A very British gesture

Commentary following the Brexit outcome

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Winston Churchill is well known for his V for Victory hand gesture of two raised fingers, palm held outwards. When a Brit makes a V hand gesture of two raised fingers, palm held inwards, it is of course very rude indeed – and it's that gesture which a majority of those who voted in the UK referendum yesterday have made to the EU.

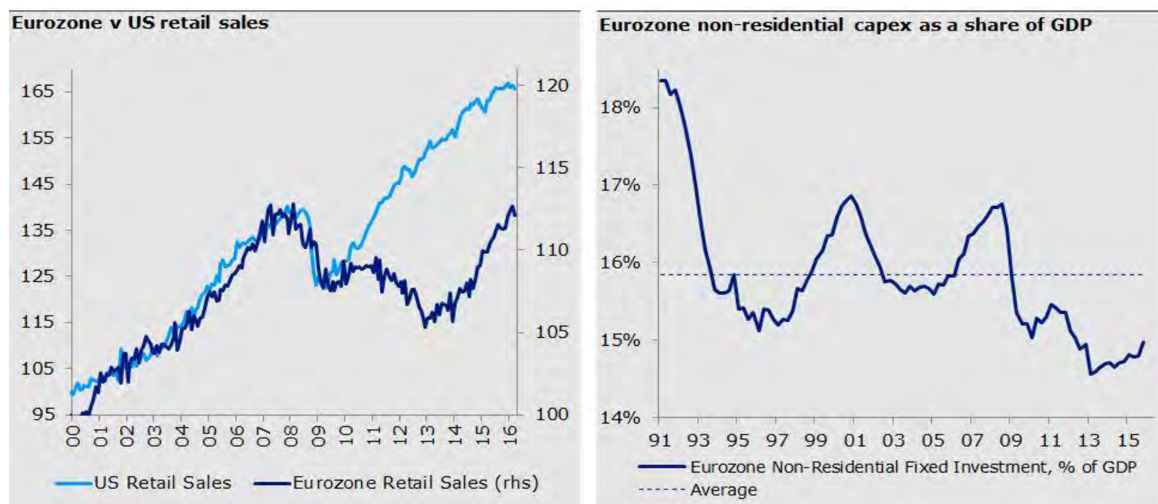
Where does this leave our European equity portfolios?
Firstly, for background comments on the macro side of things in a post-Brexit Europe, please have a quick look at the following commentary which was put out earlier this morning:

Brexit was not what we were positioned for and is clearly not helpful short term. The market is indulging in a bout of 'throwing babies out with the bath water', and brokers' strategists are - predictably and just about universally – screaming that the only thing to do is buy safe haven stocks and run for the hills because clearly, the whole of Europe will be pushed into recession by what this proud, but embarrassed, British citizen sees as his country's sad lack of foresight.

Is that the right answer? Really? We expect markets to be messy and highly volatile for some time, but at this early stage would point out the following:

