

MACROCOSM

## Brexit: Who Won, Who Lost, What's Next?

Monday, July 11, 2016

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Yes, it turned out to be a buying opportunity. In some ways it still is, more than ever.

*We're happy with our call that the global panic following the UK referendum to exit the European Union would be a buying opportunity (see "On the Brexit Referendum" June 24, 2016). With more than two weeks now to watch markets, politics and news-flow, here is a pastiche of our evolving views and observations, in no particular order.*

### THE ITALIAN BANKS

- Our hot-take twelve days ago that the Italian banks were the potential systemic flashpoint of Brexit (see "[Brexit Panic: It's The Italian Banks, Stupid](#)" June 29, 2016) has now become a [widely-held consensus view](#).
- We said then that we expected Italy to get a green light from the European Union "as soon as this week" to inject state capital into systemically important banks. As it turned out, [it was made public](#) the very next day that Italy and the EU had agreed – supposedly the agreement had already been [secretly made on Sunday](#) – that Italy could give its banks a €150 billion *liquidity* guarantee.
- That's not the *solvency* intervention Italian Prime Minister Matteo Renzi is seeking – an injection of state capital directly into the banks, or into the state-sponsored "bad bank" *Atlante* which would then buy non-performing loans from the banks.
- So an unseemly war of words has ensued, with [Renzi saying](#) after a meeting with German Chancellor Angela Merkel that "We are not here to be given a lesson by the schoolteacher" – then [threatening to act](#) without EU permission, then [walking that back](#) – then [blaming ECB President Mario Draghi](#) for not helping the Italian banks sufficiently when he was governor of the *Banca d'Italia* in the 1990s.
- At the same time, The Great and the Good – including not just current [Banca d'Italia governor Ignazio Visco](#) but also the [CEO of Société Générale](#), the [chief economist of Deutsche Bank](#), and [JPMorgan Chase CEO Jamie Dimon](#) – are all chiming in on Renzi's side. *As we've seen so many times over the last five years of euro area crises, Merkel starts out talking tough, but then becomes diplomatically isolated as, one by one, the rest of the world takes a softer view. Eventually she relents, always recognizing the reality that the only form of Germany's leadership that Europe will accept is, in fact, Germany's followership. It should be easy this time.*

### Update to strategic view

#### EUROPE MACRO, EUROPE STOCKS EUROPE BONDS, US STOCKS, US BONDS, OIL, ASIA MACRO, FX:

We were right that the post-Brexit panic would be a buying opportunity. The opportunity still exists. The Italian bank problem has been only partially solved, but that seems to have quelled the crisis, and a more robust rescue will be forthcoming if it is needed. Based on equity performance, the bet is that UK and Europe are equally wounded, but the rest of the world unaffected. The equity risk premium makes US stocks highly attractive even at all-time highs – but UK and German stocks look even better, each in their own ways. This is in part due to all-time low government yields, which will not last. But neither are they likely to massively reverse, and forward earnings are recovering. We are concerned by the residual weakness in oil, but see no good reason for it, and expect it to soon reverse. China is managing its severe Brexit FX challenges with great aplomb.

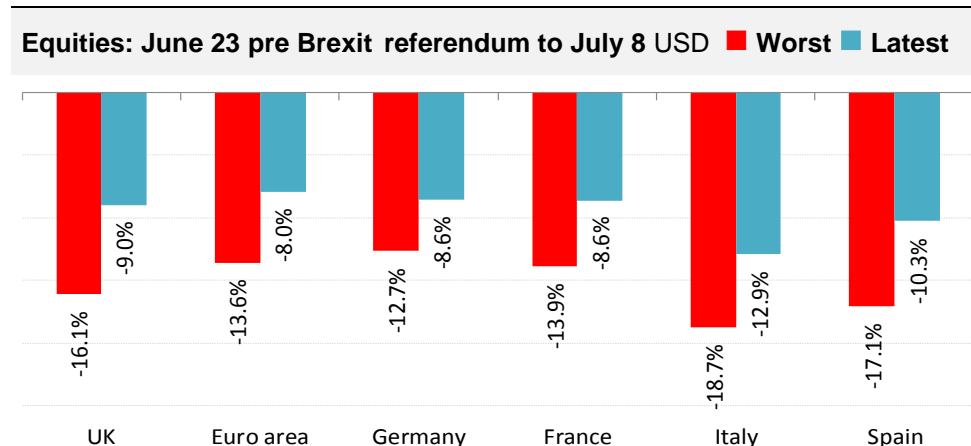
[\[Strategy dashboard\]](#)

Germany doesn't even have to write a check – it just needs to shut up and get out of the way.

