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1805
Asset Management

# Maybe Brexit won't break Britain (and the world)

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## In Brief

*June 2016*

**Luca Paolini, Chief strategist**

- Brexit could galvanise EU reforms or closer integration and prompt European and UK fiscal stimulus measures
- Italian government recapitalisation of banking sector more likely
- Brexit likely to keep global central banks on an easing bias

**The British electorate's decision to leave the European Union in the June referendum has roiled markets worldwide. It has clouded prospects for the UK and world economies, and threatens the future of the European project. Investors are obviously right to feel concerned. But they should also know that there are some silver linings to the Brexit clouds. And these could support riskier asset classes over the medium term.**

The biggest worry is that the UK's looming divorce from the EU will encourage other electorates in Europe to demand their own 'leave or remain' referenda.

After all, populist, anti-EU movements are gaining strength in France, Italy, Sweden and even Germany.

Yet there are reasons to believe that the EU's key decision-makers, who are clearly aware of popular discontent with mainstream politics, might see fit to moderate some of the conditions that have heaped pain on the populations of weaker member countries.

The European Commission has already turned a blind eye to fiscal slippage in countries like Italy, Spain and France. So the UK referendum might yet convince the German government to relent on some of its austerity demands on peripheral countries. There could even be scope for officially-sanctioned fiscal easing as a way of mitigating Brexit's impact.

Italy's creaking banking system is seen as another potential victim of Brexit, but here too there are signs that policymakers are adopting a more pragmatic approach. The Italian government is in talks with EU regulators in a bid to overcome restrictions preventing a state-funded re-capitalisation of its debt-laden banks. Giving Rome the green light to press ahead with a EUR40billion cash injection, invoking "special circmustances", would go some way to reversing recent market panic.

Spain's general election result is also cause for mild optimism. The vote, which followed soon after the British referendum and in which mainstream political parties did much better than expected, suggests Brexit might well make restive electorates a little less prone to rebellion.

As for the UK, while we expect Brexit to have a negative impact on growth, possibly dragging the economy into a recession, the fallout could well prove less severe than some think over the long run. For one thing, UK-EU negotiations over a new trading relationship might not result in an acrimonious split.

Indeed, some commentators think Article 50, which lays out the process that would ultimately lead to Britain's withdrawal from the EU, might never be invoked.

What's more, a new UK government, expected to be in place by September/October, could well provide significant fiscal stimulus, say, by quickly approving major infrastructure projects, or by implementing pro-business policies (a cut in corporate tax rates, for example), as a way of supporting the economy.

At the same time, major central banks are likely to offer support where needed. The Bank of England has plenty of ammunition at its disposal – it could cut rates or restart Quantitative Easing, though sterling's fall will also be very stimulative for exporters. The European Central Bank, meanwhile, could trim rates at the margin or announce an extension of its asset purchase programme.

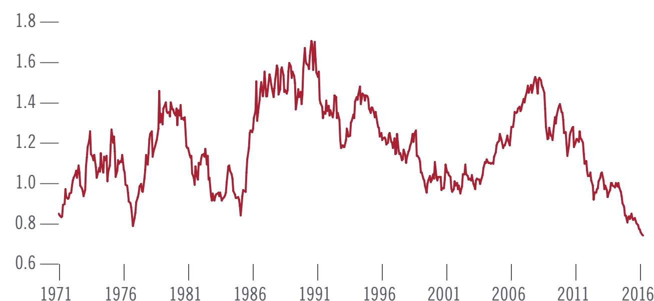
Most important of all will be the US Federal Reserve's response. Only recently there were expectations that the Fed would hike its funds rate twice this year, by half a percentage point in total. Now, the market is forecasting no move until 2018. That may place a break on the appreciation of the US dollar, which would help export-dependent emerging markets.

Even before their post-Brexit selloff, European equities were at their cheapest valuations relative to the US since at least the mid-1990s. They could rally strongly if there's a move back into riskier asset classes once the dust settles.

Clearly, Brexit is a reminder investors have to start paying more attention to political risks. US elections this autumn, French and German ones next year each have the capacity to reignite market turmoil. But investors shouldn't only discount worst case outcomes.

**FIGURE 1 – EUROPEAN STOCKS GOING CHEAP**

Ratio of MSCI Europe and US equity indices




Source: Thomson Reuters Datastream

## Luca Paolini, Chief strategist

Luca Paolini joined Pictet Asset Management in 2012 as Chief Strategist.

Before joining Pictet, Luca worked as an Equity Strategist at Credit Suisse Securities, responsible for asset, regional and sector allocation. From 2005 to 2007, he was Investment Strategist at Union Investment. Luca started his career in 2001 at Allianz Dresdner Asset Management as a assistant vice president, covering asset allocation and investment strategy.

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