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Special Feature: Post-Brexit Outlook

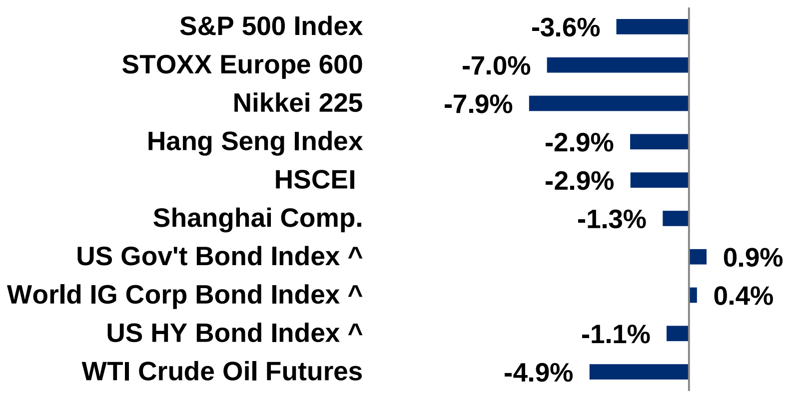
Jun 27, 2016

Wealth Management Investment Strategy Team, GCB HK

Post Brexit - First-day market performance & Outlook

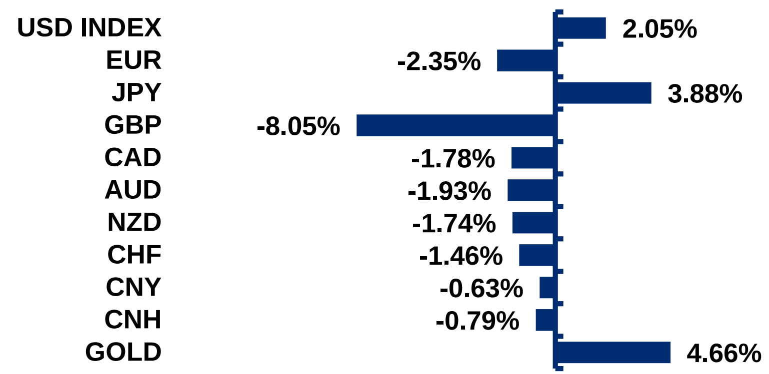
Major surprise as vote tallies point to Brexit

Chart 1: Market performance on June 24



Source: Bloomberg L.P., as of June 24, 2016 ^Reference Indices: Citigroup Bond Indices Series

Chart 2: FX performance on June 24



Source: Bloomberg L.P., as of June 24, 2016

Market	Impact	Outlook
Investment Grade Bonds	+	Performance may remain resilient on safe-haven flows
Global Equity	-/+	May have further 8% downside from Jun 24 close but not a bear market
US Equity	+	Valuation level suggests upside not downside with support from earnings
European Equity	-	Contagion fear. Lower index target and downgrade financials
Japan Equity	-	Could be hurt by a strong yen

Currency	Impact	Outlook
Gold	+	Safe-haven flow may support gold to $1,350-$1,400 in short term
JPY	+	Brexit related safe haven flows may push USD/JPY back to 95-99 levels
AUD	-	May benefit from its AAA standing and may range trade between 0.7212-0.7648
EUR	-	Prospects of the ECB delivering further stimulus may weaken EUR to 1.07/1.08
GBP	-	GBP/USD may tumble to 1.20-1.25 as Brexit may hit UK economy

Brexit Process – What's next?

Brexit could take more than two years

❖ Steps for Brexit to realize

Step 1
- Britain's Prime Minister Cameron will resign in October.
- A new Prime Minister will be chosen by a Conservative party leadership election.

Step 2
- The new Prime Minister will decide when to trigger Article 50 of the Lisbon Treaty.
- Article 50 may be triggered within months after the referendum, perhaps in Q4 2016.

Step 3
- The UK will be released from its EU Treaty obligations two years after Article 50 is invoked or when the withdrawal agreement has been accepted, whichever is earlier.
- The two-year period can be extended if agreed unanimously by the UK and every other EU members.

