

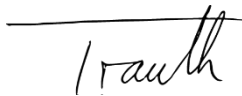
INVESTMENT OUTLOOK SPECIAL EDITION – BREXIT

29 June 2016

The UK has voted to leave the European Union. When, last Friday 24 June, the result came out, markets reacted with a major global sell-off of risky assets. The British and the European stock markets as well as the British Pound where hit hardest. Gold, the USD, the JPY, and government bonds rallied.

We – like many others – expected the UK to remain in the EU. In the following we discuss the political, economic, and market implications.

A lot has been written about the Brexit in the last few days. We wanted to observe the first market reactions before communicating our thoughts on the matter.

A handwritten signature in black ink, appearing to read 'Trauth', with a horizontal line above it.

Thomas Trauth
CEO – IMT Asset Management AG



BREXIT

IMPLICATIONS AND CONSEQUENCES

Immediate market reaction

After the result of the referendum became clear – in the early hours of 24 June – markets for risky assets sold off markedly. For example the Japanese Nikkei 225 index lost almost 8% that day, the British FTSE 100 fell 3.1%, and the EuroStoxx50 by 8.6%. Also, oil prices fell 5%, while Gold climbed 4.7%. The GBP lost 8% vis-à-vis USD. The EUR lost 2.5% versus the USD, 1% versus the CHF, and 6% versus the JPY.

In our view, the Brexit risk had already been priced in, at least partially, before the vote. European stock markets have underperformed other developed markets since the beginning of the year. For example, the EuroStoxx50 has underperformed the S&P500 index by 15.5%-points year-to-date.

Political implications

Mr. Cameron announced his resignation on Friday. It will take some time to form a new government and officially start the exit talks with the EU, although EU officials are urging the UK to start the process immediately. What those negotiations will bring is uncertain: the possible outcomes could vary significantly. In our view, this is primarily a risk for the UK and not the EU. While the EU may lose a valued trading partner, it may attract additional business from companies relocating from the UK to the Continent.

However, the major risk in our view is that anti-EU groups in other EU countries – encouraged by the UK referendum – will start similar initiatives to leave the EU. Groups in the Netherlands, France and other countries have already announced such plans. This

could lead to a prolonged phase of uncertainty for Europe as a whole. It will be very important for the EU leadership to hold euro-skeptical forces in check. Overall, this may eventually even prove to be a healthy and beneficial process, triggering necessary EU reforms.

With regard to the chances of success for further exit votes in Europe we think, however, that it will become apparent that the UK will be faced with immense political and economic costs, which will significantly reduce the probability of other exit referenda.

Furthermore, the exit costs for EMU (European Monetary Union) member countries would be significantly higher than those for the UK. In addition to the above-mentioned uncertainties with regard to international trade, for EMU members there will be added uncertainties about what currency and price will be valid for cross-border legal contracts. Also, any EMU members planning to leave, especially those with weaker currencies, may be faced with capital flight and critical systemic risks for the banking sector.

Economic implications

It is very likely that investment activities in the UK will fall off dramatically in the coming months, triggering a recession. Some companies may decide to relocate all or part of their business activities to EU countries in order to preserve full market access. Since it is to be expected that the negotiations will take years, the phase of uncertainties will last for a long time, which will also reduce willingness to invest.

Medium-term the future for UK's economic success will depend on the negotiations with Europe. In the worst case the UK could even end up without a valid free-trade agreement, especially if the EU were to take a tough stance. It seems likely to us, however, that the UK will manage to re-enter the existing EFTA (European Free Trade Association) agreement, or even the EEA (European Economic Area). The UK was a founding member of the EFTA, which is a free trade association currently taking in Iceland, Liechtenstein, Norway, and Switzerland. The EEA extends the internal market of the EU to the EFTA members Norway, Liechtenstein, and Iceland. If the UK managed to enter the EEA, market access for British companies would not be much different from the status quo. This would, however, mean that the UK had to accept all four freedoms of the EU internal market, i.e. free movement of goods, capital, services, and people.

