Implications for Asian Investing of the UK leaving the EU

The EU referendum result came as a surprise, as we could see by the immediate reactions on Friday 24 June in the currency and stock markets.

This should not be overstated however. By close on Friday the net effect of the gyrations during the day when looked at in terms of the movement over 7 days (i.e. from 17 June 2016 to 24 June 2016) was that world stock markets in US dollar terms were down 1.6%. Regionally the US (S&P500) was down 1.6%; Far East ex Japan (MXFEJ) flat; Japan (Topix) down 1.8%; Europe ex UK (MXEUG) down 2%; UK (UKX) down 2%.†

This is not quite the picture given by newspaper headlines.

In currency terms the moves from close 17 June to midday on 27 June have been where the main effect has occurred. Here the USD GBP rate moved from 1.436 to 1.321 (Sterling down 8.02%); the USD Yen rate from 104.2 to 101.5 (Yen up 2.50%); the USD Euro rate from 1.13 to 1.10 (Euro down 2.36%) and USD RMB from 6.60 to 6.68 (RMB down 1.26%).†

It will however be some weeks or months before we discover whether the UK's decision to leave the EU will have a significant effect on world economic growth. The Brexit enthusiasts hope it will reignite momentum towards global free trade, while Brexit opponents fear the opposite.

From our position as Asia focussed investors, we are most interested in:

- The knock-on effects of a weaker UK economy - if that is a result (likely quite small)
- The knock-on effects on US interest rates staying lower for longer - if that is an outcome
- The knock-on effects of a strengthening US dollar or weakening Euro on demand for Chinese exports (probably relatively small)
- The potential risks to Asian exports if EU economic recovery stalls (again small given recent anaemic growth)
- China's response, especially in the RMB, to the above

A weaker UK economy

We find that the UK has very little direct impact upon Asia at all. A shorthand way of looking at this is to look at China renminbi trade-weighted basket as published by the Bank of International Settlements (BIS). This looks at the relative importance of each of China's trading partners in assessing the relative value of China's currency. In these terms, Sterling has a 2.9% weight in the basket above the Singapore dollar at 2.7%. By contrast, the Euro accounts for 18.7%, the US dollar 17.8%, the Yen 14.1%, the Korean Won 8.5% and the Taiwanese dollar 5.6%. The UK directly has little impact on the region: it is the implications for the wider EU and spill-over effects that take our attention.

US interest rates and the dollar

We expect that a rise in US interest rates will now be deferred further as the Federal Reserve takes its time to assess global growth and liquidity implications. This would imply relative dollar weakness were it not for the backdrop of heightened risk sensitivity. The currency's safe haven properties may attract buyers which is likely to push the dollar higher. This is likely to be accompanied by falling bond yields in core markets such as the US and Germany and a widening spread between those and peripheral European markets/weaker Emerging markets.

These conditions tend to give rise to under-performance in emerging markets but a closer look suggests that Asia tends to be most defensive while Latin America and emerging markets in Europe, Middle East and Africa look more vulnerable. The reasons for Asian defensiveness are the ones we have emphasised for a long time: balance sheet strength, stable financial systems and economies supported by both export manufacturing and a vibrant domestic market provide greater stability. Lessons from Asia's financial crisis in 1997/8 have been learned is evident in national accounts, banking system stability and higher corporate returns on investment.

The impact on Asian currencies will be a function of regional interest rates and portfolio flows. The receding prospect of rising US interest rates in the short term gives Asia more room to cut interest rates if required. Central banks in the region remain accommodative but there is no immediate pressure for further cuts. Thus we think that while currencies in the region may weaken a little we do not foresee significant moves. The exception is the Yen with its safe haven status and whose prospects are also related to the success or otherwise of the 'Abenomics' programme. So far this year the Yen has appreciated 13.6% and the Renminbi has weakened 1.5%. Excluding these two, the region's currencies have risen 3.5% on a weighted average basis†.