- [It's too soon](#) to treat the Italian banks as a fully solved problem. But it is partially solved already, and fully recognized – which probably contributed a lot to the recovery in global markets last week. A more robust solution is probably coming, and certainly coming if it turns out to be intensely needed.

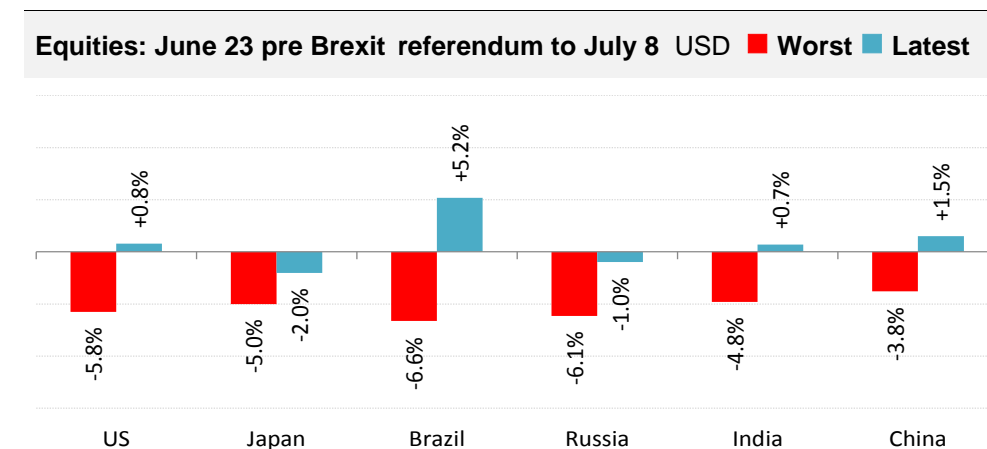
## EQUITY MARKETS AS A SCORE-CARD AND MACRO FORECAST

- Even before the referendum, we had offered the long-term view that Brexit would create long-term benefits for both the UK and the EU, but more short-term risks in the EU (see [“Brexit: Opening Pandora's Brox”](#) May 23, 2016). Adjusted for currencies, UK equities have performed about the same – a little worse, actually – than the euro area, on average, suggesting that forward-looking markets don't agree with us (please see the chart below).
- [But we'll stick with our initial bet.](#)



Source: Bloomberg, TrendMacro calculations

- Major equity markets outside the UK and euro area have all recovered from the Brexit shock (please see the chart below). Here markets seem to agree with our view that Brexit will not trigger a global recession. [We'll stick with that bet, too.](#)



Source: Bloomberg, TrendMacro calculations

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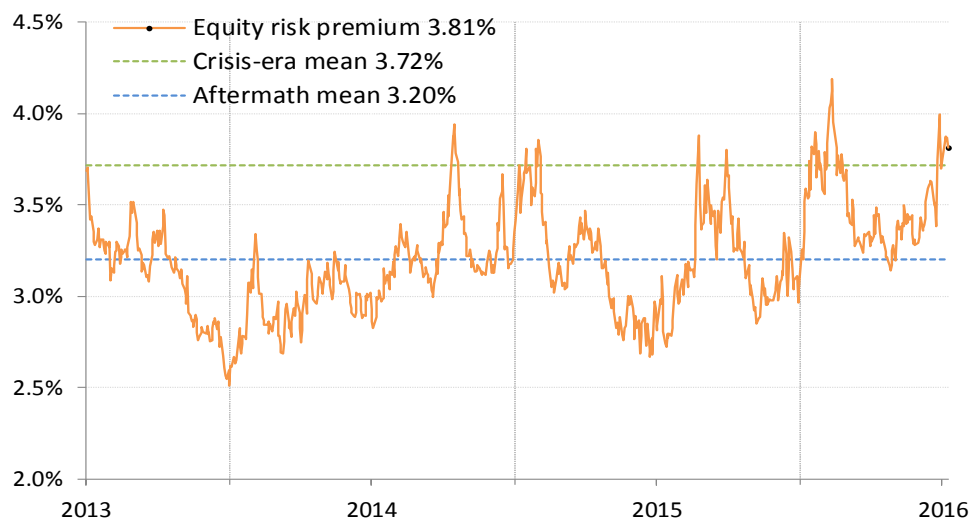
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## EQUITY RISK PREMIA SUGGEST THERE IS ROOM TO RUN