Step 4
- We would regard the likely emergence of new "steady state" in trade agreements, though not with all of the current arrangements replaced, as unlikely, before 2019 at the earliest.
- It underscores the likelihood of an extended period of uncertainty, and perhaps not until 2025 or later.

UK Political and Economic Implications

Brexit may trigger substantial downward revisions of UK growth forecasts

❖ Political implications

- ▶ **New PM:** We expect a new Conservative Party leader and PM to be chosen before starting exit negotiations.
- ▶ **Cabinet shuffle:** A cabinet shuffle, with key positions for Leave supporters, would also be likely.
- ▶ **Ireland & Scotland:** Northern Ireland and Scotland may look for a second independence referendum of their own.

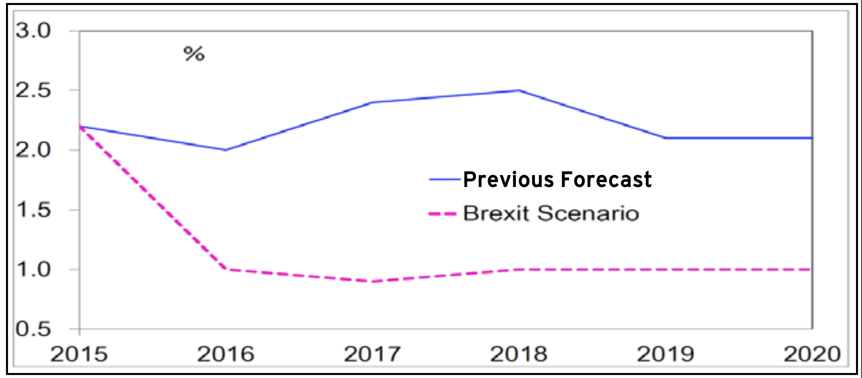
❖ Economic implications

- ▶ **Lower growth:** We expect a Brexit vote to lower UK GDP by 3-4pp over the next three years(Chart 3).
- ▶ **Technical recession:** This would come as a result of lower consumption and lower investment. UK may go into technical recession for a few quarters, starting in Q3.
- ▶ **CPI could shoot up:** The decline in sterling would increase our CPI forecasts to 3-4% in 2017 and 2018.

❖ Policy response

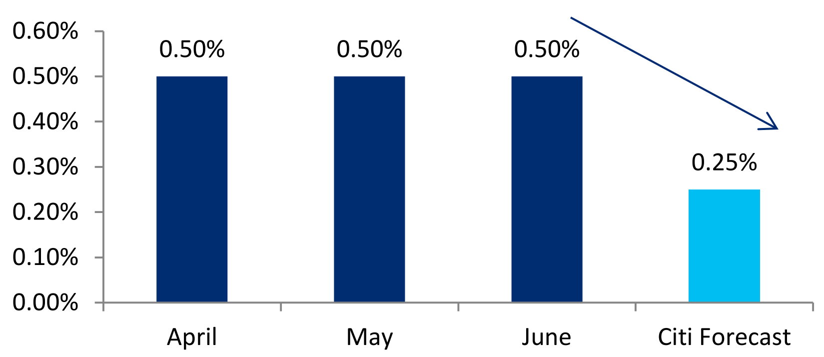
- ▶ **BoE support:** The Bank of England(BoE) Governor Mark Carney pledged coordinated central bank support to contain volatility.
- ▶ He said the central bank is ready to provide GBP250bn of additional funds to support financial markets.
- ▶ **Potential rate cut:** We expect the BoE may cut rate by 25bp (at least by July 14) and perhaps restart additional asset purchases(Chart 4).

Chart 3: UK GDP forecasts



Source: Citi, as of June 24, 2016

Chart 4: UK Interest Rate Forecast



Source: Citi, as of June 24, 2016

EU Political and Economic Implications

Brexit may lead to more referendums by other EU countries

Political implications

- **Brexit Contagion:** At the EU level, it will likely freeze EU integration and increase the risk of copycat referendums, among other political risks(Chart 5).
- **Lingering political uncertainties:** In 2017, Germany and France will have elections, which may raise uncertainties on their stance regarding EU(Chart 6).

