and this may weaken economic growth.

DIRECT REAL ESTATE

CARMEL HOURIGAN
Global Head of Property

The market's reaction to Brexit has clearly been observed in more conservatism and cautious leasing and investment decisions in the UK commercial markets over the past couple of months. The sharemarket may fall more than expected as there is margin call risk with 5-10% movements in stock prices, which could amplify losses in the near-term. The lesson from the global financial crisis is to reinvest close to (rather than wait for clear signs of) the bottom.

PUTTING THE MARKET MOVES INTO CONTEXT

Sharemarket volatility is likely to see reduced capital for unlisted assets in the short-term but once the volatility subsides, the attractive real estate yields in a world where fixed interest yields are going to fall further is likely to rekindle the demand for yield assets again.

Mortgage rates were already rising and banks were tightening lending prior to Brexit. As such, the property market has not collapsed it's merely stabilising. We expect the Reserve Bank will drop interest rates so the burden on households may actually lessen. In our view, the oversupply of apartments is likely to have a bigger bearing on prices in localised areas than Brexit.

Debt usage in real estate has fallen since the global financial crisis, so the risk of fire sales and big falls in real estate prices outside of the UK and Europe seem unrealistic this time. However, there is a risk of tighter credit markets globally in the wake of Brexit which could impact availability and pricing of real estate debt, again acting as an offset to improving rent and occupancy rates. For Australia, we see more stable markets ahead with the potential of slightly more expensive debt. We believe Australian core real estate will remain attractive on a relative basis globally and are likely to see continued interest from pension fund investors out of Europe.

MEDIUM-TERM IMPLICATIONS: DIRECT AND INDIRECT

Over the medium-term, prospects of a recession in the UK and weaker growth in Europe is going to see investors adjust outlooks for rents and occupancies which will likely result in a pricing adjustment in those jurisdictions. For the rest of the world, as long as a global recession is avoided, real estate prices are likely to stabilise.

In terms of indirect implications, weaker momentum in the UK and Europe is likely to flow to reduced exports from China which flows back to Australian and Asian economic momentum on a lag. Australia has plenty of firepower with interest rates and stimulus. We could also possibly get swamped with capital once things settle down. Interest rates could fall negative in a greater part of the world which will drive more capital towards high-yield plays such as Australia and New Zealand direct real estate.

INFRASTRUCTURE DEBT PERSPECTIVES

ANDREW JONES
Head of Infrastructure Debt

The initial reaction is related to concern over the extended period of uncertainty that lies ahead.

For UK infrastructure, the Brexit vote may in the short term mean a slowdown in investment, due partially to the uncertainty and fluctuations in GBP.

PUTTING THE MARKET MOVES INTO CONTEXT

Infrastructure in the European market can in its simplest form be looked at as forming two groups; those projects that are largely domestic and those that are dependent to a material extent on other European nations. The former would include for the most part public utilities and availability based projects funded in GBP in the UK. Provided these investments are true to their defensive characteristics and a strict view of infrastructure has been taken in the investment thesis, the assets in themselves should be sufficiently resilient to weather the storm.

The latter group of projects would include transport projects as well as energy projects that are materially dependent upon surrounding nations and interconnections.

Energy prices are likely to go up given that the UK is dependent on power imports and GBP has fallen to its lowest point now since 1985. The vast majority of UK renewable energy projects have some degree of energy price exposure and would benefit directly from an increase in electricity prices. The market as a whole is more complicated however; over the last 30 years, the EU has played a fundamental role in addressing competitiveness, security and climate dimensions of energy policy among member states. The UK is increasingly reliant on imports from and through continental Europe, its energy market is deeply integrated with Europe and a material share of the UK's electricity is exchanged with EU partners. It is widely anticipated that the energy market could not practicably be separated from Europe's energy networks and so the UK would have to continue to adhere to some extent to EU energy policy, but without having any influence over Europe's energy policy and consequently less sovereignty over its own energy policy. Further, UK governments could more easily change direction on energy policy once the UK is no longer an EU member state, but the contracts that are in place at the time of any such change would be honoured under the UK policy of grandfathering, which is enshrined in UK law and has been further reinforced in a relatively recent Court of Appeal decision.