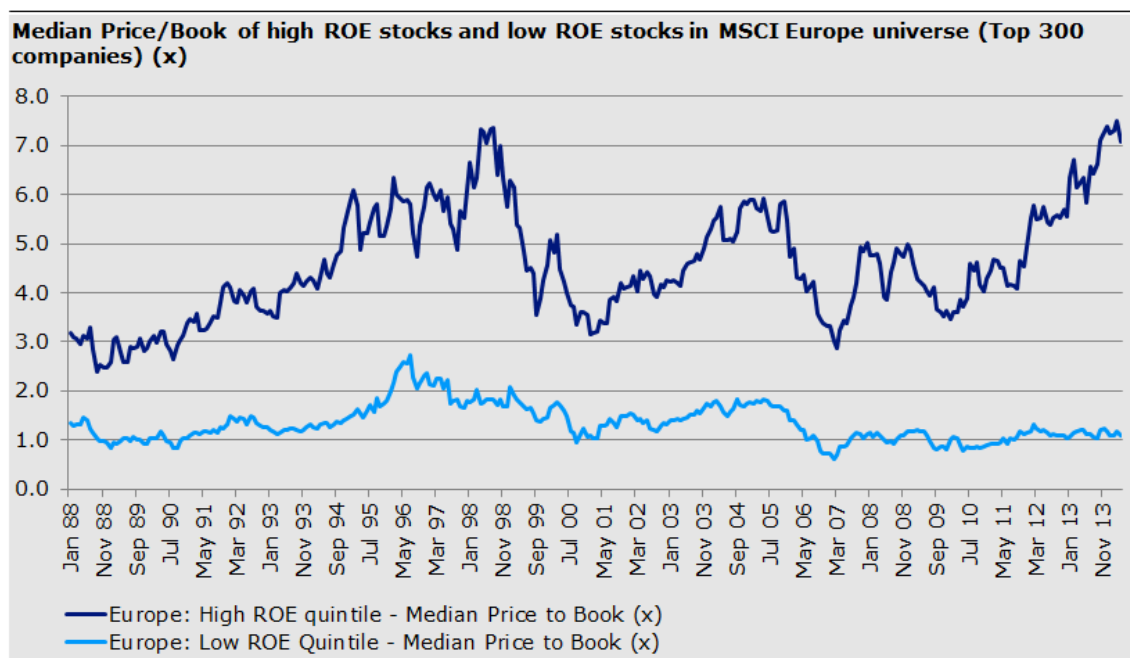
1. The Eurozone's slow but steady economic recovery in recent years has been driven by a recovery in domestic demand. See charts (Figure 1) showing the improving picture for retail sales and capex below. A domestic demand driven recovery should be harder to derail than a pick-up driven by external economic factors would be. We note that Credit Suisse's economics team (our personal favorites) have this morning reduced their 2016 GDP forecasts for the Eurozone from 1.7% to 1.5% and their 2017 forecasts from 2.0% to 1.0%. Their numbers for the UK are understandably more radical: 1.8% goes to 1.0% for 2016 and 2.3% goes to minus 1% in 2017.

Figure 1. Grounds for recovery



Source: JP Morgan as at 10 May 2016. LHC – Rebased to 100 as at 1 January 2000

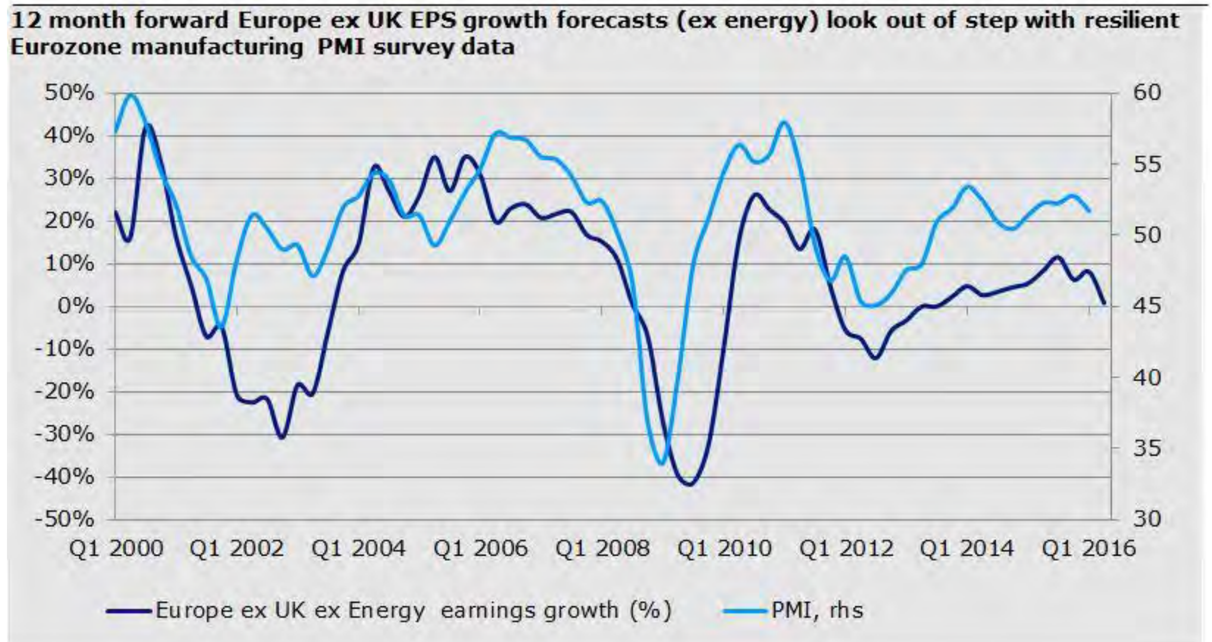
2. As valuation driven investors we care deeply about what we pay for things. Even before the Brexit result, Mr Market had been running scared for some time, to the extent that the multiples that 'quality' trades on compared with the rest of the market had already hit extremely high levels (see figure 2). Panic is cyclical and will recede when nerves settle themselves. When 'valuation elastic' is as stretched as it is now, we do not think it is rational to chase already expensive stocks to ever higher levels.