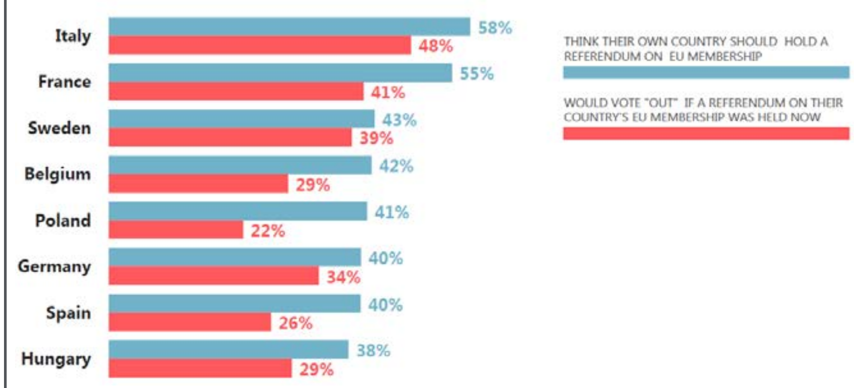
Economic implications

- **A significant trading partner:** The EU is a very significant trading partner for the UK - in 2015, more than 40% of UK exports went to the EU.
- **Weakening growth:** We estimated a weakening in the Eurozone's growth rate for the coming year of 0.3%-0.5% below a current forecast of 1.6% in both 2016 and 2017.
- **Banks could face serious losses:** Sharp adjustment in the value of UK assets held by EU residents, not just banks, (46% of rest-EU GDP in 2013) may reduce wealth, while at the margin, banks with particularly large exposures to the UK may face serious losses.

Policy response

- **ECB may cut rate:** The European Central Bank(ECB) will likely envisage a cut in their policy rate (21 July).
- **More tools from ECB:** The ECB may also temporarily exercise some flexibility on the implementation of its Asset Purchase Programme (APP), including perhaps front-loading more government bond purchases in coming weeks.

Chart 5: Brexit Contagion - Who else wants to leave the EU?



Source: Ipsos Public Affairs, as of May, 2016

Chart 6: Major EU dates and elections

Date	Country
Oct 2016	Italy Constitutional Referendum
Mar 2017	Netherlands General Election
Apr/May 2017	France Presidential Election
Aug 27-Oct 22 2017	German Federal Election

Source: Citi, as of June 24, 2016

Global Political and Economic Implications

Brexit may have limited impact on global growth

- **Political implications**
  - **Global risk:** Brexit is an unprecedented event for the EU, and the most destabilizing instance of Vox Populi Risk globally to date.
  - **Brexit Contagion:** Brexit may reinforce protectionist, inward-looking and nativist tendencies globally in near-term, and probably weaken prospects for internal collaboration.

- **Economic implications**
  - **Global:** Barring an unlikely breakup of the Eurozone, the output loss for world growth may be measured in just tenths of a percentage point, even if UK experiences a mild recession.
  - **US:** We see little direct effect of Brexit to the US economy and recession in US is unlikely, but increased uncertainty may modestly reduce the pace of US growth this year.
  - **Japan:** We revised Japan's GDP growth forecasts and now expect real GDP growth of +0.4% for fiscal 2016 and +0.5% for fiscal 2017 versus previous forecasts of +0.5% and +0.7%, respectively.

- **Policy response (Chart 7)**
  - **Global Central Banks:** In the event of disorderly currency moves, G7 central banks could launch coordinated FX interventions.
  - **Fed:** The Federal Reserve(Fed) may raise rate in September, but it may consider delaying its next rate hike until Dec or even later.
  - **RBA:** Brexit vote adds to the case for another Reserve Bank of Australia(RBA) cut, probably in August.
  - **BoJ:** The likelihood of additional Bank of Japan(BoJ) action has increased in July.

