



global weekly

Investment
Communication
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The next issue

While the consequences of the UK vote to leave the EU start to crystallise, problems around Italian banks come to the fore.

Bond markets update

In addition to the Brexit consequences, another issue was added to the uncertainty and the future of the European banking landscape: non-performing loans (NPL) of Italian banks.

Italian NPLs have become a challenge in light of the upcoming ECB stress tests, especially NPLs from some smaller Italian banks, such as Banca Monte dei Paschi di Siena. They are nearing or have surpassed levels that require banks to take action under the Bank Recovery and Resolution Directive (BRRD), a resolution put in place after the credit crisis. This resolution ensures that the burden of a bank bailout falls on its investors rather than on the country's taxpayers.

The problem in Italy is that bail-in bonds under BRRD are largely held by domestic private investors. As the Italian government has a constitutional referendum in October, it wants to balance interests of banks and voters carefully. Therefore, the Italian government is eager to compromise on the BRRD issue. However, Jeroen Dijsselbloem, Head of the Eurogroup (consisting of EU ministers), points out that evading BRRD is not an option.

The Italian bank issue can become even more dominant in the next few weeks when the ECB's stress tests are due. The situation in Italy will be carefully watched as it shows how BRRD should work in practice. It will also help bond holders to price bail-in risks for banks (see our Bond Sector Note on financials, and in particular on TLAC regulation).

We do not have Italian banks on our bond recommended list. We believe, however, that together with the Brexit consequences this issue can cause financial bonds in the eurozone to be volatile. We remain, however, positive on the euro corporate bond market as a whole and advise to invest in well-diversified funds or ETFs.

Equity index performance in local currency

	Value	One week change (%)	Year-to-date (%)
MSCI ACWI	396.9	-1.0%	-0.6%
S&P 500	2097.9	-0.2%	2.6%
AEX Index	426.1	-2.9%	-3.6%
EuroStoxx 50	2789.8	-3.2%	-14.6%
DAX Index	9467.2	-3.2%	-11.9%
Nikkei 225	15107.0	-3.7%	-20.6%
Hang Seng Index	20564.2	-1.1%	-6.2%

Important rating changes

Company	From	To
Humana	Hold	Buy
Newmont Mining	Hold	Sell
Yara International	Buy	Hold
Deutsche Boerse	Hold	Buy
Kinder Morgan	Buy	Hold

Government bond yields

	Yield (%)	One week (bp)	One year (bp)
US Treasuries 2-year	0.603	1.2	6.0
German Bunds 2-year	-0.685	-3.2	-42.0
Japan 2-year	-0.353	-1.7	-35.8
US Treasuries 10-year	1.379	-6.6	-81.4
German Bunds 10-year	-0.173	-4.7	-84.4
Japan 10-year	-0.282	-2.1	-69.6

Spreads

Index	Spread (bp)	One week (bp)	One year (bp)
CDX NA IG	76.72	-0.01	4.29
iTraxx Euro 5-year	82.25	3.02	2.00
JPM EMBI+	373.67	-2.85	-28.66

Performance data as of Friday, 08 July 2016

Source: Bloomberg

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Macro update

Mark Carney, Governor of the Bank of England (BoE), warned that some of the risks surrounding the EU referendum had 'begun to crystallise' on Tuesday. He pointed to the UK's historically large current account deficit, which is vulnerable to shifts in capital flows. Carney noted that portfolio flows into UK debt and equity have slowed, while capital flows into commercial real estate had halved in the first quarter and sterling had fallen sharply.

In addition, Carney pointed to 'growing evidence that uncertainty about the referendum has delayed major economic decisions, such as business investment, construction and housing market activity' and that the tougher economic outlook could increase the number of financially vulnerable households. He also noted, however, that the fall in sterling and gilt yields would cushion the blow, while markets had managed well and not added to the stress.

It remains to be seen to what extent Brexit will fuel anti-EU sentiment in other European countries. In our base case scenario, we assume 'exit contagion' will be limited, although we acknowledge that political risk is at elevated levels. The Italian referendum on political reform – to be held in October – also adds to the political uncertainty, even more so in light of Italy's current banking woes.

In macroeconomic terms, the post-Brexit era represents a new reality. We expect political risks to remain high in the coming months. The uncertainty surrounding the timing and terms of the 'divorce' between the UK and the EU is high.

Equity update

The consequences of Brexit are also felt in investments in UK real estate. This week, several investment funds were forced to postpone redemption requests as an increasing amount of investors wished to retreat their investments. There is not enough cash available to meet these requests, forcing asset managers to (partly) liquidate their UK property investments. Since the Brexit referendum, UK real estate investment funds declined by more than 10%.

The impact of the Brexit vote on UK stocks is mixed. Interestingly, the FTSE 100 Index has performed in line with other European indices, even now that the pound has fallen by 10% since 23 June. An explanation could be that many FTSE 100 companies generate the majority of their revenue and profits outside the UK and thereby benefit from the declining pound. UK mid-caps are faring far worse, however, and the

FTSE 250 Index has lost some 20% since the Brexit. Many of those companies depend heavily on the fortunes of the UK economy.

Equity markets declined across the world this week. Stocks in Europe were particularly weak and fell around 3% during the week on concerns of the consequences of the Brexit vote and fears about the health of the Italian banking sector. Moreover, the continuing low interest rates pose a threat to profitability of banks and insurers.

Danone announced the acquisition of WhiteWave Foods, known in Europe for its Alpro brand. Danone offered USD 10 billion for the largest US producer of soy milk. WhiteWave benefits from an increasing shift of US consumers from traditional milk towards milks from vegetable sources such as soy and almonds.

Currency update

After a period of stabilisation, the pound sterling came under renewed pressure on Tuesday. Investors sold sterling ahead of the Bank of England publishing its Financial Stability Report and on the expected measures to cushion the Brexit shock. The bank's downbeat comments on the economic outlook and hints that the central bank would roll out further easing measures subsequently also weighed on sterling. In addition, the UK's woes were underlined by three asset managers freezing their real estate investment funds.

We expect a further decline of sterling, as financial markets have yet to anticipate the full impact of Brexit on the UK economy and its ability to continue to attract the flows necessary to finance its large current account deficit. We expect GBP/USD to fall to 1.20 before the end of this year and EUR/GBP to rally to 0.92.

Asset allocation

The Global Investment Committee, at its meeting on Thursday 7 July, has decided to maintain its current asset allocation strategy, which represents an unchanged modest overweight in equities, an underweight in bonds and a significant overweight in cash in the more defensive profiles. Commodities are overweight, with neutral allocations to real estate and hedge funds.

Current uncertainties and lower expected growth may negatively affect industrial companies. That is why the Global Investment Committee decided to lower its positioning in the industrial sector from neutral to underweight. It was decided to

increase the positioning in consumer staples instead, moving this sector from neutral to overweight.

Published this week

Bond Markets Monthly: digesting the Brexit

The British vote to leave the EU has driven bond investors into safe havens, pushing down core government yields and widening credit spreads

Reporting calendar

Company	Date
Alcoa	11 July
Yum Brands, CSX, KT&G	13 July
Taiwan Semiconductor Manufacturing, Blackrock, JPMorgan, WNS	14 July
Wells Fargo, Citigroup, Swatch, Infosys	15 July

Investment Strategy & Portfolio Expertise

Group Economics

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General

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