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# The Day of (B)reckoning



London - June 24, 2016

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## A – H2O’s assessment of Brexit implications

**Today’s event is not financial but political.** A period of exceptional uncertainty started this morning for the UK, including a fierce leadership battle in a deeply divided Conservative party, the timing of the trigger of the EU’s Article 50, as well as a potential referendum in Scotland, and Northern Ireland.

**Today’s event is not going to lead to a disorderly Lehman-like market sell-off** fed by credit losses and forced deleveraging. The central banks’ ability to backstop the risk-off stampede is definite, while leverage in the system remains very low. This morning’s resilience of Italian sovereign bonds is a proof thereof. This is very different from the lack of preparation prior to the 2008 global, and 2011 European crises.

**Today’s event is going to result in a gradual re-assessment of risk between the UK and Europe.**

- ✓ The implications of Brexit are unambiguously negative for the UK economy. This morning’s 10% collapse of the cable in Asia presaged the inevitable further depreciation of sterling, which is particularly harmful given the country’s large current account deficit financing needs. The ensuing contraction of purchasing power and imports, delays in foreign investments, and loss of business and consumer confidence, should undoubtedly translate in an **economic recession as early as next year**;
- ✓ Above and beyond its short-term negative spill-over on EMU growth, **Brexit is ultimately positive for Europe**. Pulling out of the Single Market implies relocating some of the accumulated FDIs over the previous decades back to Europe. **Brexit is a negative asymmetric shock for the UK, a mirroring positive asymmetric shock for Continental Europe, and a very marginal shock for the world**;
- ✓ The transmission mechanism of Brexit to global markets goes through Europe and the re-pricing of a higher political risk premium across the region. Between the two main channels of risk retrieval out of Europe, the GIPS sovereign bond one should be obstructed by the ECB’s backstop, as exemplified by today’s BTP resilience. As a result, next week’s **performance of European financials** (the equity channel) will be critical to assess global contagion risks.

Our anticipation is that **today’s shock is enduring for the UK, and transitory for Europe**. Past the simultaneous drop in asset prices on either side of the Channel, European markets should rebound and outperform UK ones thanks to resolute ECB action among other drivers.

## B – H2O’s handling of the crisis

We kept our portfolio positions unchanged today.

The violence of the risk-off move last night and this morning made it totally impossible for us to curtail risk and trim some positions without jeopardizing the portfolios’ risk balance and performance potential.

Also, as indicated in our June 20 note, we had imbedded a few hedges in case of a Brexit, including a short GBP & short FTSE (for the funds exposed to equity markets), a long European duration, and a long USD. These did not prove sufficient to absorb the shock.

At 4:00 pm London time, part of this morning's risk-off market crash was absorbed. Nevertheless, all our funds are exhibiting negative returns on the day. This negative showing split as follows:

**1. Bond strategies:** negative contribution:

- ✓ negative contribution of our bear flattening stance on G4 (essentially US) yield curves; short-dated US Treasuries rallied massively on the back of safe-haven repatriation flows out of Europe and as Fed monetary tightening expectations were repriced; note that, after dropping below 1% this morning (as they did last February 11), 5-year rates jumped back to 1.08%;
- ✓ negative contribution of the exposure to GIPS sovereign bonds: after stretching to 190 bps this morning, the 10Y BTP-Bund slipped back to 160 bps, thus incurring a minor loss. Conversely, despite a late session rebound, Portugal & Greece took the brunt for the risk-off stampede;

**2. Currency strategies:** positive contribution:

- ✓ positive contribution of our long exposure to the US dollar; as expected, the US Dollar Index (+2.5%) fulfilled its protective function in the midst of a global market turmoil; the greenback rose +2.4% against the euro, +1.4% against the Canadian dollar, and +1.53% against the Swiss franc: note that our long USD/CHF exposure was strengthened in the early morning on the heels of the SNB's intervention;
- ✓ negative contribution of the G10 forex strategies, mostly due to the rally of the JPY, and to the retreat of oil- (NOK) and emerging (MXN) currencies. Our long EUR/GBP gained as sterling is now under massive downside pressure in the wake of a probable economic recession and easing by the BoE, and of a reversal in FDIs. This position was strengthened at the very beginning of today's market session.

Relative to the GFI portfolios, the global macro ones suffered more because of their exposure to equity markets, including:

- ✓ the long EuroStoxx 50 (-7.5%) versus the FTSE 100 (whose drop was contained to -2.3%, as it was buttressed by the collapse of GBP), and versus the S&P 500 (-2.3%);
- ✓ the long EMU banks that nosedived -16% back to the EMU debt crisis levels of 2012.

*Edited by the H2O team in London, on 24/06/16 – Sources: H2O, DB, UniCredit, GaveKal.*

## Additional notes

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