Chart 7: Interest rate forecasts on major countries %

	6/24/16	2Q '16	3Q '16	4Q '16
US	0.50	0.50	0.75	0.75
Eurozone	-0.40	-0.40	-0.50	-0.50
UK	0.50	0.50	0.25	0.25
Japan	-0.10	-0.10	-0.30	-0.30
Australia	1.75	1.75	1.50	1.50
New Zealand	2.25	2.25	2.00	2.00
Canada	0.50	0.50	0.50	0.25

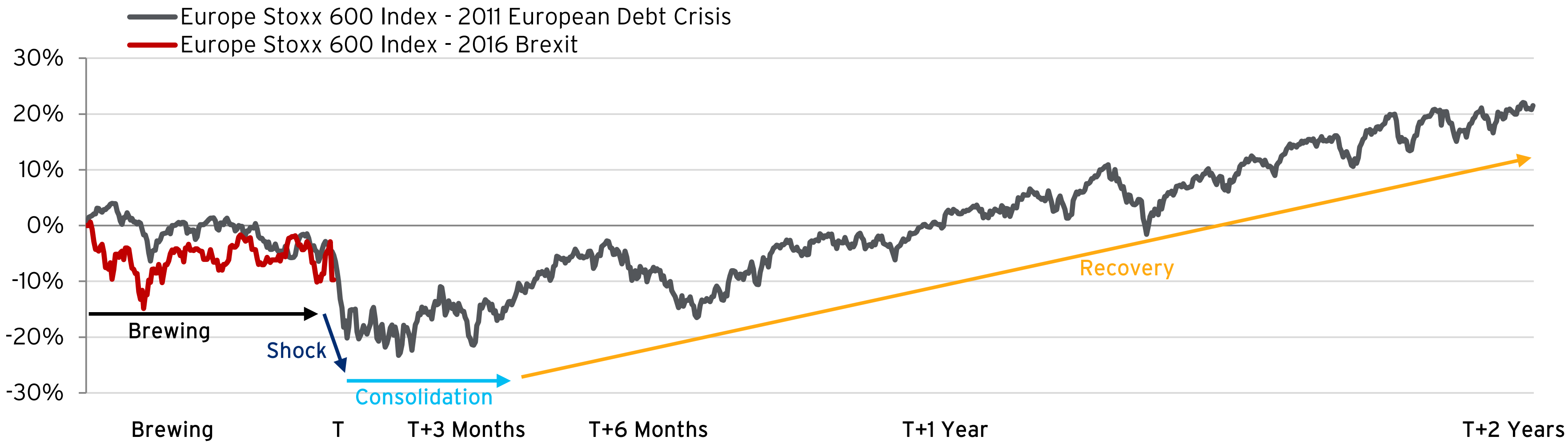
Source: Citi, as of June 24, 2016 Rate cut Rate hike

Please note and carefully read the Important Disclosure on the last part

Experience from European Debt Crisis

Fixed Income and gold outperformed but equities consolidated for some time

Chart 8: 2011 European Debt Crisis vs 2016 Brexit – 4 Market Stages



Asset Classes	Indices	Sell off			Consolidation	Recovery		
		Post 7 days	Post 15 days	Post 1 Month	Post 3 Months	Post 6 Months	Post 1 Year	Post 2 Year
Equities	MSCI AC World Index	-3%	-11%	-16%	-15%	-10%	-10%	8%
	S&P 500 Index	-4%	-11%	-16%	-10%	-3%	1%	26%
	Europe Stoxx 600 Index	-2%	-12%	-18%	-14%	-7%	-5%	10%
	MSCI AC Asia ex Japan Index	-1%	-9%	-16%	-21%	-16%	-17%	-11%
	MSCI Emerging Markets Index	-1%	-10%	-16%	-21%	-15%	-19%	-18%
	Topix Index	-3%	-8%	-13%	-14%	-15%	-16%	39%
Fixed Income	Citi High-Yield Market Index	0%	-2%	-4%	-4%	0%	8%	19%
	Citi World BIG Index USD	1%	1%	3%	1%	0%	2%	1%
	J.P. Morgan Asia Credit Index	1%	2%	1%	-1%	1%	10%	11%
Others	Gold	2%	4%	16%	1%	4%	-1%	-19%
	Oil (WTI)	-4%	-13%	-18%	-15%	1%	-8%	8%