- Even with US stocks having recovered from the Brexit shock – to new all-time highs, as of this writing Monday morning – the equity risk premium makes stocks extremely attractive.
- For the S&P 500, at the worst of the panic, the equity risk premium rose to its highest level in what we think of as the “aftermath era” beyond the global financial crisis, beginning in July 2013 (the very highest was February 11, 2016, when WTI crude double-bottomed at \$26, and it looked like a global recession was underway – please see the chart below, and [“Yuan Direction”](#) February 16, 2016).

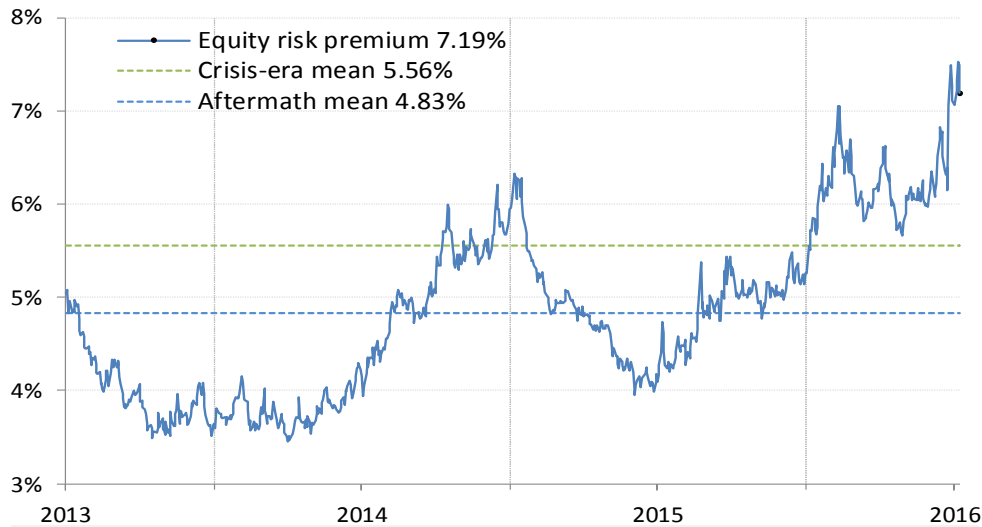
**S&P 500** From July '13, forward earnings yield minus 30-yr Treasury



Source: Bloomberg, TrendMacro calculations

- The S&P 500 equity risk premium remains above the mean that obtained throughout the 2007-2013 crisis-era.
- Yes, this is in part due to record-low Treasury yields (we will turn our attention to that, and to low yields around the world, in another report this week). For now let us say that we don't think these extreme low yields will last – but then again neither are we expecting a massive back-up.
- And at the same time, S&P 500 forward earnings are growing nicely. Overall, including the still-impaired energy sector, they are still below their peak in early October 2014. But month-over-month, they are now growing at a 10.4% annual rate (with the energy sector growing at an astonishing 282.5% rate). Ex-energy, S&P 500 forward earnings recovered from their slump to make new all-time highs three weeks ago, and are growing at a 7.2% annual rate (this data is refreshed each week in our [“Strategy Summary”](#)).
- The UK equity risk premium is even more attractive, making sharply higher aftermath-era highs that are well above the crisis-era mean (please see the chart on the following page).
- Here, even more than in the US, this is the result of extremely low long-term government bond yields. Since before the referendum, 10-year gilts yields have fallen 64 bp to 0.74% -- putting the UK's