Source: MSCI, Thomson Reuters, Bernstein analysis as at 30 April 2016. Based on each company's 12 month trailing Return On Equity for the Top 300 companies within the MSCI Europe, the universe is arranged into quintiles, with the highest ROE companies included within the top quintile and the lowest ROE companies included in the bottom quintile. For both the highest and lowest ROE quintiles the Price to Book (12 month trailing) is calculated based on the median of all the constituents within each quintile (as shown above.) All quintiles are re-balanced quarterly.

3. Analyst's expectations for European earnings were already very depressed. Figure 3 below implies that the rate of earnings growth expected for the next 12 months was already at a level compatible with PMI data significantly below the levels seen in the Eurozone for many months. We struggle to believe that Eurozone data will end up 'justifying' a decline in PMIs of this magnitude. We also note that the weakness of the Euro post Brexit is, at the margin, positive for European earnings growth.

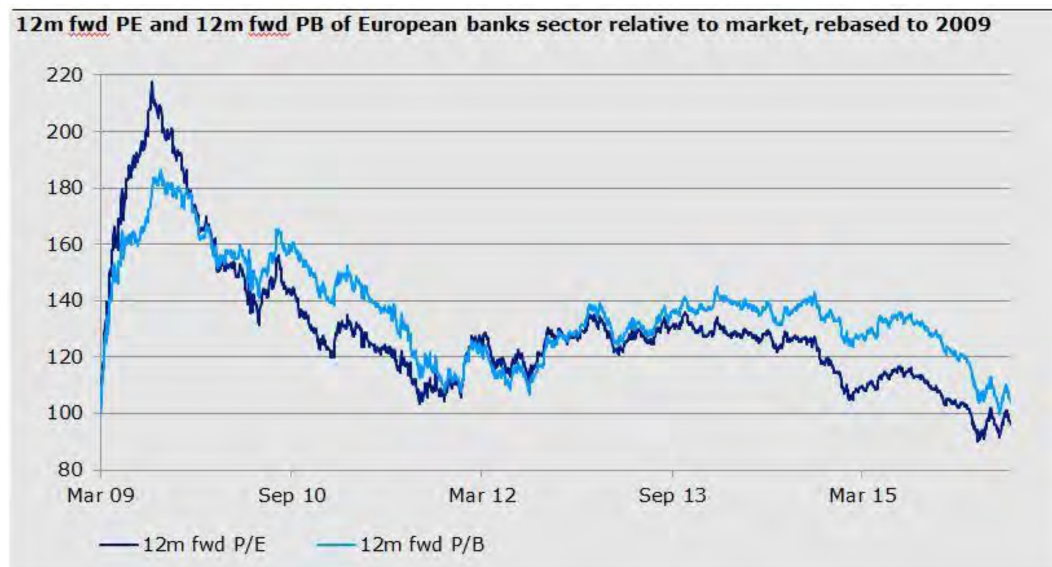
Figure 3. Earnings expectations already depressed



Source: UBS European Equity Strategy, Datastream as at 30 April 2016 using latest Q1 2016 data. The earnings growth is 12 month forward IBES consensus, Europe ex UK, PMI is Eurozone manufacturing PMI. Opinions and forecasts are based on current market conditions and are subject to change without notice.