Source: Bloomberg L.P., as of June 24, 2016

Investment Strategy Post Brexit

Stay On Course with Yield Plays

(1) Stay On Course with Yield Plays

❖ **Bond Refugee and CDS-adjusted Dividend Plays (Chart 9)**

- **Investment-Grade Bond:** More than 30% of global developed sovereign debt now trades with yields below zero. Overweight investment grade corporate bonds as yields remain relatively attractive. Favour long-duration US credits.
- **Dividend stocks:** MSCI World High Dividend Index now yields 4.03%, compares to MSCI AC World Index's 2.79%. On June 24, global equities dropped 4.8%, while high dividend stocks fell 4.3%.

(2) Reduce Portfolio Risk from certain assets

❖ **UK and European Assets**

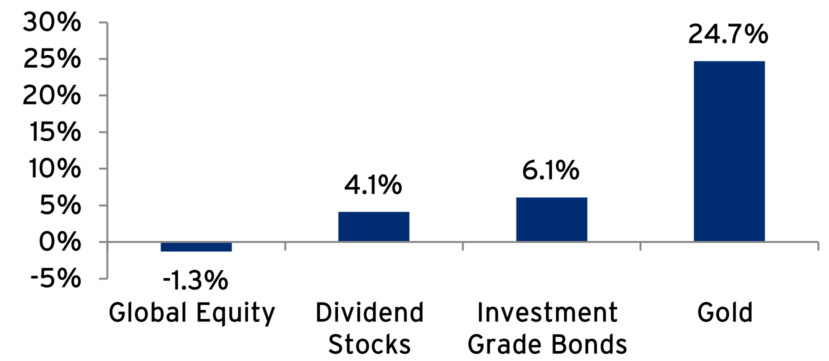
- **UK and European equities** – Citi analysts have revised down Stoxx 600 end-2016 target from 380 to 310(Chart 10), FTSE 100 revised down from 6,600 to 6,000.
- **UK and European Financials** are likely to be big losers. Banks could fall 20-30% in coming days/weeks. We lower exposure to European Financial sectors.
- **European credit:** A sell-off in risk assets would lead to sharply wider spreads.

(3) Find Opportunities from Market Dislocation

❖ **Europe only accounted for 9% of S&P500 Sales**

- **US equity** - Earnings are up roughly 20% since 2011-2012; therefore, US equity index may not re-test of those lows during the case with Grexit anxiety. In Oct 2011, S&P dropped to as low as 1,100.

Chart 9: Year-to-date performance



Source: Bloomberg L.P., as of June 24, 2016

Chart 10: The Stoxx 600 Index

Source: Bloomberg L.P., as of June 24, 2016

Investment Implications – HK & China

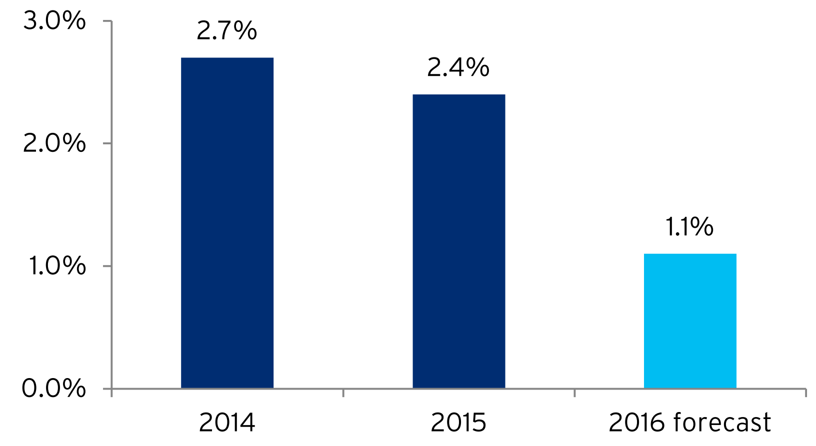
May buy into weakness on China equities

- **Implications on China**
  - **Economic transition push:** Given rising uncertainty of globalization, China may have to increasingly emphasize domestic consumption and manufacturing R&D innovation.
  - **Passive CNYUSD weakness:** Unfavorable to deep cyclicals and FX-debt sectors, but should not lead to panic as in Jan/Feb 2016 given likely milder FX reserve declines.
  - **High-dividend-yield stocks:** High-dividend-yield stocks may be favored given lower-for-longer yields expectation.

