Communiqué

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South Africa

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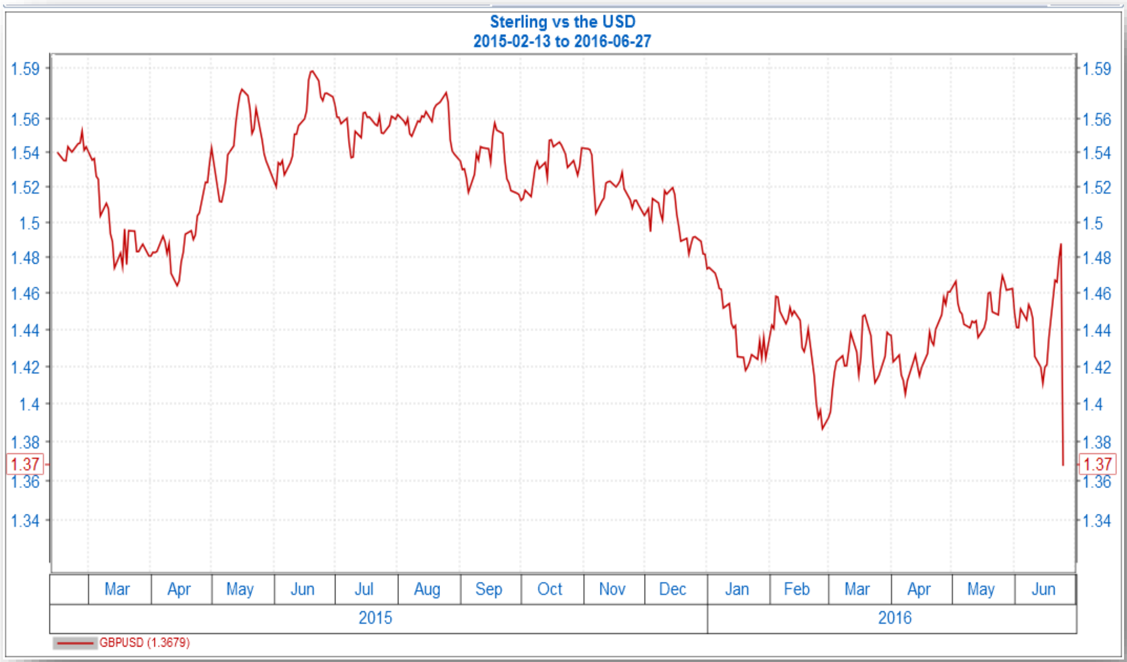
Life after Brexit

Abroad

Following the choice by Britons to exit the EU it emerged that Europe is quite miffed over the Brexit result and wants the UK to get on with its departure and it is expected that David Cameron will invoke Article 50 of the Lisbon Treaty as soon as possible. Article 50 of the Lisbon Treaty requires that the departing member of the Eurozone invokes this article which then provides for a two-year negotiating period taking into account the state's future relationship with the union as well as further obligations. It is likely that the EU will take a hard stance on the UK's access to the common market so it is probably in their best interest not to invoke the treaty before they have formed a negotiating plan. It should also be mentioned that the two-year negotiating timeframe is not cast in stone and could be even longer. No member has done this yet, so lots of uncertainty will likely prevail.