We would anticipate that investment into the energy sector is likely to decrease in the UK in the short term but the effect would be much less pronounced than in other sectors. More aggressive players will be looking to take advantage of electricity price volatility and expected longer term increases so we may see the energy sector rally in the medium term.

MEDIUM TERM IMPLICATIONS: DIRECT AND INDIRECT

There may be a risk that Brexit could create economic pressure across Europe and potentially further afield. The worst-case scenario is that Brexit sparks further Eurozone unrest, which could have the potential to disrupt the European Union as a whole.

DIRECT INFRASTRUCTURE EQUITY

BOE PAHARI
Global Head of Infrastructure Equity

Given the relatively illiquid nature of the asset class there is no clear evidence immediately available as to how the market is reacting to the vote to leave. We do not expect any material impact on valuations or returns of the underlying assets in the short term, and given its defensive nature expect direct infrastructure to continue to perform well relative to other asset classes in this environment.

POTENTIAL OUTLOOK

We may experience some uncertainty in growth for assets whose performance is closely correlated to UK GDP. However, we have been considering the impact of Brexit with the management teams of each of our assets and are confident that the impact will be limited across the portfolio, particularly considering the long-term investment horizon of the asset class. Many of our assets (regulated utilities or businesses with medium to long term contracts) have very little exposure to short term economic fluctuations.

There is also current speculation that expected sales processes for UK & European assets could be delayed whilst the current market turbulence settles and the appetite of investors and debt providers in both UK & Europe becomes clearer. We expect sales activity to pick up again in the medium term given continuing strong demand for quality infrastructure assets. Overall, we remain confident in the attractiveness of the direct infrastructure asset class. As a result of its defensive nature - given the essential nature of the services provided, long term contracted revenues, low volatility and stable cash yields - we do not expect to see a material impact on asset valuations.

MEDIUM TERM IMPLICATIONS: DIRECT AND INDIRECT

Prior to the UK referendum we have been shoring up a well balanced portfolio in non-UK assets globally, including the U.S., Australia and Europe that has well diversified our underlying regional exposure. As a specialised mid-market active asset manager, we believe that such an environment can play to our advantage in the medium term. With a focus on each of the infrastructure sub sectors, we continue to see value and attractive yield opportunities and look to mitigate assets from the current market uncertainties. As it is yet early days post the referendum results, we need to see where the dust will settle in relation to pending negotiations with the European Union, as we may well be faced with nuanced outcomes that are relatively favourable than might initially appear.

BREXIT – CONCLUDING REMARKS

> While the immediate impact across regions and markets has varied, it is apparent that Brexit has increased uncertainty about the future.

> The medium term broader implications of the Brexit referendum lie with Europe and, particularly, relate to the sustainability of the European Union as we know it; anti-EU political movements have seen strong support in countries like Italy, France and the Netherlands, whilst the economic recovery from the Eurozone crisis in 2011-12 has been weak with relatively high unemployment rates and banking sector under pressure.

> From a political perspective the results of the weekend's Spanish general elections are suggesting a renewed deadlock. Italy has a referendum in October, whilst France and Germany will have general elections in 2017.

> AMP Capital will be running a series of teleconferences for our clients, to provide additional insights from multiple experts across our investment teams as new information emerges on Brexit and its implications for portfolios. We will continue to communicate with you on concerns you may have about the investment implications of Brexit and to share the diversity of investment thinking across our capability.

> We invite our clients to send us questions on matters of concern. Please contact your AMP Capital relationship manager with questions or concerns that you would like us to address.

CONTACT US

If you would like to know more about how AMP Capital can help you, please visit **www.ampcapital.co.nz**