The major rating agencies have already started to react to the Brexit vote and they indicate a worsening economic and fiscal outlook for the UK. Moody's cut its UK rating outlook from stable to negative. On Tuesday S&P lowered its sovereign credit rating from AAA to AA by two notches and warned that further downgrades could follow. Fitch also downgraded its rating for Britain to AA from AA+. The credit ratings are important for the costs at which a government can borrow on the bond markets.

Major contagion effects from the UK to other countries look very unlikely to us and should be minor. However, we do see the risk that uncertainties about the future of the EU, especially if euro-skeptical forces gain influence in other member countries, might easily derail the EU's slow and frag-

ile progress to growth by discouraging investors and consumers alike. In addition, central banks have fired most of their powder and have limited means to fight another recession. We expect, however, that EU politicians as well as the ECB will focus on calming markets and ensuring a smooth exit process.

Outlook

In general, we are convinced that in times of elevated uncertainties and high market volatility, the best recipe is to remain calm. Furthermore, markets tend to react emotionally and may undershoot immediately after such an event as the Brexit. As a result, we decided not to adjust our portfolios immediately after the vote.

As discussed above, we are skeptical with regard to the outlook for the UK economy and, in turn, for UK equities and the GBP. Therefore, we would stay away from those markets for now.

We will continue to monitor the situation. In general, major sell-offs tend to offer interesting buying opportunities. Since the uncertainties regarding the stability of Europe will remain high, we are taking a rather cautious stance for now.

We do not think, however, that the stability of Europe is seriously endangered, and in line with that we consider that the massive underperformance of European equity markets will reverse sooner or later.

Also, we do not think that the recent sell-off of, e.g., Asian stock markets in reaction to the Brexit vote is fundamentally justified.

BREXIT MARKET REACTION

Fig. 1: Equity markets, year-to-date

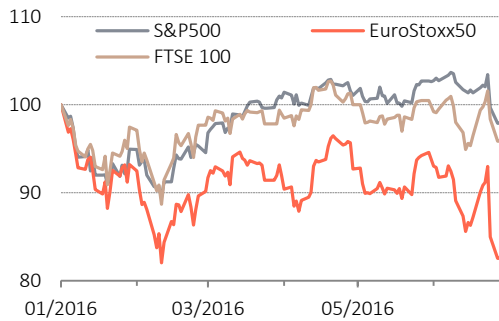


Fig. 2: Gold

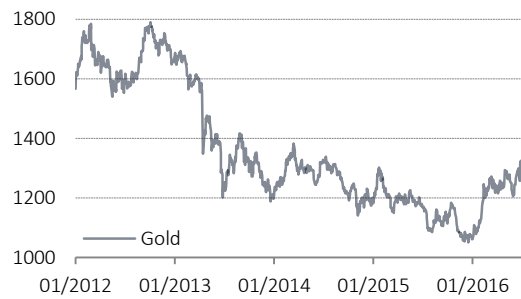


Fig 3: GBP

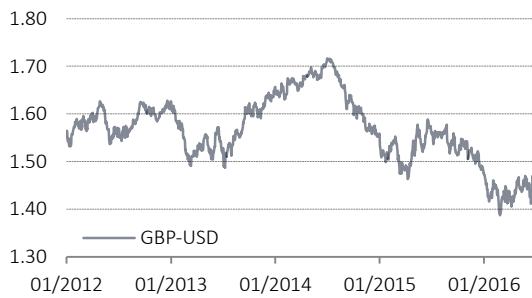
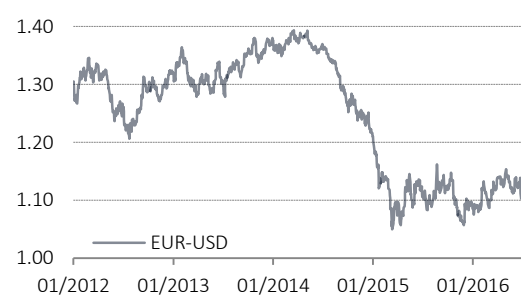


Fig. 4: EUR



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