4. Financials have many flaws and Brexit is giving the market another excuse to have a go at them today, both banks and insurers. We are not blithely or blindly ignoring the risks, but we also note the following: bank valuations are already below Eurozone Crisis lows (Figure 4), Eurozone banks typically have very little UK exposure, Eurozone banks' balance sheets are dramatically stronger than before the Global Financial Crisis (Figure 5):

Figure 4: European banks Valuations

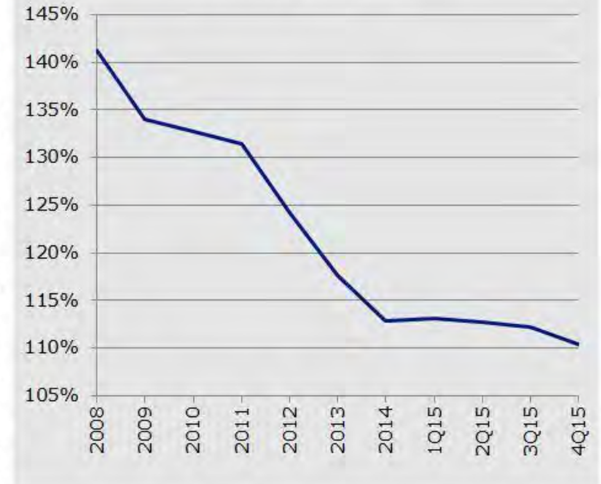


Source: UBS as at 10 May 2016. For illustrative purposes only.

Figure 5: European Banks' Capital has been rebuilt

Core equity tier 1 capital ratios under Basel II in 2007 –v– the latest available under stricter Basel III

Bank	Q2 2007 Basel II	Q3/Q4 2015 Basel III
Lloyds	7.2	13.7
Barclays	5.3	11.0
RBS	6.4	15.0
Santander	6.3	10.1
BBVA	6.2	10.3
Intesa Sanpaolo	7.2	13.1
Unicredit	6.1	10.9
Commerzbank	5.4	12.0
Deutsche Bank	7.0	11.1
ING*	7.5	13.4
BNP Paribas	6.1	10.9
Societe Generale	6.4	10.4
Credit Suisse	11.6	11.4
UBS	10.8	14.5



LHC Source: Invesco Perpetual Fixed Income team, based on latest individual bank results as at 12 February 2016. *Latest data is for the ING group and is pro forma for the full disposal of ING's stake in NN. For illustrative purposes only. RHC Source: [1]ECB, Deutsche Bank as at 12 February 2016. This is not financial advice and not a recommendation to buy / hold / sell these securities.

We also beg to differ with the much suggested idea that other Eurozone countries must necessarily follow the UK's lead and head helter skelter towards their own referenda. Protest parties can protest, but that does not mean that there are clear mechanisms that will by necessity lead to referenda elsewhere. It is a very British assumption that other countries see things as we do. What seems more logical to us is that other European leaders will show solidarity with the EU whilst simultaneously pointing to reforms which need to be made within the EU. Heiko Maas, Germany's justice minister said this morning that "we respect the decision by a narrow majority of Britons. The Brexit must now be implemented quickly". He didn't give a specific timeframe. Maas added that "one thing is clear: we will fight for Europe". He said that Europeans must stick together for their "ideas of peace, freedom and justice".

Expect policy action to be taken whether by the ECB or individual governments. Watch this space

Predictably, there have been wild moves in markets. Portfolio action by us at this early stage has been limited, but where single stock moves downwards have been particularly extreme, we have looked to take advantage of them, in some cases trimming holdings which have held up well. As I write, there have been no major changes overall and no shift in our overall investment stance.

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