Crossbow Partners
Experience & Discipline

London Trip Report

Brexit – The Aftermath

July 4 - 5, 2016

Executive Summary

The CSPP, the ECB's corporate sector bond buying programme, has artificially inflated European high-yield markets

While CSPP keeps spreads muted, much greater credit differentiation emerges, as idiosyncratic, event and liquidity risks increase

The CSPP and poor liquidity have dramatically sharpened gap risk for investors and traders – particularly if a company does not deliver on their financials or if they miss on their milestones in their restructuring

The CSPP drives yield-seeking investors further down the credit spectrum and/or forces them to hold longer duration papers

In the US, we could see a tipping point in inflation in 3Q, as higher energy prices and wage pressure percolate through the system

Equity managers consider the violent move out of cyclicals into expensive defensive stocks as overdone and are fearful of a counter-trend rally

Equity investors seek to implement strategies that distinguish between assets that are likely to remain "impaired permanently" (notably stocks predicated on the UK domestic economy, i.e. FTSE 3ftsef50) and those that are likely to recover once uncertainties around Brexit will be fading away

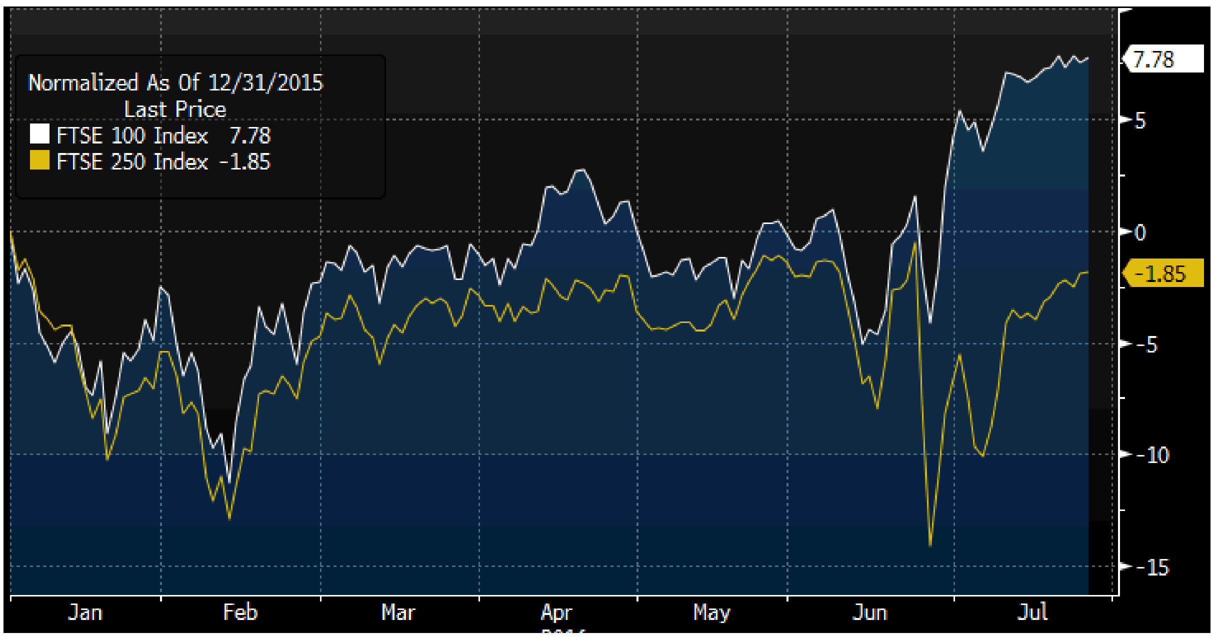
After Brexit, put options on the FTSE 100 performed poorly, as this crowded trade was closed out by many others at the same time, while institutional investors sold the volatility spike on those days, hammering volatility even more in a falling market and leading to inefficient hedging strategies

Macro and Equity View

1. Fallout from Brexit

June will go down in history as a historic turning point: The UK has voted to leave the EU and all other events were clouded by this surprising outcome. The vote to withdraw from the EU has rocked markets and risk assets, notably putting equities on a roller coaster ride. Markets had appreciated very strongly in the week preceding the referendum decision on anticipation of a vote to remain. But equities' sharp two-day rout quickly came to a halt and reversed, as central banks pledged to step in and investors were lured back by noticeably lower price levels.