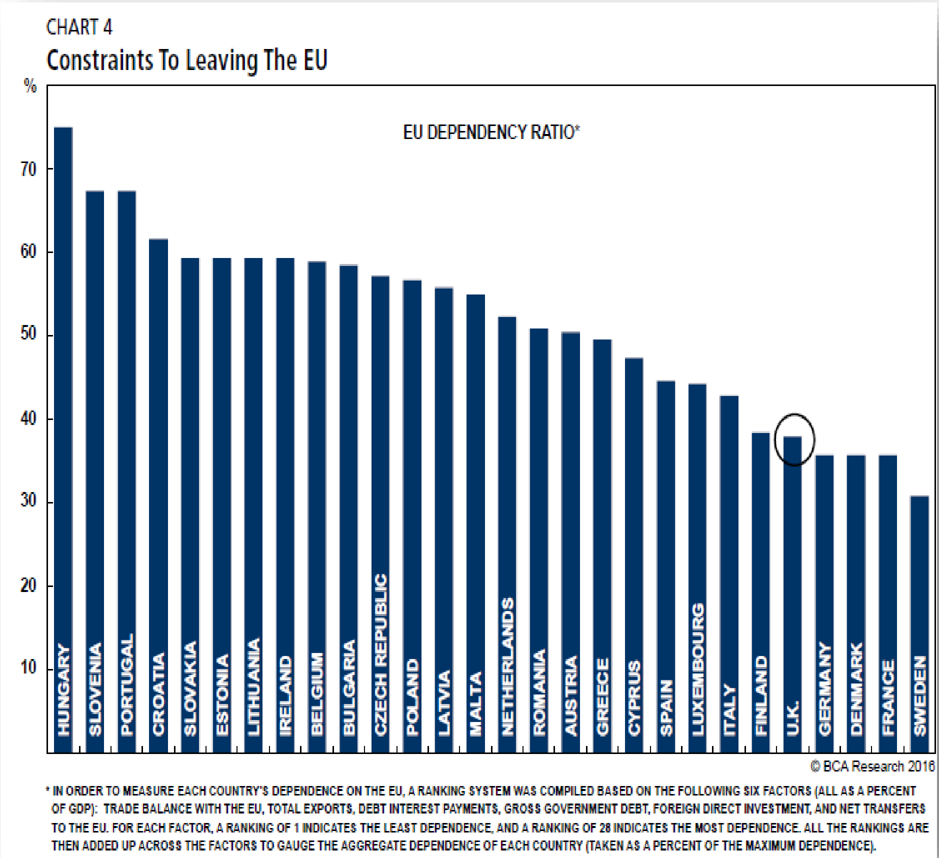
Source: INet Bridge

Add to that the leadership crisis in major British political parties, Scotland and Ireland voicing concern that they are being dragged out of the EU against their will and that the 'leave' campaigners hadn't thought further than marking their ballots. Markets are clearly unhappy with the current uncertainty. Sterling has been knocked and global equity markets continue to be sold off (although recovering a bit). The rampant USD may convince the Fed to keep rates where they are until December this year.

Neither the US nor Europe have performed well since the global financial crises. The structural defects of the EU economy have been costly to Britain. Capital flight form the mainland for many years has artificially caused the pound to strengthen, hurting UK exports, of which 50% goes to mainland Europe. The UK vote is a major blow for "globalisation" and fears of a contagion effect on other countries will likely put upward pressure on bond yields across Europe which will undoubtedly increase the risk of another debt crisis. The fear of voter revolt will likely lead to less austerity and more stimuli from policymakers which could cause inflation to eventually rise, which is much needed in order to support the fragile recovery.

The immediate question that investors were asking following the event is who is next? The nervousness was reflected in a sudden surge in bond yields of peripheral countries.

A recent study done by the Bank Credit Analyst, devised an EU dependency ratio for members of the EU based on factors such as total trade with the EU, debt interest payments, total government debt, foreign direct investment and net transfers to the EU. As can be seen in the chart below, it's easier for Sweden to leave the EU than it is for Hungary as almost all of that country's exports go to the EU.



The last 4 decades of free trade and inadequate policies in Europe and the US have led to growing income inequality and stagnant wages particularly among blue collar workers. If policymakers respond to populism with protectionism and higher fiscal expenditure the end of the current deflationary spiral might be close. Reflationary measures by policymakers my give rise to a renewed search for yield which could in turn buoy risky assets.

The Brexit result paints a bleak picture for global growth and financial markets. We expect risky assets to remain volatile in the near term. This may well cause the FED to pause their decision to hike rates for some time. The FED funds futures are currently pricing in a 15% probability of a **rate cut** by year end compared to a zero probability prior to the UK vote. The dollar is likely to remain fairly strong in the short term given the fall in sterling but could weaken somewhat over the medium term due to the pause in the hiking cycle. This could eventually be supportive of commodities and risky assets like emerging markets.