- **China Equity Strategy**
  - **Buy into weakness:** Expect manageable mid-single-digit-percent downside for China indices in the near term before recovering/stabilization. We suggest investors buy into weakness.
  - Prefer sectors such as I.T., Cons. Disc. & Health Care, and suggest avoid deep cyclicals such as Materials and Energy.

- **Implications on Hong Kong**
  - **Impact on HK economy:** We keep our 1.1%yoy GDP growth forecast for HK, but see downside risk given the unfolding impacts on equity and property markets. (Chart 11)
  - **Impact on banks:** Brexit may delay rate hike, and expectation on future net interest margin benefits may reduce.
  - **Preference:** Dividend stocks preferred; Rate hike angle reduced.
  - Banks focusing on HK and China may see relative loan growth and net interest income outperformance, compared with their UK-rooted peers.

Chart 11: Hong Kong GDP growth (yoy)

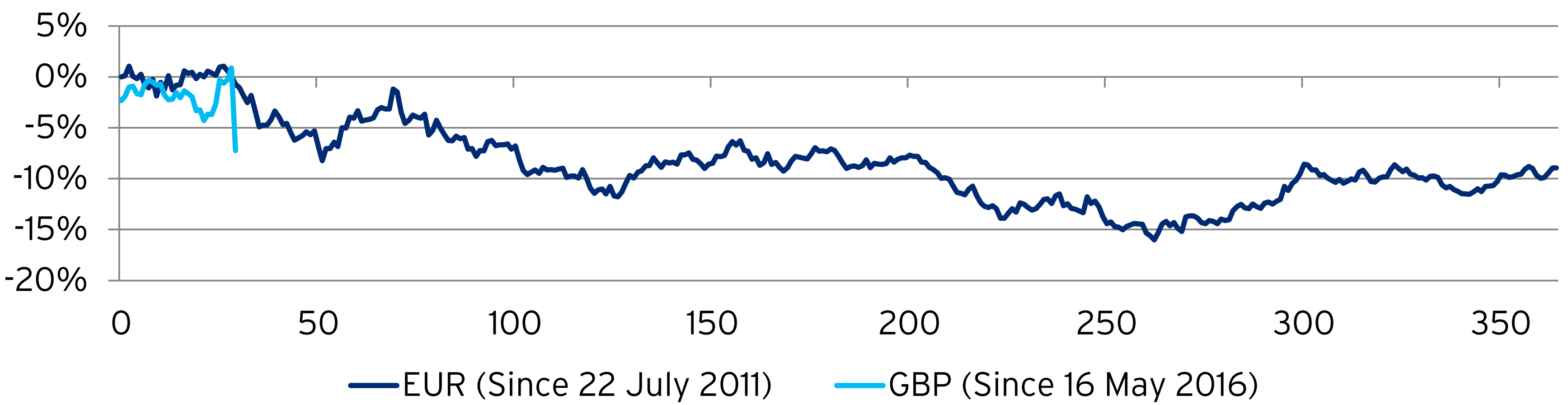


Source: Bloomberg L.P., as of June 24, 2016

Experience from European Debt Crisis

Gold and JPY outperformed in short term

Chart 12: European Debt Crisis vs Brexit Crisis



vs USD	Post 7 days	Post 15 days	Post 30 days	Post 90 days	Post 180 days
EUR	-1.1%	-0.8%	-1.1%	-7.8%	-7.1%
GBP	0.0%	-0.1%	-0.5%	-5.3%	-1.8%
AUD	-0.7%	-4.6%	-1.9%	-10.5%	-4.7%
JPY	1.8%	2.4%	2.2%	1.0%	-5.2%
Gold	3.7%	9.1%	17.6%	5.1%	4.2%

