EMEA PERSPECTIVES

Post-Brexit Europe

J.P. MORGAN PRIVATE BANK

Opportunities and challenges within a new relationship

J.P.Morgan
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Post-Brexit Europe: opportunities and challenges within a new relationship

Whatever the long-term outcome of the UK’s recent vote to leave the European Union (EU), uncertainty is likely to persist for a number of years. In this edition of *EMEA Perspectives* we explore the economic background and the medium to long-term implications for portfolio strategy of this unsettled period not only for the UK, but for Europe as a whole.
The morning after the night before

The initial market reaction to the UK’s decision to quit the EU sent shockwaves around the world, and was accompanied by political instability in Britain and confusion abroad. This phase saw a global sell-off in riskier assets and a flight to safe havens, prompting further falls in government bond yields. Stock markets have since regained most of the lost ground, although sterling remains significantly weaker against the US dollar than on the day before the referendum.

Following the referendum result and the subsequent change in UK leadership, new Prime Minister Theresa May seems in no hurry to invoke Article 50 of the Lisbon Treaty, which would trigger the two-year period to negotiate exit terms. There are many unanswered questions about the future framework of the UK’s engagement with the EU, particularly regarding the balancing act of maintaining beneficial trade agreements while increasing control over migration.

The UK now faces a period of uncertainty and adjustment, and we expect some market and economic volatility as the process unfolds. On the positive side, a weaker pound is good news for British exporters because it makes the cost of their goods and services more competitive abroad. It should also boost the overseas earnings of FTSE 100 companies, which will be worth more when repatriated into sterling. Notably, the FTSE 100 has outperformed the domestically focused FTSE 250 in the wake of the Brexit vote (figure 1).

However, the shockwaves are likely to reverberate for some time. Some large companies are already thinking about moving staff or even their headquarters out of the UK. In particular, banks and fund managers are concerned about maintaining access to the single market. Meanwhile, there is potential for a loss of output and jobs caused by a delay in investment and consumption.
The FTSE 100 has outperformed the domestically focused FTSE 250 since the Brexit vote.

EXPORTS OFFER A SILVER LINING

Forecasts anticipate a 3.4% increase by 2017
Political risk extends beyond the UK, with presidential elections in the US later this year and France in 2017, and general elections in Germany and The Netherlands next year too. Meanwhile, European leaders face two pressing problems - managing the negotiations with Britain and holding their union together. The EU will need to reassure its populations and investors regarding its stability and future.

Uncertainty surrounding Brexit is adding to existing anxiety about Europe’s banking system (figure 2). The spotlight is on Italy, where banks are struggling with a burden of bad debt - loans worth €360 billion (£307 billion) that are unlikely to be repaid fully. These form a potential flashpoint in Europe’s third-largest economy that has for some time been seen as posing wider risks to the euro area.

There is a risk that the failure of a large bank could set off a wider financial crisis. This situation cuts to the heart of Europe’s problems, with different economies running at different speeds. It presents another test for the region’s policymakers and whether they have the resolve - and the popular support – to push ahead with further measures, including creating a fully functioning banking union.

“Political risk extends beyond the UK, with presidential elections in the US later this year and France in 2017, and general elections in Germany and The Netherlands next year too.”
FIGURE 2: ANOTHER BANKING CRISIS?

European banking stocks have underperformed the rest of the market substantially this year.

Assessing the economic backdrop

The uncertain environment is likely to constrain domestic business decisions within the UK as well as foreign investment flows. There has already been a dip in UK consumer confidence, as well as a large drop in the latest Purchasing Managers’ index. Economic data over the next six to nine months will reveal the full impact of recent events, although so far the signs of economic weakness are limited to the UK.

These events are happening within a world of low growth, low inflation and record low interest rates (figure 3). The economic impact of Brexit is likely to be most pronounced in the UK and possibly continental Europe. Yet any dip in sentiment and confidence could have wider implications for the global economy.

Although recent employment data in the US has been volatile, on the whole its economy appears resilient across various other measures. Activity in China has also held up relatively well over the first half of the year following extensive monetary and fiscal stimulus by the government. Conditions across other large emerging markets remain mixed, but largely stable (with the exception of Brazil).

Major central banks continue to be supportive with their accommodative monetary policies, and the chances of any significant tightening in the foreseeable future remain low. Bank of England Governor Mark Carney believes a downturn is on the way and has suggested the UK is already suffering from “economic...
FIGURE 3: RATES ARE AT RECORD LOWS

Benchmark 10-year German government bond yields have entered negative territory for the first time recently.

post-traumatic stress disorder”. To mitigate this risk, he is prepared to cut the base rate and unleash another round of stimulus. Meanwhile, the European Central Bank is likely to extend or even expand its quantitative easing (QE) measures, having already been aggressively purchasing European listed corporate debt this year through its corporate sector purchase programme (CSPP).

