Mind the Gap Jun 2016: Brexit and beyond

One of the key tenets of our investment philosophy has been a thoroughly-researched, independently sourced and quantifiable approach when we promulgate our views. We abhor opinions that are conjunctive, anecdotal and are unverifiable with hard data. We have heard from many so call experts on Brexit in past weeks espousing view that they are so certain that UK will vote to remain or to leave. But empirically, no one knows for sure how it will pan out because the percentage of undecided votes from any polling methods used are decidedly large that it can swing the results either way. Furthermore, there is no way anyone can predict how many voters will turn out on the day itself. Many could choose to stay and watch the exciting Iceland vs Austria Euro 2016 game (Not!) or attend Billy Bragg and Underworld in Glastonbury. Who knows?

So instead of listening to hearsays, conjunctures and opinions, we establish some facts.

Fact 1: UK economy accounts for 4% of the world. Not small but not disastrous as compared to our focus of attention on US and China which account for close to 40% of global GDP.

Fact 2: In the event of Brexit, many economist estimate impact of -1% to UK GDP from 2017 onwards (DB, JPM, EIU estimates). Not small as it will halve the current 2017 GDP forecast for UK.

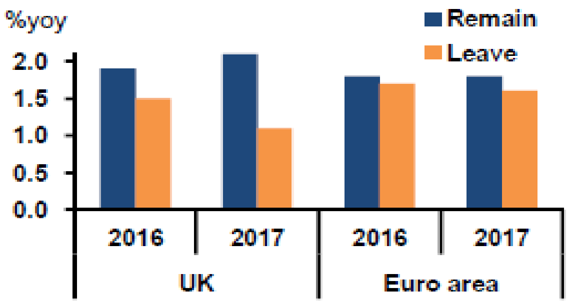
Fact 3: But the GDP impact is highly localised. Halving UK GDP from 2% to 1% in 2017 will impact Euro growth by less than 0.5% pt and the world by 0.1%.

Leave risk has swung but margin error still high

Week of	6 June 10-Poll Av.	Change over two weeks
Remain	44.1%	-3.3pp
Leave	43.4%	+4.1pp
Undecided	11.2%	-0.6pp

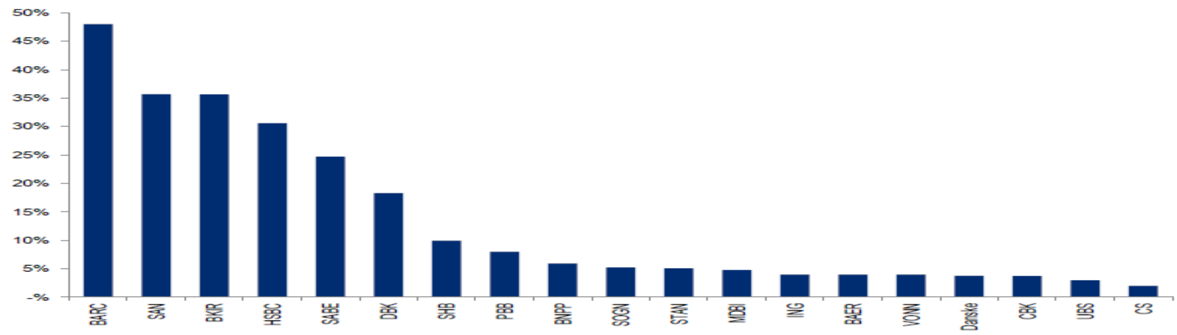
Note: Poll shares do not add to 100%, remainder undecided.
Sources: YouGov, ICM, Survation, Ipsos/MORI, ORB, Populus and Citi Research

Impact is manageable for rest of the world.