Source: Bloomberg L.P., as of June 24, 2016

FX Implications – JPY & Gold

BoJ's intervention may fail to bottom USD/JPY out

- **Fund inflow may support JPY**
  - **Safe-haven flow:** Safe-haven demand given concerns over global growth may be positive for JPY.
  - **Stand-alone intervention:** Although further rally in JPY may trigger BoJ intervention, European authorities may focus more on the stability in asset prices than that in FX market.
  - **USD/JPY may be pressured:** As such, the stand-alone intervention may fail to bottom USD/JPY out.
  - **On technical analysis** (Chart 13), USD/JPY may consolidate before testing lower to 95-99, with resistance at 105.55.

- **Gold may rally on safe-haven demand**
  - **Safe-haven flow:** The Brexit outcome may increase the demand for safe-haven assets due to global growth concerns.
  - **Increasing ETF holdings:** We are likely to see ETF inflows and holdings of gold resume a March upwards above 2,000 MT level.
  - This is likely to increase bullish pressure on gold prices short term, with perhaps testing $1,350 or a bit higher into Q3 2016.
  - **On technical analysis**(Chart 14), Spot gold/USD may rise toward 1,392-1,433, with support at 1,250.

Chart 13: USD/JPY

Source: Bloomberg L.P., as of June 24, 2016

Chart 14: Spot gold/USD

Source: Bloomberg L.P., as of June 24, 2016

FX Implications - GBP & AUD

GBP/USD may tumble towards 1.3031

- **GBP may drop further**
  - **Worries on Brexit:** GBP may fall by up to 15% on a trade-weighted basis, on worries that Brexit may send shockwaves through markets, economies and politics.
  - **Potential rate cut:** The prospects for the BoE to cut rates by 25bps and talk of a 2nd Scottish independence referendum will likely to take GBP lower.
  - **On technical analysis** (Chart 15), GBP/USD may tumble to 1.3031 or even 1.25 level. Resistance may find at 1.4013.

- **AUD may range trade with mild downside bias**
  - **Small direct impact:** The Brexit impact on Australian economy may be limited, as the export and import from Australia to UK are below 1% of total GDP.
  - **AAA Rating:** AUD may benefit from its AAA standing, and may outperform GBP and EUR.
  - **Rate cut by the RBA:** However, given the uncertainty of global economy, we expect the RBA may be forced to cut the interest rate again in August, which may be negative for AUD.
  - **On technical analysis** (Chart 16), as the RSI dropped from the overbought region, the pair may trade inside 0.7212-0.7648 range with mild downside bias.

Chart 15: GBP/USD

Source: Bloomberg L.P., as of June 24, 2016

Chart 16: AUD/USD

Source: Bloomberg L.P., as of June 24, 2016

Upcoming Economic Events

Yellen's speech may become market focus this week

US	**Fed Chair Yellen will give a speech** ➢Fed's Powell (6/28), Yellen (6/29) and Bullard (6/30) will give their speech this week. With US short rates beginning to price in cuts, it may be important to monitor how recent developments shift their commentary and if they are considering rate cuts.	**Jun 29 (Wed):** Fed Chair Yellen's speech
UK	**BoE Governor Carney will give a speech** ➢The BoE's Carney will attend the forum in Portugal. He may reiterate keeping a close eye on financial markets and will likely step in if markets are disorderly.	**Jun 28 (Tue):** BoE Governor Carney's speech
Japan	**Tankan large manufacturing Index** ➢We expect deterioration in the business confidence, given the uncertain external economy, sluggish exports and production and further yen strength since March.	**Jul 1 (Fri):** Tankan large Manufacturing index Citi Forecast: 2 / Previous: 6
China	**Chinese Jun official Manufacturing PMI** ➢We estimate the manufacturing PMI likely dropped to 50.0 in June on the back of sluggish manufacturing investment figures in May. ➢Citi analysts believe that a strong USD may trigger another wave of capital outflows and add to the perception of rising risk in EM. It may be important to watch the reaction of the Brexit vote of policymakers in China.	**Jul 1 (Fri):** Manufacturing PMI Citi Forecast: 50 / Previous: 50.1

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