Global Investment Strategy

# Global Macro Strategy: International Briefing

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## Weekly International Update from Wells Fargo Investment Institute

- » On Thursday, June 23, voters in the United Kingdom (UK) voted in favor of leaving the European Union (EU).
- » We believe that the outcome of yesterday's vote will lead to long-lasting negotiations between the British government and the EU, and we expect periods of geopolitical, economic and global financial-market uncertainty in the coming months and years as a result.

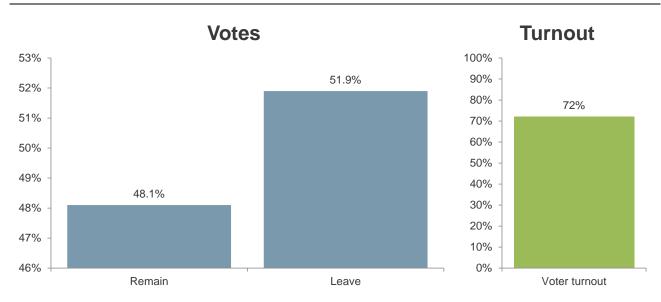
## What it may mean for investors

» In the near term, we believe that the result of the leave vote will lead to heightened levels of market volatility. In this context, we highlight several implications for stocks, bonds, currencies and commodities. We also suggest prudent portfolio-management practices.

## UK's EU "Leave" Vote: Expect Volatility, Stay Invested

On Thursday, June 23, voters in the UK voted in favor of having their country leave the EU. In essence, British citizens have handed their government a mandate to begin proceedings that will eventually lead the UK out of the EU. Some investors may be wondering, "what now" following the buildup and global financial market disappointment with this week's vote.

Chart 1. UK EU Referendum Vote Results and Turnout



Source: UK Electoral Commission, 6/24/16

#### **Looking Forward**

In the immediate future, the UK will remain a member of the EU as the British Parliament makes preparations for the country's exit. This process is expected to take at least two years to complete, and until its divorce from the EU is finalized, the UK will continue to be bound by laws, rules and regulations prescribed by its membership in the EU. The motives behind the decision for yesterday's referendum vote are manifold, and we have touched on some key points in past reports.¹ Looking forward, we believe that the forthcoming negotiations between the UK and the EU are bound to be contentious, potentially emboldening other nationalist movements in Europe in their own Euroskeptic movements—all the while leading to global economic uncertainty and global financial-market volatility.

As a result, we anticipate capital expenditures, a key component of economic growth, to likely slow in the UK and Europe during the second half of this year as firms put business investment plans on hold. A slowdown in business spending could have a knock-on effect on consumer confidence, further aggravating an already weak growth environment in Europe. Our initial estimate of the slowdown could take 2016 economic growth down to 1.4 percent from 2.2 percent in the UK and to 1.2 percent from 1.6 percent in the Eurozone.

Outside of limited trade ties, the direct impact around the world is likely to be contained, and we believe that growth in the U.S. economy may slow from 1.9 percent to 1.7 percent in 2016. Systemic risks are likely to remain subdued, as we pointed out in our report last week, given significant financial tools available to central bankers and the significant amount of global liquidity available.<sup>2</sup>

Yet, a break from the EU is unprecedented, and the indirect global repercussions could be greater, depending on how sentiment evolves. For example, if fears of further EU disintegration spread quickly, investor sentiment could deteriorate more sharply and have a more serious spillover around the world. We expect that the global impact will be concentrated in the direct effect and that sentiment will eventually settle into a wait-and-see mode, while likely protracted negotiations commence. After all, it will take time to negotiate Britain's departure, and any country contemplating an exit probably will want to see the eventual terms of the breakup as determined in the coming years. Thus, a sharply negative sentiment reaction remains a possibility but seems unlikely this year.

## Likely Near-Term Investment Outlook

For the immediate present, we anticipate that the unknowns related to the UK's exit from the EU will lead to elevated levels of market volatility. Fears about the future may push the yen higher against the U.S. dollar, even as the pound and the euro slide further. These movements illustrate the neutral view—but with strong swings up and down—that we expect in the dollar's value into year-end. We have been expecting emerging-market currencies to slide against the dollar, and the British vote may quicken that pace somewhat. In general, however, we do not expect strong currency depreciation, aside from the pound and, to a lesser extent, the euro.

International disappointment also may squeeze capital into gold and U.S. Treasury securities, both of which appeared to attract a perceived safe-haven bid in recent weeks. Spreads between German yields and those of smaller continental Eurozone countries should widen, as the threat of future EU fracturing grows.

More broadly, we expect global equity prices to weaken, led by emerging and developed international markets. We believe U.S. equities may fall by less than the international equity markets, since the direct impact on the U.S. economy seems limited. The risk to this view is that sentiment falls more steeply than we currently expect, which, to reiterate, seems a low probability. Nevertheless, the S&P 500 Index may again retest its low around 2010 from earlier this year.

