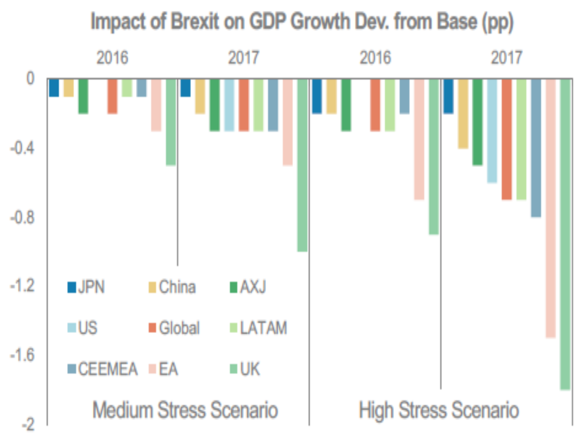
Cheerio Good Mates Jun 2016

As we commented last week on Brexit, the call is going to be close. Nobody could possibly say with conviction how UK will vote. As of this morning, they have voted to leave on a thin margin of 51.8%. Global markets suffered the full brunt of this outcome with Nikkei -7.9%, HSCEI -3.9% and FTSE 100 -6% (Asia hours). Risk on currencies all clobbered, GBP -7.3%, KRW -2.4%, SGD -1.3% and Yen strengthen along with Dollar Index 3% and 1.8% respectively. Gold rallied 4% along with US Treasury 10years dropping 24bps.

But before we panic and throw the baby out with the bath water, we remind readers the few key facts we have shared last week. While economic fallout is material for UK (estimated will half 2017 growth forecast to 1%), the impact to global growth is insignificant shaving off 0.10% of current global forecast of 3.2% for 2017. Brexit is a highly localised problem that shouldn't have lasting adverse effect of global dynamics. The bigger concern and uncertainty is will Brexit leads to a de-balkanization of EU? We will not pretend to know the answer but suffice to say it will make anti EU plebiscites bolder in other countries and any "Leave" premonition will really depends on how the UK economy perform in the coming quarters.

MS forecast on impact of to GDP



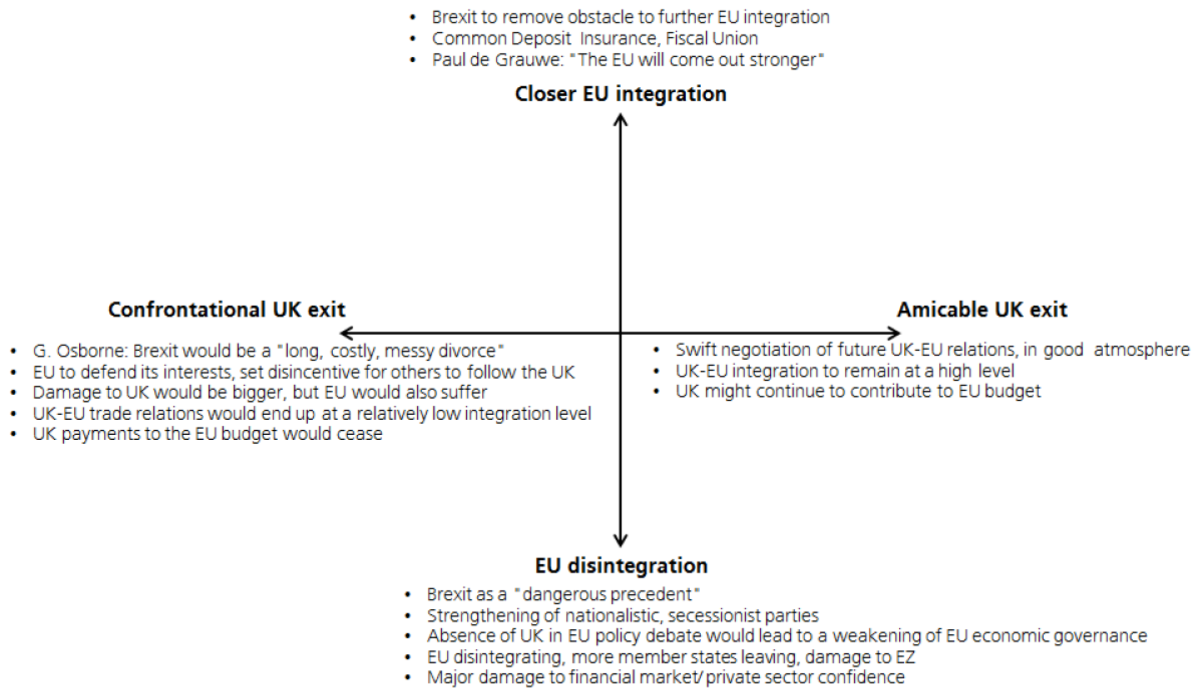
Source: Morgan Stanley Research estimates