Yet financial markets have become sceptical about QE because they realise the impact on the real economy is muted, while record low rates are causing pain for savers. They are also causing problems for company pension schemes, where falls in the discount rates (linked to the interest rate) they use to assess future liabilities have increased their deficits dramatically. There is a sense that more will need to be done, potentially including significant fiscal stimulus, to help support and hopefully accelerate global growth.

“There is a sense that more will need to be done, potentially including significant fiscal stimulus, to help support and hopefully accelerate global growth.”
An uncertain environment for investors

When it comes to corporate earnings expectations for European companies, the pattern has been similar over the past few years. Analysts have started the year with double-digit profit growth forecasts. These have gradually fallen to zero by the end of the year for various reasons, such as sluggish growth in the broader economy or collapsing commodity prices recently (figure 4).

For 2016, analysts started with a low figure. Although there are pockets of growth, the impact of Brexit has led to further downgrades of consensus expectations in anticipation of a drop-off in earnings and profits growth. On these lowered expectations, this year’s earnings seasons have so far been broadly positive for European companies. However, companies also continue to guide for caution as the full impact of Brexit is yet to be felt on their businesses.

Currency markets are also likely to remain volatile and driven by upcoming political events. Following a dramatic fall on the day of the referendum announcement, sterling has stabilised, but could see renewed pressure owing to the UK’s large current account deficit and public debt.
FIGURE 4: LOWER EXPECTATIONS

World GDP forecasts have continued to fall, which is likely to lead to slower earnings growth.

Percent

4.0%

3.6%

3.2%

2.8%


Stay focused on enduring investment themes

In a world of low growth and low rates, holding assets that generate yield, such as high-dividend yielding stocks, extended credit and investment grade credit, remains an attractive strategy. Yet we believe the uncertain outlook should not distract investors from seeking exposure to enduring reasonably stable investment trends and companies that may deliver consistent growth.

For example, cosmetics manufacturers are benefiting from the substantial growth in demand around the world for make-up. In the automotive industry, the transition towards driverless cars is happening faster than expected with the rapid adoption of features such as assisted parking, emergency braking and automatic lane changing (Visual 2: In the fast lane).

Other technology trends have further development potential including cloud computing, the ‘internet of things’ and augmented reality. These drivers of growth offer resilience against a volatile and uncertain economic backdrop, and are attractive investment stories alongside yield generation.

At a time of uncertainty in different parts of the world, exposure to large, geographically diversified companies can help offset regional risks. We also seek out companies with strong balance sheets, which can take advantage of the low cost of debt to invest in their own businesses or grow through strategic acquisitions.

Although markets tend to be effective discounting mechanisms, we believe
they may have overreacted in the initial aftermath of the referendum. For example, the suspension of commercial property fund redemptions by a number of big players has precipitated a broader sell-off in the UK property sector including housebuilders and other asset managers. This situation may have opened up value opportunities for patient long-term investors because any economic uncertainty is probably more than discounted already.

Meanwhile, emerging markets have been less popular with investors over the past three years owing to slowing growth and weak commodity prices, but long-term growth trends persist. These include rising household incomes, which are pulling spending closer to averages across the developed world. Moreover, the stabilisation of emerging market currencies, after a long period of weakness and against the backdrop of a more cautious stance by the Federal Reserve in raising interest rates, makes European companies with exposure there incrementally more attractive. We are increasingly focusing our attention on this subset of companies in consumer-exposed areas and mining.

Many investors will be waiting for clarity on the UK’s future relationship with Europe. Yet we believe it could be a long time coming. That is why we are maintaining our commitment to disciplined investment research in order to continue seeking out attractive investment opportunities.

“In a world of low growth and low rates, holding assets that generate yield, such as high-dividend yielding stocks, extended credit and investment grade credit, remains an attractive strategy.”
IN THE FAST LANE

Automated driving is predicted to grow dramatically over the next decade.

**HMI**
The user interface or human-machine interface is the part of the machine that handles the human-machine interaction.

**RADAR**
Prevents accidents by detecting obstructions in the car’s blind spots.

**LIDAR**
Accurate to within 2 cm, the Lidar is a ranging system that takes a 360 degree picture of the car’s surroundings.
Acronyms

CSPP Corporate sector purchase programme
EU European Union
Eurostoxx 600 Index Represents large, mid and small capitalization companies across 18 countries of the European region
Eurostoxx 600 Banks Index Represents capitalization banks across 18 countries of the European region
FTSE 100 A share index of the 100 companies listed on the London Stock Exchange with the highest market capitalisation
FTSE 250 A capitalisation-weighted index consisting of the 101st to the 350th largest companies listed on the London Stock Exchange
GDP Gross Domestic Product
QE Quantitative easing

Important information

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