The FTSE 100 (white line) - which mainly consists of large companies operating internationally and with a strong revenue base abroad - has shrugged off the brief post-referendum dip, and is one month after the event at levels not seen since August 2015. As many companies on the index generate their revenue outside of the UK, the fall in the British pound will boost their earnings power when translating earnings back into GBP.

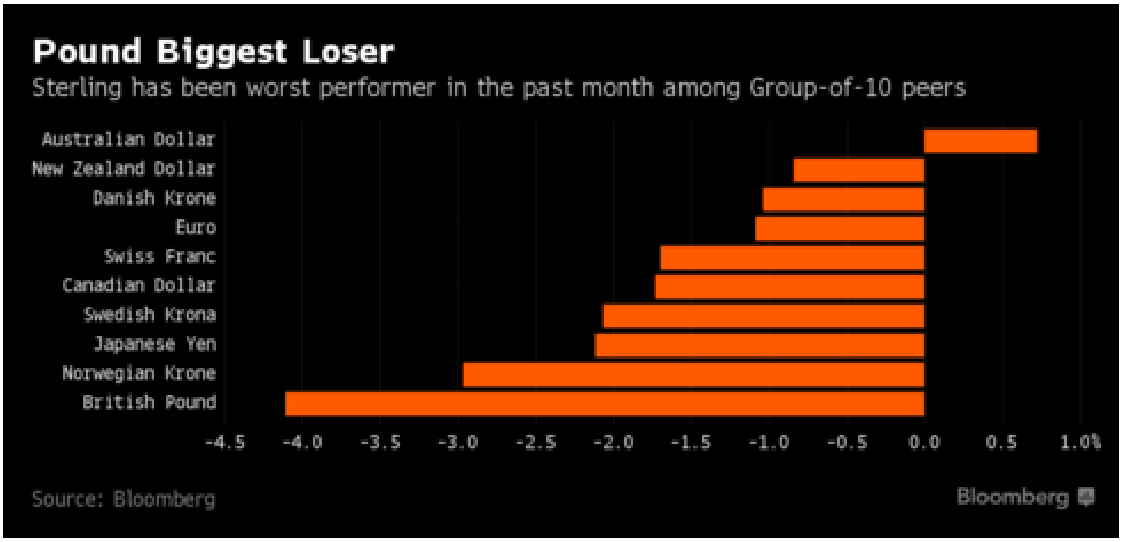


Source: Bloomberg

By contrast, the FTSE 250 (yellow line) is much more representative of the UK's domestic economy, as a much greater proportion of companies on the index derive the majority of their income domestically. The FTSE 250 has not recovered as strongly as the FTSE 100 from losses, implying that investors take a more dire view of the economic prospects of UK-focused companies.

The main transmission channel of the Brexit outcome, however, was the trajectory of the British pound. The GBP was worth USD 1.4810 on 23 June and is now trading around USD 1.3130 – a fall of more than 11%. Sterling has not been at levels this low against the USD since the mid-1980s. The GBP has also lost ground on the Euro. On 23 June the pound was worth EUR 1.30. It is now trading at around EUR 1.1950.

Bloomberg reported on 8 July that the GBP had overtaken the Argentinian Peso to become the world's worst performing currency in 2016. According to Bloomberg, even now, one month after the referendum, the GBP remains the worst performer (vs the USD) among a group of 10 peers. Yet some analysts have suggested that the GBP was overvalued prior to the referendum in any case:



