eastspring investments

A member of Prudential plc (UK)

28 June 2016

EVENT COMMENTARY: "BREXIT"

Eastspring Investments Berhad

EVENT

After being the European Union for 23 years, the UK voted to leave on a slim majority (51.9%) on the 23 June 2016, but still a substantial one with 17.4m people voting in favour of a BREXIT.

THE AFTERMATH

With such an unexpected vote result, despite the telling pre-vote polls (now in hindsight) investors were caught off guard.

Will this sell-off see similar rebounds to their pre-shock levels in a few months like when the Japan earthquake occurred in March 2011, US debt ceiling standoff in August 2011, and 2012 Euro zone recession triggered by the debt crisis? In these instances, markets declined by about 11%.

So what now? UK needs to trigger Article 50 of the Lisbon Treaty, which puts in place a 2 year timeline for formal talks.

The immediate impact will be the weakness on commodity rich economies that export to the UK, whilst the traditional safe havens such as the USD and YEN will gain, as it did. The USD strengthened by 2% whilst the Yen rose 4% since the Brexit vote. Gold rose by 5%. USD treasury yields fell by 19bps to 1.56%, and likely to continue to move lower.

The Bank of England activated its contingency plans to support financial and monetary stability. The BoE is ready to provide GBP250bn in additional liquidity.

UK's political landscape has started to change with the PM David Cameron announcing his resignation. Even Labour leader Jeremy Corbyn has his leadership questioned given his support behind the Remain campaign. With Cameron stepping down, and a successor not in place for at least 3 months, things get further complicated.

Moody's has lowered its outlook on Britain to negative from stable due to heightened uncertainty as the country begins the long process of withdrawing from the EU.

Contagion effects to come – Scotland now talking about a referendum to press for independence but yet to keep a relationship with the EU bloc.

There are 1.2m British citizens living in EU countries, and now forced to reassess how to continue working where they are given the changes the UK will have in their membership to the EU.

RESPONSE BY THE EUROPEAN UNION

The EU members are increasing pressure to leave as soon as possible rather than wait the expected 2 years.

The Dutch prime minister made a comment that the process for UK to leave the EU may not start until after the German elections in 2017.

However, apparently only UK can trigger the mechanism to leave, hence the expected 2-year negotiation with EU.

Austria is apparently one of the more at risk countries to follow UK's example, given the fragmented politics.

MALAYSIAN EQUITY TEAM VIEW

Malaysia equity market reacted negatively to the Brexit event, which is not a surprise. Political uncertainty in the UK and the contagion effect is very real which is what we feared going into the event.

In this period of uncertainties, defensive stocks would be favoured, especially stocks with decent dividend yield. We also favour the domestic-driven consumer staple and construction sectors. Selected Malaysian companies have exposure in UK and Europe in the

Source: Eastspring Investments, 24 June 2016.

utilities, property, oleochemicals and gaming sectors. These companies may suffer some downside risk as earnings may be impacted by the sharp depreciation of GBP and the potential economic slowdown in UK and Europe. A weak GBP may impact Genting Malaysia and Genting Group, the YTL Group and property companies such as SP Setia, Eco World and Sime Darby. A slower economy in Europe may impact IOI Corp, IHH, Hartalega and other exporters to the Europe region.

ASIAN FIXED INCOME TEAM VIEW

The Brexit vote that saw a "leave" result has injected considerable uncertainty in global financial markets. This is expected to keep volatility in the Asian currency and bond markets high in the near term. Markets are looking for greater clarity on the UK's political and economic direction vis-a-vis the EU, and are assessing the economic implication of this development. Asian currencies are expected to bear the brunt of this increased risk aversion as we have witnessed in today's trading. Currencies of more open, trade-dependent countries like MYR and KRW, came under more intense selling pressure. Asian credit spreads also widened , with high yield bonds being more adversely impacted. However, the impact of credit spread widening is mitigated by the decline in US and Asian government interest rates, which helped buffer the fall in the overall prices of corporate bonds. In view of the uncertainty brought about by the Brexit vote and the consequent increased market volatility, we will adopt a more cautious stance in our portfolio positioning. However, we see further sell-offs in Asian currencies and credit markets as potential buying opportunities for our portfolios. While global growth could take a hit this year, we view that the economic fallout globally and more so in Asia should be manageable. Growth will slow but we are not about to have a Lehman-like event. The dependence of Asia on the developed markets have been reduced significantly over the past decade. Major central banks are also likely to turn more dovish, which should keep US interest rates low. In this environment, we will look for opportunities to add to our duration position while seeking for buying opportunities in Asian currencies.

ASIAN EQUITY TEAM VIEW

Markets have been volatile following the UK referendum result in favor of Brexit. Asian markets have not been spared with Japan declining the largest as the Yen gained. At Eastspring Investments, we focus on companies. We see value investing as a price-sensitive process that takes advantage of asset mis-pricing arising from investor behavioral traits. We try to ensure we have a significant margin for error by investing only in our highest conviction opportunities where price has moved significantly from the value of a company. What ultimately drives the investment process, is bottom up fundamental analysis to test valuation signals. Our approach is research intensive and requires a detailed understanding of the fundamentals of each investment candidate to determine the longer term sustainable earnings potential of the business. The market volatility that we have witnessed today can provide opportunities for long term value investors as share prices appear to have moved significantly from their intrinsic value. This is the type of behavioral bias that our process seeks to exploit. Reviews of our Asian Equity portfolios have confirmed that we have very little direct exposure to the UK. As valuations in Asia are attractive, price to book at 1 standard deviation below historical levels, the investment case is more compelling. ROE of Asian companies have been rising and is converging with that of the rest of the world. We look for opportunities to add to our holdings as Asian Equities has now become more compelling following the "Brexit" induced selling.

GLOBAL ASSET ALLOCATION TEAM VIEW

The result is clearly a surprise to markets. The big picture point is that both the GBP and UK equities were only "neutrally" valued leading into the episode. The 10% correction suggests that they are now modestly undervalued.

However, one could argue that an overshoot is warranted. That said, it is important to note that UK profits are well below trend. Therefore, the market might be attractive based on trend earnings which also applied to Europe broadly. For the UK, the sharp decline in Sterling will likely help both competitiveness and profit translation for the top 100 companies (80% of sales are generated outside the UK). For Asia and EM, the macro implication is the importance of the European region (and the UK) for trade and profits. Both USD and Yen strength and the potential impact on growth and risk perceptions is the key transmission channel. On the positive side, it is plausible that the episode will lead to further central bank or fiscal policy easing and that might support equities over the coming weeks after the rapid and emotional correction. Often an emotional and rapid move in price is an over reaction and something to take on. Moreover, from a relative stand point, Treasuries and sovereign bonds more broadly offer even less compensation for risk relative to Thursday. We look for opportunities to add on risk assets at attractive prices.

For more information visit
eastspringinvestments.com.my

Source: Eastspring Investments, 24 June 2016.

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