Federal Funds Futures Rate

Source: Quandl

We expect global markets to be driven in the near term not so much by the FED and China as before but rather events in Europe and in particular what will happen to the peripheral economies in Europe around the Mediterranean.

Local

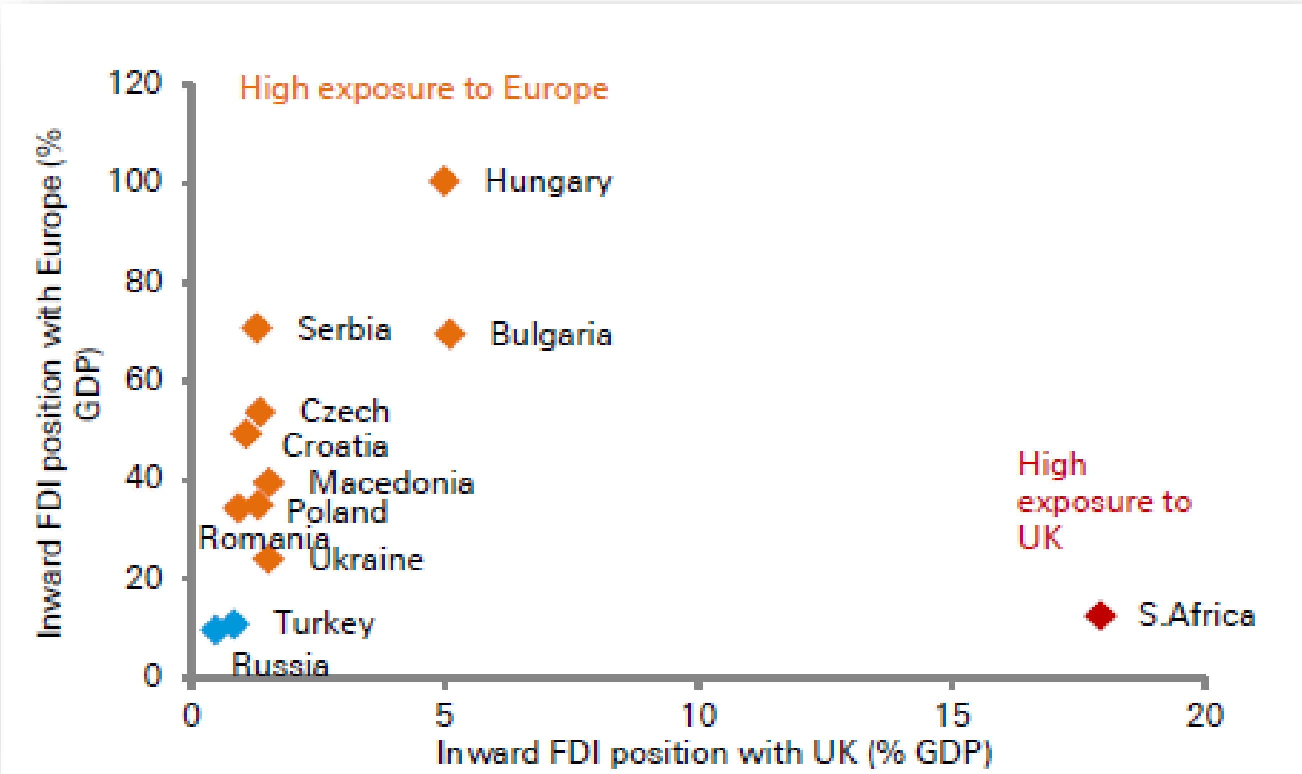
What are the Brexit implications for South Africa?

The outcome of the UK referendum could pose downside risks for the local economy as well as some specific locally listed shares. Exports and financial investment flows will more than likely be directly impacted as financial linkages between SA and Europe as well as the UK are large.