Source: J.P.Morgan

Fact 4: A leave outcome cannot have a prolong contagion effect like the US sub-prime debts or even China growth ambivalence. Revenues exposures to GBP isn't large even for European banks. For example, UK largest bank, HSBC, derives 30% of its earnings from UK operations. However, aside from earnings from local lending or GBP/EURO loans, other parts of its business like trading can easily move to other parts of Europe. CS and UBS income from GBP is negligible while DB has under 20% of which close to half is related to easy to relocate trading desks.



Source: Company Reports and Citi Research Estimates. Note: * Based on available disclosure from revenues, loans, or assets. Banks will also hedge currency exposures. We have omitted UK -focused banks, with the exception of Barclays and HSBC, as they have at least 90% exposure to GBP.

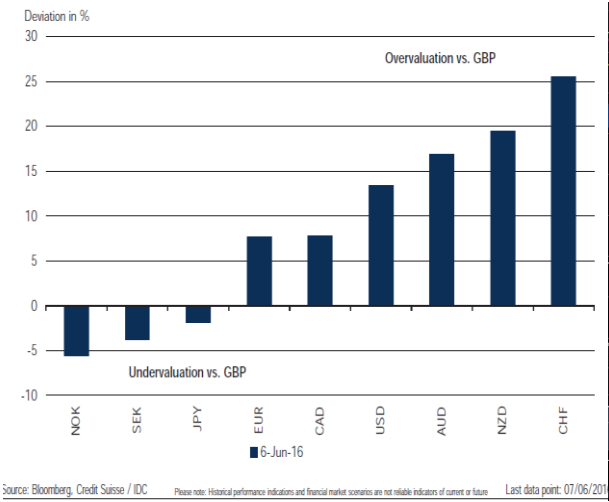
Fact 5: Complacency is not wide-spread. FX and credit ready for it, equities not. For a systemic shock, there must be wanton leverage undertaken by complacent participants. This event is already well-televised and there isn't any evidence of over-leveraged positioning. GBP has already reacted down 10% since 3Q15. Street worst case scenario is another -10% to 1.20. Its implied volatility is 1.5x higher than USD/EUR and even USD/JPY. Its 3months implied volatility is higher than back in Europe existential crisis in 2011.

GBP has fallen 10% from 3Q15; another -10% max

GBP implied volatility is high

For some currency crosses, GBP appears cheap now. Credit spreads has tightened 10bps from recent low, but admittedly at 40bps spread is half of 2011 levels. It is the equities market that is vulnerable to a Leave outcome with a -10% downside probable in the short-term and more in the longe-term as the impact percolates to the economy, especially for the property sector, and equity risk premium rise for UK assets.

GBP is cheap relative to CHF, AUD, NZD



UK Equities risk of another 10% down

The Big Unknown: Political contagion to rest of EU. Could UK voting to leave be the fulcrum for other anti-EU parties to instigate their own "To-Leave" referendum? It will really depend on the final outcome of the UK experience. A less negative outcome for UK will certainly pique anti-EU parties to be more militant. A debilitating impact may just energize the pro-parties to push for greater integration. Furthermore, a united EU will likely to be able to initiate pro-fiscal policy that is very much needed now.

Asset Allocation Strategy:

In summary, we believe a Leave outcome will only have a temporary adverse impact before ECB and BOE step in to intervene. It is a highly localised issue and some asset classes like GBP and credit have already discounted the outcome.

We have been positioned defensively in the past month raising cash, increasing our USD exposures and keeping equities underweight all this while pursuing an income strategy. We will be looking to deploy our cash by extending this theme further in the event of a leave outcome and dislocation in asset prices. We will be looking at an income-streaming infrastructure fund and global dividend strategy. In a Remain scenario, we will be closing out our hedges quickly and look for tactical long into European financials and initiating into a European small-cap fund. The bigger issues remain the path of US rates, sustainability of growth in China, the looming spectre of cost-push inflation pressures against the backdrop of negative growth in productivity and capex globally.

Featured Picture/Quote: Maybe he knows the outcome ahead.

https://www.youtube.com/watch?v=RK34uNGvMbs