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## Brexit: How resilient is the financial system?

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The vote in favour of leaving the EU by the UK means one thing above all: uncertainty. Because the effects on the sentiment and the behaviour of companies, the public, the financial market participants, and the political parties are difficult to predict. Paradoxically, the prices of risky assets such as equities, corporate bonds, and emerging markets bonds have even increased. At the same time, the yields of safe bonds and the prices of bank shares in Europe have nosedived, while the gold price has risen. How does one fit the other?

### **Epicentre UK**

The uncertainty created by the Brexit vote manifests itself on various levels. The epicentre is of course the UK, where a political, constitutional, and possibly economic crisis has been set off. Some important questions remain unanswered: When will the official withdrawal negotiations according to article 50 commence? What will the relationship between the UK and the EU ultimately look like? Will the UK disintegrate? Will sufficient volumes of capital flow into the UK in order to fund the high current account deficit of about 4.3% in terms of GDP? Will the British pound come under even more pressure because of the current situation? Is the economy headed for a recession? Can the split through the population and the political parties be overcome? At the very least, the question of who will succeed Prime Minister David Cameron has been answered, and the new Prime Minister Theresa May has made it clear that Brexit does indeed mean Brexit. A large part of the government programme will probably be the Brexit process.

### **Centrifugal forces in the EU**

In the EU, one mega-trend is at risk of ending: the integration of Europe. The centrifugal forces have increased. In other EU countries, too, the anti-EU sentiment has been on the rise. In this context, important elections will be held in the coming quarters in Europe: a referendum on constitutional changes is scheduled for autumn in Italy. This will also be a de-facto vote of confidence for the cabinet of Matteo Renzi and the EU. Next spring, France will be holding general elections. Marine Le Pen's anti-EU party is in with a chance of making it to the run-off stages. In addition, general elections are also scheduled for the second half of 2017 in Germany. There, too, anti-EU parties have been on the upswing.

## **Globalisation in danger**

On a global level, the mega-trend of globalisation is increasingly flying into strong headwinds. The anti-establishment movement in particular have been calling into question the relationship of openness and prosperity. A prominent representative of this camp is the serious contender for the US presidency, Donald Trump. Most recent example: on 13 July, President Barack Obama filed a complaint about China at the WTO for alleged unfair trade practices.

## **Below-par growth**

Real global economic growth is admittedly below its historical average. However, given the many opposing forces, the growth rates are remarkably stable. The structural forces dampening growth are mainly the disadvantageous demographic development, falling productivity growth, the low growth of world trade, and the pressure for lower debt growth. In addition, we have seen shocks like the euro crisis, the decline of commodity prices, and the weakening economic growth in China. Most forecasts are based on the assumption of a drastic decrease in economic growth in the UK. The risk of a recession is elevated. The Eurozone growth rate will dip by a few tenths of a percentage point as well. The consensus estimates do not expect any significantly negative effects on global growth, but there are still downside risks.

## **Resilient financial system**

Given the numerous negative events, the financial system is also remarkably resilient. Yet again, the financial markets have gone through the shock (i.e. Brexit) relatively unharmed. The indices measuring whether the financial environment has become more restrictive or more expansive (the Financial Conditions indices) have even increased, not the least in the UK.

## **Monetary and fiscal policy in the UK**

In the UK the fiscal and monetary policy reacted with expansive signals right away. Governor Mark Carney has already signalled a cut of the key-lending rate for August (from currently 0.5%). And another cut will be executed if need be. The resumption of the purchase programme for government bonds is also in the cards. In terms of fiscal policy, the planned reduction of the budget deficit of 4.4% of GDP last year to a small surplus by 2021 will probably not be achieved. The cyclical component of the public budget is going to expand. It is hard to imagine that the planned reduction of the structural deficit of 0.8 percentage points per year could actually be pulled off in the current environment. This means that the deficit will therefore remain high.

## **Loose monetary policy**

We have seen a similar development of the monetary and fiscal policy, i.e. a loosening, also in other countries, albeit in a watered-down version. In tandem with the uncertainty, the key-lending rate expectations have also fallen in other important countries. In USA, a rate hike by December is now only priced in with a 30% probability anymore. At the same time, the economic data in the USA indicate good economic growth of 2%. Solid growth and an expansive monetary policy represent a good combination for risky asset classes in the short run. This applies to the current environment in particular, where a possible divergence in the development of key-lending rates between the USA and the rest of the world constitutes a latent risk. At the next Fed meeting on 27 July the chair of the central bank, Janet Yellen, will have the chance to clarify how the elevated level of uncertainty generated by the external sector and the good US economic data enter the decision-making process.

## **The end of austerity?**

The fiscal policy is heading towards less austerity, with Japan in the driving seat. Prime Minister Abe has pushed back the VAT increase scheduled for next year and announced extensive stimulus measures for the second half of this year. In the USA, both presidential candidates have signalled an increase in public spending. In the Eurozone, too, the pressure to end austerity has been on the rise.

**In simple terms:** the Brexit shock comes with negative repercussions on numerous levels. The response to uncertainty has been even more expansive monetary policies. This supports the risky asset classes and explains the extremely low yields of safe government bonds and the higher oil price. However, while we are now on the other side of the Brexit vote, we are still on this side of finding a solution to the tense situation in the Italian banking sector. This means that the downside risks prevail, which is also why the positioning of our portfolio remains defensive.

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