Independence Day

Gerhard Winzer

On 23 June the people of the UK voted in favour of an exit from the European Union. Basically the UK thus strengthened its supposed (?) state sovereignty at the expense of the economic advantages of an EU membership. For the rest of the EU, its economic and political clout weakens as a result.

Flight to safe havens
The short-term consequences affect mainly the capital market. In reaction to the result of the referendum, a flight to safe havens has set in. The increase in uncertainty premium pushes the yields of safe government bonds down and weakens risky asset classes. The British pound has shed quite a bit of value, whereas the gold price has picked up.

Will the interbank market dry up?
Will we now see overshooting? There are particularly two direct vectors of impact that we can observe: firstly, there is the risk that the banks' willingness to lend each other money declines and the interbank market dries up. The interest rate differential between the interbank rates and short-term government bonds is a good indicator.

Forced selling of risky investments?
Secondly, forced sales might set in: once risk thresholds are reached in portfolios and / or capital outflows occur, portfolio managers are forced to sell risky asset classes even if their fundamental assessment has not changed.

Risk of negative feedback for the real economy
When these to vectors are strong, the risks of negative feedback from the capital market to the real economy emerge, much like what we saw in 2008. The central banks are prepared to avoid such a spill-over. In its press release from 24 June the British central bank clarified: "The Bank of England is monitoring developments closely. It has undertaken extensive contingency planning and is working closely with HM Treasury, other domestic authorities and overseas central banks. The Bank of England will take all necessary steps to meet its responsibilities for monetary and financial stability."

EU will be questioned even more
The medium-term effects of the Brexit are complex. It affects politics, economics, and finance as well as the interplay of these levels. The referendum happened in the context of an increasing strengthening of anti-establishment forces and national as well as regional movements in Europe. The centrifugal forces have increased after the Brexit decision. The EU and its associated units such as the Eurozone will now be subject to even more scrutiny. That being said, crises in the EU have often had the effect of a structural whip and thus led to further reforms. In this case a political tour de force will be necessary on an EU-wide level. Basically now it is crucial to illustrate the legitimacy of a supranational organisation. It is clear that the nature of the EU has changed. With the UK, an important representative of the liberal camp is gone.

Economic disadvantages
The free flow of goods, services, capital, and labour is one of the pillars of the EU. Numerous academic texts suggest a positive correlation of economic growth and openness. This means lower potential growth for the future in the UK and probably also for the EU. It is unclear at this point what regime the relations between the UK and the rest of the EU will be subject to. The uncertainty about this question will be dampening the companies' willingness to invest and thus economic growth in the EU over the coming quarters.

Safe US dollar bonds benefit from uncertainty
How does all this affect our funds? In the funds based on the assessment of Erste Asset Management the US bond classes are currently overweighted. This affects Treasury bonds, mortgage bonds, and corporate bonds (investment grade and below investment grade). US bonds should clearly outperform their European peers in this environment. At least the safe US dollar bonds will benefit from the increased uncertainty. Also, the short-term government bonds of developed markets with open currency are overweighted. This asset class profits from a depreciating euro. That, too, should help in the current environment. We also hold bonds from Central and Eastern Europe as well as generally bonds from emerging markets (in local currency) in the portfolio.

Underweighted equities and Eurozone government and corporate bonds

Relative to the strategic benchmark, we have an underweight in equities, Eurozone government bonds, Eurozone corporate bonds (investment grade), and government bonds from emerging markets in US dollar (hard currency bonds).

Some asset classes are not in the portfolio, i.e. inflation-protected bonds (NB the "Brexit shock" has a deflationary effect), Japanese government bonds, and emerging markets corporate bonds.

Normalisation after escalation?

Overall our asset allocation is defensively positioned, but does not hinge on an "escalation" scenario. Much like the central banks, we, too, monitor the market very closely. The assessment of whether we will see a process of normalisation or escalation after the initial overshooting will be a crucial one.

Gerhard Winzer

Gerhard Winzer has worked at Erste Asset Management since March 2008. Up until March 2009, he was Senior Fund Manager in Fixed Income Asset Allocation; he has been Head Economist since April 2009.

He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.