<sup>&</sup>lt;sup>1</sup> International Briefing: "What You Need to Know About a Brexit, Wells Fargo Investment Institute, February 12, 2016.

<sup>&</sup>lt;sup>2</sup> International Briefing: "UK's EU Referendum—Potential Impact of the June 23 Vote", Wells Fargo Investment Institute, June 17, 2016.

## Views to Year-End Mostly Unchanged

Looking into year-end, the surprise and disappointment of the vote could moderate. Not only will the breakup process take time but, again, the global economic impact is likely to be contained around its epicenter in the UK. Consequently, it is possible that most of our current view will continue intact. We will be watching most closely how sentiment develops.

The European currencies may suffer the most sustained negative effect. We think many investors will express their uncertainty first by selling the currencies as a hedge against future disappointments from the negotiations. The pound could fall to \$1.25 per pound and the euro to \$1.04-\$1.08 per euro. The yen may strengthen further and break parity with the dollar, possibly reaching ¥96-¥100 by year-end. Emerging-market currencies may show less downside against the dollar, due to their distance from the shock, and especially if their domestic growth engines are mostly unscathed, as we expect.

The bond-market impact also may be limited. British Gilt yields may rise, and smaller European countries (those at risk for exit votes of their own) may see rising yields relative to German bunds. However, yields on German bunds and U.S. Treasury securities may fall by another quarter to half percent (that is, 25 to 50 basis points), depending on how long worries about further EU fractures persist. Federal Reserve policymakers have not committed to specific actions following the vote, but the disappointment may be enough to delay any rate hike in 2016.

A weaker outlook for interest rates may maintain some downward pressure on energy, metals and food-related commodity prices. One exception to this view is gold, which has exhibited stronger linkages to risk-on/risk-off market behavior this year. We expect this near-term trend to continue in the coming weeks, but ultimately view the longer-term trend in gold to be limited as commodity prices as a whole remain in a long-term decline.

For equities, we stress that the economic impact probably will be strongest in Great Britain, less so in the Eurozone, and marginal in the United States. Moreover, the strong currency crosscurrents may leave the dollar roughly unchanged, to the benefit of U.S. firms selling overseas, and help commodity prices to steady above their major lows from earlier this year. International developed-market equities could see the largest downward earnings revisions, but we expect little sustained impact on emerging markets. These economies face more important domestic issues, particularly domestic debt levels. For U.S. equities, the coming months could be rocky, but we believe the positives can sustain our year-end S&P 500 Index target range of 2190-2290.

#### **Bottom Line**

The result of yesterday's "Leave" vote in the UK's EU referendum likely will weigh on economic activity in the UK and the Eurozone but with limited impact globally. We expect global economic growth to remain positive, with growth in the U.S. and China sustaining moderately positive global economic activity during the second half of this year. General market uncertainty and the volatility it brings are likely to favor U.S. stocks, while developed and emerging-market stocks are expected to face downward pressure in the near future. We expect equity-market volatility to remain elevated for at least the next few weeks, likely following the same path exhibited in January and February; therefore, our ranking for equities remains biased toward U.S. stocks, while we remain evenweight on developed and underweight on emerging-market stocks.

For bonds, we continue to favor exposure in the U.S. with a bias toward investment-grade issues. We remain underweight developed-market bonds given low yields and U.S. dollar strength. The dollar's strength will likely leave unhedged international exposures vulnerable, particularly in emerging markets. We therefore recommend that investors maintain dollar-based exposure to emerging-market bonds.

Given the ongoing uncertainty regarding the referendum vote and resulting financial-market volatility, we reiterate our belief that investors can benefit from the investment themes discussed in our

"Disruptions and Volatility" report—and should position their portfolios accordingly.<sup>3</sup> We suggest that investors employ prudent portfolio-management strategies that include aligning their strategic asset allocation with their long-term investment goals. We also recommend frequent rebalancing by bringing portfolio allocations in line with strategic objectives, while also adding and trimming allocations as favorable market conditions present themselves.

As we pointed out in our report on Disruptions and Volatility, uncertainty poses risks as well as opportunities for investors. We recommend that investors seek to exploit price drops in markets as entry points for favorable investments. We also suggest that investors avoid trying to time the equity markets, particularly as it relates to events surrounding Brexit—as being out of the markets at the wrong time can be costly. As such, we believe that it is important that investors look through the uncertainties related to UK's upcoming negotiations with the EU and remain fully committed and fully invested in their long-term investment plan.

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<sup>&</sup>lt;sup>3</sup> " Disruptions and Volatility: Where to Invest When Markets Are in Perpetual Motion", Wells Fargo Investment Institute, May 17, 2016.