بنك أبوظبي التجاري
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Brexit confirms our stagnant global growth scenario

The UK referendum is much more a symptom of persistent secular deflationary forces in advanced economies than the inevitable outcome of longstanding cool relations between the UK and EU

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- *Whilst the traditional discomfort of the UK within the EU has certainly facilitated the Brexit outcome, its deeper cause lies in the incapacity of governments across advanced economies to lift their countries out of secular wage stagnation towards more inclusive and sustainable economic growth*

- *Brexit merely confirms our stagnant global growth scenario which has been the basic argument for our underweight stance on risky assets, and equities in particular. See in particular our latest Quarterly Investment View, in which we once more reiterated our February 2015 shift to an underweight equity stance*

- *The risk of a global recession has once more risen*

- *On the back of increased political risks we had already switched in January to an underweight in European equities. There is no reason to change our stance since the risk premium on European and UK assets has now effectively been permanently raised. In fact it is important to note that the political ramifications of this referendum outcome will take months, if not years, to work out:*
    - *EU governments will struggle to take a united position on UK exit*
    - *new UK government will struggle to define a coherent exit strategy (as of now the country has no policy whatsoever with regard to its relationship with its biggest business partner)*
    - *potential EU domino effects (referendums in other countries) and Scottish secession are not on the immediate horizon, but will continue to hang over European – and global – equity markets as a black cloud*

- *Global central banks will once more do the heavy-lifting in terms of stabilizing the markets. The trick will be for the Federal Reserve in particular to ensure that the US dollar remains relatively weak such that the rot does not spill over to China, emerging and commodity markets. Thus rate hikes are off the cards for now.*

- *A continuing weak greenback, however, will have a further deflationary impact on Europe and Japan, reinforcing our view that global central bank intervention has increasingly become a zero-sum game.*

- *Thus, while Brexit might not turn out to be the final Lehman event, it does resemble the preliminary Bear Stearns episode. For us the prospects for global equity and risk markets remain clearly downward, not upward.*

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Reiterating our asset allocation, adding gold

It has been since February 2015 now that we moved underweight global equities and overweight US Treasuries. At the beginning of this year we additionally moved to an underweight position in European equities in view of heightened political risks in the old continent. Over the past months we have on numerous occasions reiterated our bearish stance by insisting on Treasuries and defensive equity sectors, and recently pushing for domestic market oriented US equities that are inherently more insulated from negative spill-overs of international trade shrinkage and potential growth implosions in Europe and elsewhere.

Brexit is a shock, yes, but in fact it is "merely" reinforcing an already ongoing trend of stagnant global growth

Over the next weeks and months global central banks might well be able to stabilize currency movements and thus financial markets. The domino effect of other referendums on the European continent is likely not to materialize very soon as prudent electorates and politicians will want to first understand what exit means for the United Kingdom, before experimenting a separation themselves. Similarly the Scots would want to better comprehend the new terms of "agreement" between the EU and the UK before divorcing from the latter.

A permanent solution to Europe's political, economic and financial architecture is, however, nowhere in sight and the secular forces (historically high debt levels and unfavourable demographics) that are determining structurally lower growth rates and increasing inequality across advanced economies, and thus also in Europe, are unlikely to abate in the coming years.

What's worse, a significant fall in investments could push the UK in recessionary territory. And since about 16% of the exports of the remaining EU countries goes to the UK, such development might well jeopardize growth in the EU sooner rather than later.

On the other side of the Atlantic we have not seen a lift in wages and personal spending that will be able to further protract the US relatively resilient business cycle in the absence of continuing demand support from Europe. Not surprisingly, political risk in the United States has also risen to an unprecedented level, just as in Europe (whilst, of course, in absolute terms the political risk level in the United States remains much lower than in Europe).

Adding gold to our risk-off asset allocation

So far we had backed away from recommending gold as we considered that global deflation and shrinking emerging markets' trade surpluses are not good for the precious metal. The further increase in global risks (including the inevitably increasing risk of central bank paralysis or policy errors) might now well outweigh those factors. Thus we add a call on gold to our asset allocation.