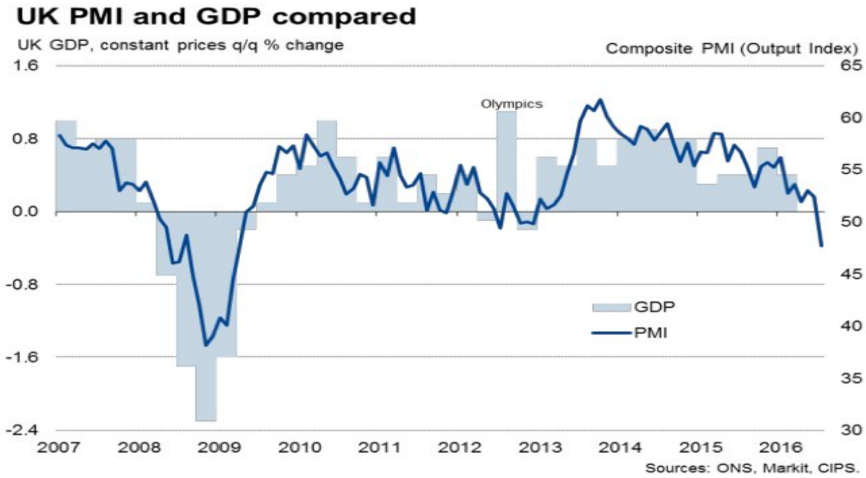
Source: Bloomberg, July 26, 2016

The flipside of the coin is that a lower GBP makes exports more competitive, even though the UK has not that much to export. In July, new export business rose for the second straight month and to the greatest extent for almost two years. This was mainly linked to the sharp drop in the GBP exchange rate. There is no question that a weaker GBP will also have an impact on inflation. The downside of the exchange rate was a steep rise in manufacturers' input prices, mainly due to higher import costs. The rate of purchase price inflation hit a five year record. The latest inflation results for June 2016 indicate there was a 0.5% rise in the consumer prices index compared to June 2015.

Also in housing and property it is too early to draw firm conclusions. The Bank of England's regional agents' survey found that there was a dip in housing market activity after 23 June, but that transactions had so far proved to be more resilient than some had expected. UK average house prices had increased by 8.1% in the year to May 2016. It will be September before new data on average house price movements begins to cover the post-referendum period. Most economists issued dire predictions about the UK housing markets. It is, in particular, the freezing of several property funds in the UK that brought back nasty memories of the subprime crisis.

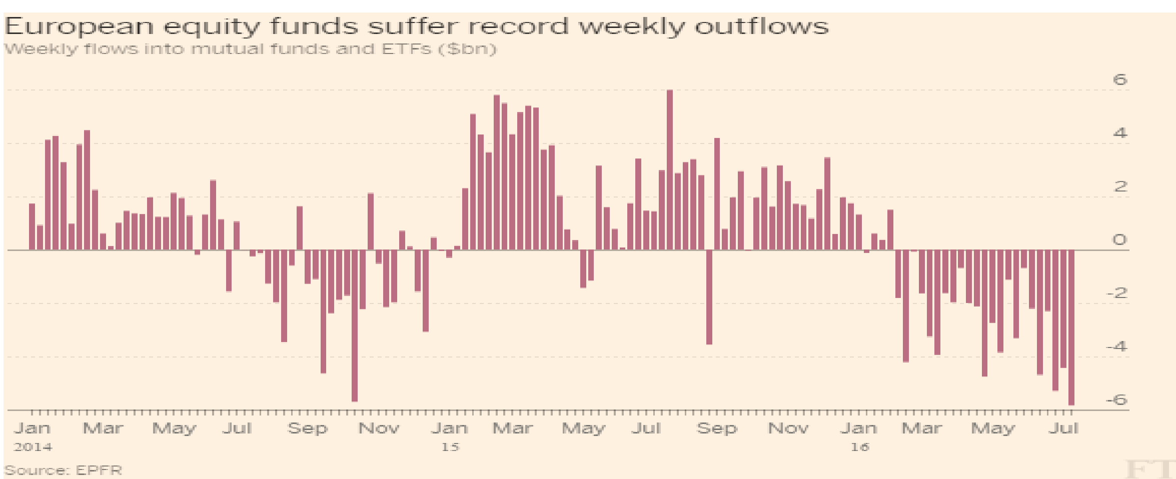
Contrary to the dire predictions, one of our hedge funds has suggested that the prospect of tighter immigration controls may actually cause a surge in migration to Britain as the country prepares to leave the EU. In similar periods in the past, attempts to tighten immigration rules had always led to a spike in immigration as long as the window of opportunity was open. If post-Brexit such a scenario were to materialize, consumption and the housing market are unlikely to suffer a sharp slowdown, at least as long as the UK is still a member of the EU. And it would also imply that the GBP has far less room to fall than most market participants anticipate today, as the economy would not fall off a cliff and the Bank of England could soon face inflationary pressures, leaving the room for interest rate cuts rather limited.