The risks of slower GDP growth in the EU and a weaker Euro

We are unable to tell at the moment how great the shock to growth will be or indeed if there will be a shock at all but it does look at least probable that expectations will be lowered. The length of time lowered expectations persist will determine how great the real effect will be on items such as corporate investment. In part this will depend upon how quickly and how amicable the EU/UK split will be. Slower growth in the EU will likely be felt by Asian exporters with lower volume demand and, if accompanied by a weaker Euro, lower revenues in dollar terms.

Export manufacturing is still important to the Asian region. If we exclude Japan and look only at Non-Japan Asia (NJA), gross exports account for 33% of GDP. If we look at the value-added component of exports then the figure drops to around 18.4% of GDP. Then we need to look at the share of exports from NJA that go to the European Union: the value-added component of exports from the region to the EU accounts for 14.3% of NJA's total exports and equates to 2.6% of GDP*. The conclusion from this analysis is that the impact on overall Asian GDP is likely to be small; however, it is significant when investing in Asian export manufacturing businesses.

From a different perspective we can consider the impact of a GDP slowdown in the US. World growth in 2015 was estimated by the IMF to have been 3.1% while that of the EU was 2.0% according to Eurostat. In the spring, the EU itself forecast 2016 growth to be 1.8%. The impact of the UK's withdrawal from the EU could be a further weakening of EU growth by 0.1% to 0.5% according to UBS. In 2015 Asian export volumes to the EU were up 15% but were down 6% in dollar terms due to currency weakness. The overall impact of a decline of 0.5% in real EU GDP from 1.8% to 1.3% in 2016 could be a reduction of 0.1% in Asian GDP, according to UBS. Again, this does not represent a significant danger for the region but certainly suggests tougher times for the export sector at a time when trade growth is already below world economic growth.

China's response

There is much less to say on this point but since China fears have persisted to a greater or lesser extent in recent years we should consider it. We would expect to see greater stability in the renminbi exchange rate against the dollar (USDCNY). In recent weeks the CNY has weakened against the dollar partly as a result of dollar strength on a trade weighted basis but also thanks to the handy opportunity presented by the fact everyone has been looking the other way (US election, UK referendum, stronger Japanese Yen etc). However, now global risks have risen again and the possibility of capital outflows have risen with them, we expect the current rate to be defended.

Domestic monetary conditions in China remain supportive. We can look at money supply growth, 7-day repo rates and interest rates on money market funds in China to get a sense of underlying conditions and we see the central bank doing a good job in maintaining stability. We do note however that the central bank's role in this is still substantial. Therefore, it remains our view that China issues which have been well telegraphed are not likely to be a source of immediate worry. Indeed, signs that producer prices which have been falling for four years will start to rise by the end of the year would be a significant positive development for an indebted nation.

Conclusions

It is too early to tell whether Brexit will lead to a stronger and more vibrant economy in 5 years time or not. And whether the negative effects of uncertainty will outweigh benefits from a lower (and some argue more appropriate exchange rate) is also unclear. For the rest of the world this is a risk event that may or may not have destabilizing effects on the 28 (soon to be 27) – strong European Union. Signs of financial stress may become evident through the yield spread between government bonds in the core and the periphery of the EU and we would look at both 5 year and 10 year yields as indicators.

The response from central banks around the world is likely to be supportive with the possible provision of additional liquidity. The aim, as ever, will be to maintain stability in financial markets and for investors this has implications. Perhaps the greatest implication is that market distortions will remain with us for longer – low interest rates, low bond yields, ample liquidity. For equity investors it makes macro calls riskier and concepts such as momentum and mean reversion become unreliable in these conditions. Momentum relies on administrative support while mean reversion seems to be exactly what this administrative support seeks to avoid.

Therefore, a focus on investment in good quality businesses, those whose operations generate strong cash flows that do not rely on 'ersatz' manufactured growth would seem the most appropriate strategy, as it has been for the past 5 years. And, as ever, we should look for value. It is hard to gauge the present value of future growth opportunities when the path to growth itself looks so uncertain and therefore a value bias even for growth investing is surely the way forward.

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Data sources

† Bloomberg and Guinness Asset Management Calculations

* UBS