	2016			2017		
	Base case	Medium Stress Scenario	High Stress Scenario	Base case	Medium Stress Scenario	High Stress Scenario
Global	**3.0**	**2.8**	**2.7**	**3.4**	**3.1**	**2.7**
US	1.7	1.7	1.7	1.6	1.3	1.0
EA	1.5	1.2	0.8	1.8	1.3	0.3
UK	1.7	1.2	0.8	2.3	1.3	0.5
JPN	0.6	0.5	0.4	0.5	0.4	0.3
China	6.5	6.4	6.3	6.4	6.2	6.0
AXJ	5.9	5.7	5.6	6.1	5.8	5.6
CEEMEA	0.8	0.7	0.6	2.3	2.0	1.5
LATAM	-0.8	-0.9	-1.1	1.4	1.1	0.7

Source: IMF, Morgan Stanley Research estimates

There are also a few technicalities worth highlighting. First, the referendum is not legally binding and current government could choose to ignore the will of the people though that is quite unlikely. Second, Article 50 of the Lisbon Treaty needs to be invoke for the formal process and negotiation to begin for UK to leave EU and once started it is irreversible. David Cameron has used this irreversible conditionality as threat in his campaign though his opponent has said that there is no need to trigger Article 50 and instead a series of informal negotiation could take place. Third, if Article 50 is invoked, UK has 2 years to negotiate after which all treaties that govern UK and EU relationship will expire. The terms of exit will be negotiated between UK's 27 counterparts and each will have a veto over the conditions. Furthermore, all 27 countries national parliaments have to ratify these new deals. The one profession that benefit from this furore is the lawyers. (Note to self, time to market our services to them). How the rest of EU acquiescence to the UK and how EU within reacts will dictate the path of asset prices in the coming months. Bearing in mind there is Dutch elections next March, French in April and Germany in autumn.

Four possible scenarios to rule the world



Source: UBS

What can we expect from policy arsenals in the coming days and how to position for it?

Possible policy responses and actionable trades:

1. We think there will be coordinated liquidity support globally from all central bankers. Swap lines will be activated to ensure functioning markets. **There wouldn't be a liquidity crisis like LTCM or GFC episodes.**

   Actionable trade: We will be buyers of GBP. Prior to today, GBP is already undervalued to the likes of CHF, AUD and USD. We are looking at this as a tactical trade. In order for currencies to weaken further at such accelerated pace, there must be a shortage of that currency. We know for a fact BOJ and ECB have activated lines with BOE this morning and we believe there would be intervention in the coming days hence shortage of GBP will be short-lived though longer term economics will dictate currency. With UK running a budget deficit of 7% of GDP and expected to worsen further as they exit, GBP should depreciate further in the long ran though this scenario is again contingent of post-exit state of its economy.

2. Monetary policy will ease further. BOE will cut rates and ECB/BOJ might as well while Fed will stave off hiking in July.

   Actionable trade: While the obvious choice would be Euro/UK govies, we prefer US govies for better yield and better delta of change from tightening to easing versus the other ECB/BOJ path remains the same albeit a bit more easing in the coming months. We are already well positioned in this space. We also prefer Gold over European and UK govies.

3. QE may be restarted for UK while ECB will front-load its QE, although give ZIRP/NIRP the efficacies must surely be limited compared to previous episodes.

   Actionable trade: Buying European credit spreads especially in high-grade would be the obvious choice given it has the twin propellers of lower interest rates and accelerated pace of QE. We suggest looking at XDEP.GY (European Investment Grade High Yield ETF, YTM: 2% coupon: 3%).

4. Our hope of coordinated fiscal stimulus responses written in May 2016 edition has evaporated. A fractious EU is unlikely to enact any fiscal response. Leaving only Japan to implement additional fiscal impulses. We expect Korea and India to implement as well but their economies are too small to move the needle.

   Actionable trade: We continue to favour Japan small-cap given the earnings risk to Brexit or even Europe is limited. We will continue to look for dividend and infrastructure funds.

5. European financials have been one of the hardest hit sectors. (down 16.78% at the time of writing) Some have asked if this is an opportunity to buy in. As mentioned above, we believe we will see an extension of easy monetary policy and this will continue to be a headwind to European financials. The relatively high yielding Bank Bonds is a sector we've liked before but had sold out of the position about 2 weeks ago. If the asset class pulls back sufficiently we will revisit the space.

Featured Picture/Quote: This old man, he plays one …

"I do not view the European Union as an inspiration for the world. I view it as an enterprise that was conceived wrongly because it expanded too fast and it will probably fail."

LKY, May 2012