It is not clear at this point in time in which direction foreign investment flows will settle. The initial reaction was negative with a global risk-off approach by investors. If central banks across the world work in tandem to manage the exit in an orderly manner, this could very well be supportive of the rand, equities and local bonds. As mentioned above, emerging markets may well benefit from the crises in Europe in due course as investors search for yield.

Spill overs via the trade channel from Europe will likely be relatively small; however, foreign direct investment and portfolio flows will be the key risks. Direct exports to the EU and UK contribute 0.3% and 0.2% to GDP. The local manufacturing industry could feel the brunt off stricter lending conditions within the UK and EU in terms of the funding of capital goods and will probably also impact the exports of capital goods manufactured locally due weaker demand in Europe. More importantly though is what might happen to trade relationships going forward? Will the UK redirect trade to more competitive countries?

Fixed Direct Investment in SA from Europe

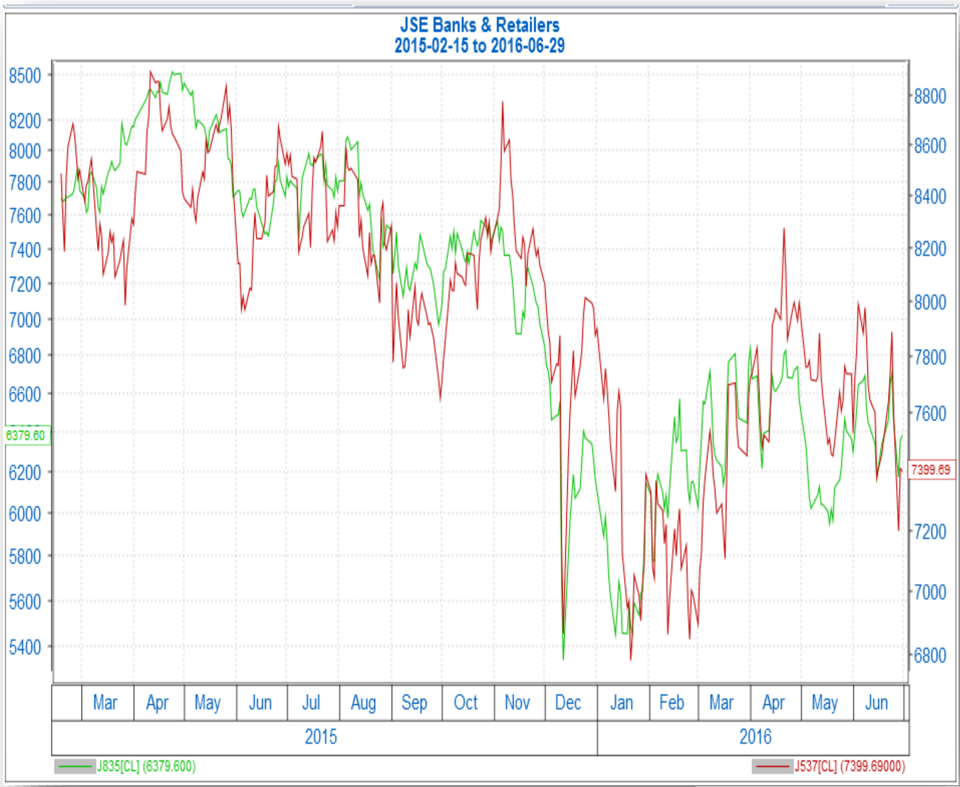


Source: Deutsche Bank

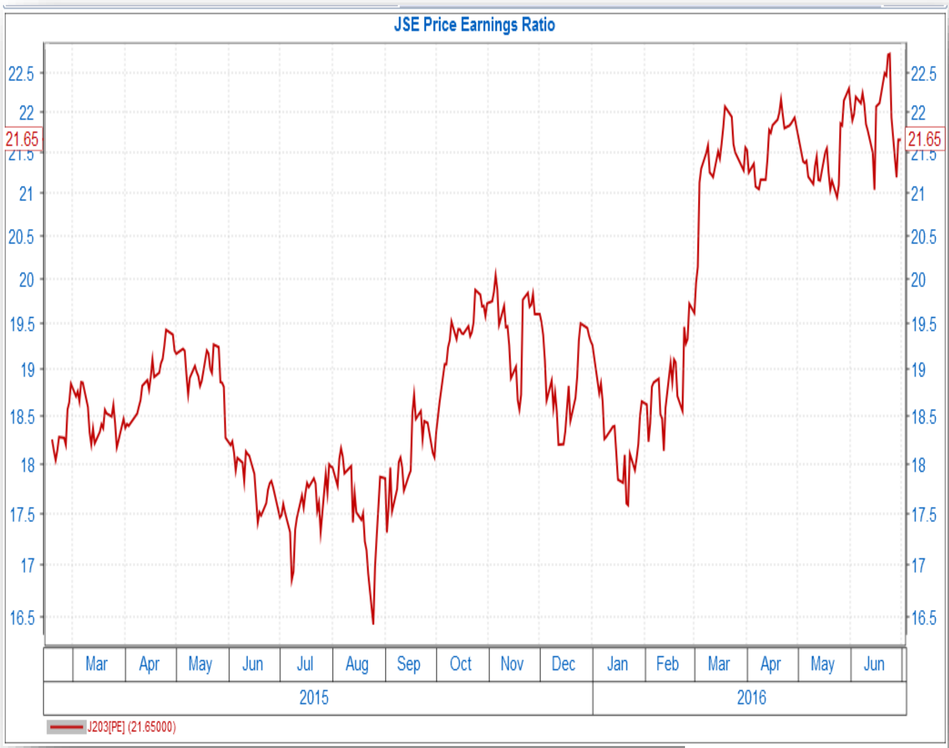
On the positive side though, the spike in the gold price together with the lower oil price should at the margin be positive for the local economy. The rand weakened sharply after events in the UK but has strengthened again to just over R15 to the dollar and R20 to the pound. The rand is likely to remain a binary trade, possibly going down to R13 or R16 to the dollar in the near term as events in Europe unfold and also the global appetite for risky assets.

Local inflation could be positively influenced in due course as local corporates doing business in the Eurozone and UK will have to make productivity adjustments to remain competitive and meet potential lower demand. We do not foresee an immediate reaction from the SARB and remain of the opinion that we are near the end of the rising interest rate cycle. But much depends on what will happen to interest rates in Europe and the UK.