Brexit remains a credible threat to markets, as the ripple effects of the vote have started to kick in and to percolate through the system. Markit's latest PMI report from July 22 suggests that the UK economy is shrinking at its steepest pace since early 2009, declining at a quarterly rate of 0.4%. Output and new orders both fell for the first time since the end of 2012, while service providers' optimism about the coming 12 months slumped to a 7 ½ year low. But it is still open whether this number was an outlier or whether the UK slips into a light recession, as other economic data and news have been equivocal and we have not (yet) come across reports about massive layoffs and the shelving of significant investment plans in the wake of Brexit.



2. Investment Implications

The vote to withdraw from the EU has pushed the UK into uncharted waters as the degree of uncertainty has increased considerably and also compounded the difficulties for investors where to put their money. But uncertainty also weighs on Europe's markets. Some of our global macro managers have reduced their exposure to European markets in favor of the perceived safety of US stocks. The unease about Europe was heightened by the Italian banking crisis and the upcoming stress tests of European financials. As a result, European equity funds saw record withdrawals in the second week of July, extending an already long streak of weekly outflows since January, as notably retail investors repatriated their money.

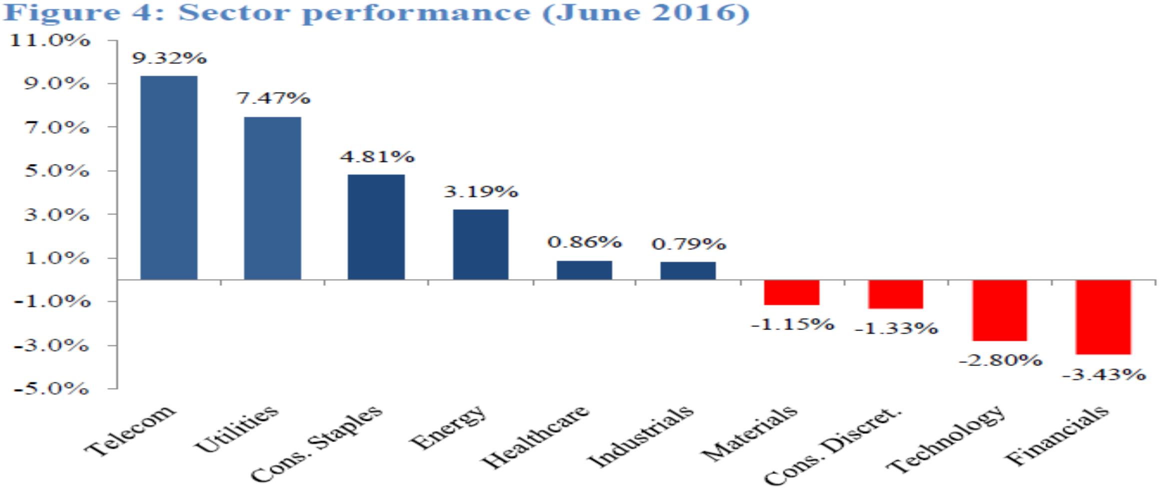


Most of our fund managers suggest to avoid political forecasting. Making large implicit macro calls on the various potential exit scenarios seems unwise at this point in time, as one bets one's money on untested assumptions. Institutional investors may have tactically adjusted their asset allocation, but not taken huge wagers based on Brexit. The key is to remain flexible and to implement a data-dependent investment strategy as the Brexit negotiations unfold. The vast majority of our fund managers stick to their tested-and-true investment principles which have served them well in the past, particularly in times of market turmoil.