### FTSE 100 From July '13, forward earnings yield minus 10-yr gilts

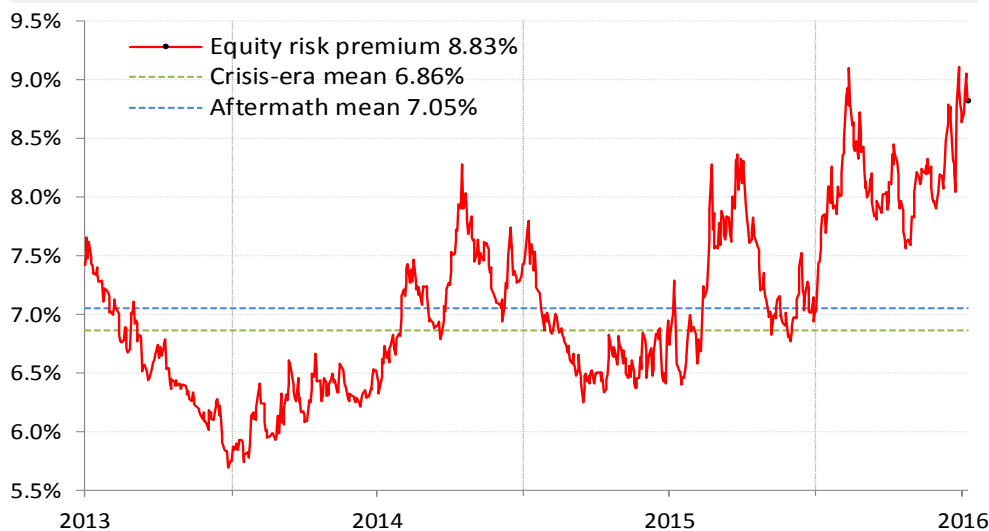


Source: Bloomberg, TrendMacro calculations

real 10-year yield at an amazing negative 2.38% (based on 5-year/5-years forward inflation swaps).

- We assume that the market is betting that the Bank of England will resume its quantitative easing program. But QE generally drives yields higher. Be that as it may, we don't see how much lower these yields could possibly go anyway, considering the specter of inflation rising at least 1% in virtue of the weakening of sterling, and the UK's net-import position – and market-implied inflation in the UK is already the highest among the major economies.
- At the same time, UK forward earnings have been recovering mightily this year as oil prices have recovered.
- *The German equity risk premium has a rather different pattern, but is still attractive* (please see the chart below).

### DAX From July '13, forward earnings yield minus 10-yr bunds



Source: Bloomberg, TrendMacro calculations

- In Germany, the mean equity risk premium has been higher in the aftermath-era than in the crisis-era. This is because, after the crisis, yields in Germany have been persistently far lower than they were during the crisis.
- German forward earnings have been faltering a bit recently, while they've been generally recovering nicely almost everywhere else. But in the global earnings rollover that began in October 2014, Germany has been the best-performing single nation. This has been due largely to the complete absence of direct energy exposure. That said, Germany has had to endure first, an earnings hit from sanctions against Russia, a major trading partner; and second, the emissions scandal at earnings powerhouse Volkswagen.
- *With all those caveats, the fact remains that the German equity risk premium is extraordinarily elevated – indeed, it is at levels only exceeded in rare moments during the crisis-era.*