From an investment perspective, the most vulnerable shares could be retail and banking stocks. Retail stocks due to their large foreign shareholder base in the event of a risk-off scenario and banking socks due to, in some cases, fairly large business units in the UK. As can be seen in the chart below, the banking (green) and retail (red) indices experienced a rather sharp correction, along with global banks and retailers, on the day after the BREXIT announcement but has recovered somewhat since the sell-off.



Source: INet Bridge



Source: INet Bridge

The JSE's as a whole also experienced a slight sell-off alongside banks and retailers with current valuations at more palatable levels. We still expect approximately 12% earnings growth overall on a rolling 12 month forward basis and regard this as an estimated return from equities over the year.

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To conclude:

- Europe is quite miffed over the Brexit result and wants the UK to get on with its departure as soon as possible.
- It is likely that the EU will take a hard stance on the UK's access to the common market so it is probably in their best interest not to invoke Section 50 of the Lisbon Treaty before they have formed a negotiating plan.
- The structural defects of the EU economy have been costly to Britain. Capital flight form the mainland for many years has artificially caused the pound to strengthen, hurting UK exports, of which 50% goes to mainland Europe.
- The FED funds futures are currently pricing in a 15% probability of a **rate cut** by year end compared to a zero probability prior to the UK vote.
- The outcome of the UK referendum could pose downside risks for the local economy as well as some specific locally listed shares.
- If central banks across the world work in tandem to manage the exit in an orderly manner, this could very well be supportive of the rand, equities and local bonds.
- From an investment perspective, the most vulnerable shares could be retail and banking stocks. Retail stocks due to their large foreign shareholder base in the event of a risk-off scenario and banking socks due to, in some cases, fairly large business units in the UK.

Sincerely

Chris

Chris Botha

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