Equity managers have started to sift through the rubbles of the post-Brexit world in search for value after the sharp dislocation. Most managers have focused on stocks that were beaten down, but which have the potential to recover strongly once the uncertainties of Brexit will have faded away. They typically snapped up stocks which are listed or domiciled in the UK but which have sustainable, strong sources of revenue abroad. By contrast, managers tended to avoid stocks with a revenue base which is largely predicated on the strength of the UK economy and on domestic UK consumption, as uncertainties are greatest in those areas.

Equity managers are also concerned about the massive rally in defensives, as investors rotated out of cyclicals into the perceived safety of more defensive stocks with better earnings visibility. But the violent move appears to be overdone and valuations of defensive stocks expensive. This might trigger a counter-trend rally in the near future and whipsaw those managers who had only recently given in to joining those crowded trades.

Figure 4: Sector performance (June 2016)



Source: Bloomberg, Standard & Poor's

Managers fundamentally disagree on the European banking sector. While one manager considers an upside potential of more than 30% to 50% possible, another fund manager strongly disagrees. He suggested to focus only on national retail champions and to avoid banks and financial institutions which are geared towards capital market activities. The fund's view is that the bank's equity is the ultimate underwriter of economic and capital markets' dislocation risks. Investment and wholesale banks are exposed most to those risks which can hardly be quantified in today's environment. Investors are therefore not adequately compensated for taking those tail risks and shun banking stocks, as the banking sector's dismal underperformance demonstrates in 2016.

Commercial real estate in the UK is another sector that is increasingly seen as a source of risk. The large UK banks hold significant exposure to UK commercial real estate (c. 55%

of core equity Tier 1), but have meaningfully reduced their exposure since the crisis in 2008 and implemented sensible lending practices. The smaller, specialized lenders, on the other hand, have disproportionately more levered and concentrated lending in their books and are therefore more exposed to shocks in UK real estate values. While the larger UK banks are believed to be well positioned to weather the storm, the challenger banks and the shadow banking sectors may eventually face large losses down the road.

In bond markets, the Brexit move down was sharp, but short-lived. For most bond fund managers the more important force at work appears to be the ECB's corporate sector purchase programme (CSPP). On March 10, the ECB decided to launch the CSPP as an additional component of their more general asset purchase programme. It involves buying investment grade euro-denominated bonds issued by non-bank corporations established in the Euro area. The CSPP kicked off on June 8 and in the first days the ECB was notably buying five-year utility bonds in the secondary markets. The impact of the CSPP is felt across the entire bond market, as the ECB's buying spree keeps spreads muted across the board. As a result, the CSPP drives yield-seeking investors further down the credit spectrum and/or forces them to hold longer duration papers.

The rally in high yield is pushing yield and spreads to extremely tight levels. Most market participants appear to seek yield and spread, while accepting only minimal credit risk, resulting in the widening of the spread between senior secured and unsecured tranches of an issuer's bonds.

Despite the decompression between higher and lower rates issuers, idiosyncratic, event and liquidity risks increase in the artificially inflated HY market. If a company does not perform according to expectations, the markets will immediately reassess the credit risk, leading to significant gap risk to the downside.

It will be interesting to see what happens in the latter half of the year. One of the global macro funds expects to see a tipping point in inflation in the US in the third quarter, as notably higher energy prices and wage pressure will feed into the system. The Fed will be forced to raise rates at one point or they will be too much behind the curve. This upcoming move will contrast with the CSPP and create interesting trading opportunities for bond traders both on the long and the short side.

Another lesson learned from Brexit was the fact that "easy" hedges did not work well in times of stress. As managers could prepare for the event, many had purchased shorter dated put options on the FTSE 100 or on continental European indices during the run-up to the vote. After Brexit, they all sought to close their hedges at the same time, thereby pressurizing volatility in a falling market. The situation was then even more exacerbated by the behavior of large institutional investors who tried to take advantage of the volatility spike by also selling volatility into the market, hammering volatility even more as markets started to roll over. As a result, investors who had bought volatility were not rewarded as expected, as the volatility spike was muted and their hedging strategies turned out to be crowded trades that did not deliver the expected bang for the buck.