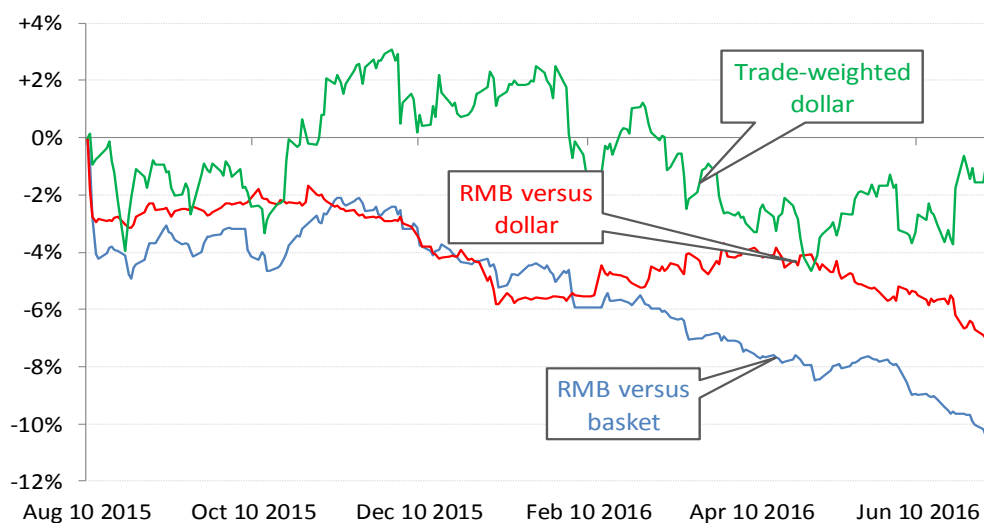
## WEAKNESS IN OIL

- *While most risk-assets recovered smartly last week – outside the UK and Europe, as though the whole Brexit shock had never happened – oil was a potentially important exception.*
- We have long argued that the crash in oil prices beginning in June 2014 risked causing a global recession, through its impacts on credit quality and US dollar strength. Just as that recession was getting underway in Q4-2015 and Q1-2016 (see [“The Recession Caused by Low Oil Prices”](#) January 8, 2016), oil double-bottomed in January and February, and recovered sufficiently to abort the recession – as we've seen through narrowing credit spreads and the general softness of USD, even given the impact of Brexit (see [“Have We Suffered Enough?”](#) February 26, 2016).
- *So it is especially concerning to us for oil, which we have seen as the causal agent of so much risk, to perform so badly coming out of the Brexit crisis.*
- *We see no good reason for the softness in oil. Perhaps that should deepen our concern, but when we see something happen in markets for no good reason, we have to assume it will be reversed, and is therefore only an opportunity. So for now, we stand by our earlier expectations that oil prices will rise to \$65 by year-end.*
- We don't see Brexit as likely to cause a global recession that would significantly weaken the oil demand outlook. At this point, if it did, that would in turn weaken the supply outlook, leaving oil in about its current increasing net deficit position a year out (see [“Who Knew? OPEC Actually Matters Again”](#) June 6, 2016).
- We note that emerging economies – where oil demand growth will likely mostly come from – have generally had the best-performing equity markets through the Brexit crisis, suggesting they will be least subject to any cyclical risk (again, please see the chart at the bottom of page 2). And over the last month, while front-end crude prices have fallen in the crisis, long-dated futures prices have increased. At the same time, credit spreads in the US high-yield energy sector have barely budged, suggesting that the market most at-risk from further oil price weakness isn't expecting much trouble.

## FINALLY, A QUICK WORD ABOUT CHINA

- Exactly a year ago China was thought to be the world's basket-case, and the conventional wisdom was that it was about to implode and take the rest of the world down with it. We said it wouldn't happen, and indeed it hasn't happened (see ["China: Toil and Trouble, but No Bubble"](#) July 10, 2015).
- We have blamed China's difficulties on its highly overvalued currency (see ["On the RMB Devaluation"](#) August 11, 2015) – collateral damage from the extreme USD strength after oil started to crash in October 2014 (see ["Dollar Strength: A Crude Connection"](#) April 23, 2015).
- With the extraordinary FX volatility in the wake of the Brexit referendum, China has been challenged to manage the RMB to its "reference basket" of currencies, against which we believe it is now committed to execute an orderly and gradual devaluation (see ["More Anbang For the Buck"](#) April 13, 2016).
- China has risen to the challenge with great aplomb (please see the chart below), and has been rewarded with equity markets that were the least perturbed in the world after the Brexit referendum (again, please see the chart at the bottom of page 2).
- *If Brexit were to be a globally contagious event, then this might have been a prime vector. It has happily proven not to be.*

**FX change from August 10, 2015** The day before first RMB devaluation



Source: Bloomberg, TrendMacro calculations

## Bottom line

We were right that the post-Brexit panic would be a buying opportunity. The opportunity still exists. The Italian bank problem has been only partially solved, but that seems to have quelled the crisis, and a more robust rescue will be forthcoming if it is needed. Based on equity performance, the bet is that UK and Europe are equally wounded, but the

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