The short term and the solitude of being a bear

Equity markets only want to go up. Over the last months the main driver behind the pick-up in global risk assets has been the weaker US dollar, as it became increasingly clear that the Federal Reserve was moving away from its hawkish policy stance. The last week the main driver was the "conviction" that the UK electorate would opt to stay in the European Union. Throughout we have insisted that the weaker greenback was unlikely to solve the world's growth problems, and that the Brexit issue – whatever the outcome of the referendum – was merely symptomatic of much deeper issues related to stagnating wages across the UK and Europe, and the consequent disenchantment of the middle class with the political institutions and governments, whatever their political colour. We were, in our concern, amongst the lonely bears.

And we might still remain in solitude for a while: in the short term markets, specifically China and emerging markets might well continue to benefit from a relatively weak greenback. There is a distinct possibility that the US dollar will remain in the range of 1.05 and 1.15 versus the euro, where it has effectively been trading since March 2015. This is so because any divergence in monetary policy between the Federal Reserve and the European Central Bank was already priced in by that date, and now the Federal Reserve's reluctance to further hike rates constitutes by itself an important cap to a further appreciation of the greenback. As we have recently pointed out, the purpose of hawkish language by the Federal Reserve is to avoid market complacency, rather than announce a certain and effective upcoming rate hike. On the contrary, Mrs. Yellen's growing concern about overseas *and* domestic growth might well lead to more significant reversals in the Fed's thinking: do not exclude a rate cut!

The long term and the inevitable rise of the greenback, emerging market troubles

Over the longer term, one should have few illusions: US household deleveraging will continue. As one can see from below chart, US household deleveraging – in other words the personal savings rate – is *the* main long-term driver of the US dollar. Indeed economic logic suggests that only a stronger US dollar will allow US households to remain the "global consumer of last resort", whilst at the same time reducing their debts. Over time, relatively high US Treasury yields – versus depressed German Bunds and Japanese Government yields - will facilitate such strengthening.

Source: Bloomberg

The weaker US dollar temporarily puts a brake on further capital outflows out of China, thereby allowing the government to continue to stimulate the economy. The problem is that by now such stimulus is highly ineffective: for every single US dollar of additional (stimulus-induced) GDP, there is a larger increase in debt. Thus when the US dollar will finally strengthen, China's problems will come back with a vengeance and the devaluation of the Renminbi will be inevitable.

In a similar vein the weaker US dollar is preventing commodity prices from further collapsing, thereby making life easier for emerging markets that export commodities. As soon as the US dollar will strengthen again, however, commodity prices will further correct whilst many of these countries have still large amounts of US dollar-denominated debt outstanding.

Conclusion: Brexit might not be Lehman, but it does resemble Bear Stearns

Central banks might very well be successful in preventing Brexit from becoming the new Lehman. In September 2008, the global economy caught up with the reality of massively overvalued securities that had intoxicated the major banks and financial markets. In June 2016, on the other hand, it is the financial markets who are receiving (once more) a warning shot from a global economic system that is increasingly struggling to deliver sustainable and wide-spread growth.

Whilst stagnation in advanced economies has now reached the point that it is seriously jeopardizing political stability, a relatively solid banking system and still supportive monetary policies (specifically the continuing supportive policy by the Federal Reserve), might well once more trigger a temporary upward reversal in the fortunes of risk assets.

We will of course be looking for tactical opportunities, but we will trade very cautiously in any relief rally. For now we suggest to sell on strength and, in fact, we stick to our already highlighted over-weights in the defensive and domestically oriented US equities, such as – amongst others – consumer staples, telecoms, utilities and health care. In general we will continue to steer clear from emerging markets with the exception of larger emerging markets that do not export commodities, such as India. We will also continue to avoid the financial, consumer discretionary, industrials and technology sectors.

Over the longer term, and for sure as we move into 2017, we have little doubt that equity and other global risk assets will continue to suffer, and our current asset allocation will once more be vindicated. Brexit might not be the final Lehman event, but it might very well resemble the preliminary Bear Stearns episode.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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