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24 June 2016

The die is cast

The future of the EU is in question

The UK people have made their decision, with a 51.9% vote in favour of leaving the European Union. Prime Minister (PM) Cameron has announced he will resign once the Conservative Party has chosen a new leader. The next PM will have to 'deliver the instruction' given by the popular vote and activate Art. 50 of the EU Treaty in order to initiate the exit negotiations. For the rest of the European Union, we believe political implications are more important than short term economic and financial impact: the hard times are yet to come. Within countries, political equilibria will shift further. Between countries, there will be attempts to show unity and initiative, but public opinions and the markets will be reluctant to give the benefit of the doubts to leaders that have been largely impotent, when facing the rise of populism and nationalism. At this stage, all options are open, from impotency leading to the fragmentation of the EU and, to far reaching reforms that might give a new life to the European project. Future developments will be the result of interactions between politics and economic developments. Financial markets will try to anticipate these complex interactions, but since they are highly uncertain, may change views relatively often. To some extent, financial markets' reaction may influence political reactions, in case of acute tensions, on periphery debt, or some key sectors of the economy, such as banks.

In the short term, economic growth and jobs are unlikely to be affected: real economies are like supertankers – they are slow to react to political and financial changes. Yet, market and political developments will be critical. As for the former, if well targeted, they will reduce financial market volatility and limit the extent of contagion across countries and thus mitigate the impact on real economies. Here is a wrap-up of our thoughts, based on our pre-vote analysis.

Markets' reactions: as expected, thus far

Markets have already reacted to the vote, in line with our 'Brexit case': sterling and European equity markets sharply down, 'safe haven' vehicles, US$ and JPY on the currency side, German Bunds, US Treasuries and Gilts, sharply up. Within the euro area, periphery spreads are widening and may widen further. The case of Portugal is important, since the European Central Bank (ECB) has less leeway to frontload its purchases of government bonds than in other constituencies. While volatility is likely to remain high, the first market reactions are consistent with a more fundamental analysis, based on likely economic developments and reactions from central banks, including their potential blind spots.

Central banks in action

Central banks are ready to inject liquidity as much as needed in order to prevent any liquidity squeeze in any important market, starting with equities. This is a standard, well-oiled reaction. If global demand for liquidity turns into a rush on US$, as happens when a global systemic stress is forming, the Fed will provide US$ liquidity via the swap lines that were open during the financial crisis which are now open. Key central banks have already published communiqué to this effect and there should be no doubt whatsoever on the capability of central banks to provide liquidity.

The case of the Bank of England (BoE) is particularly important, since the British sterling is at the epicentre of the storm. Beyond providing ample liquidity, the BoE may consider using its monetary policy tools, such as interest rates and quantitative easing (QE), if the real economy is seen at risk of a sharp slowdown. Yet, there is a dilemma: the devaluation of the sterling will increase inflation, thus challenging the inflation controller that is the central bank. We think that the BoE will most likely look through the spike of inflation and ease if necessary. Yet, a downward spiral of the currency may force the BoE to take the opposite view.

The ECB will also consider its options in order to stabilise euro area financial markets. Within the current policy framework, there is not much that the ECB can do, except frontloading purchases of assets seen as unduly stressed. In this regard, we see an extension of the purchase program to corporate bonds issued by financial institutions, or equities, as unlikely. If the market pressure becomes too strong, on periphery bonds

for instance, the Outright Monetary Transaction weapon could be activated, but only upon a decision by the country under fire to request help and to accept a program of reforms attached to this help.

As for the Fed, the July hike we had in mind in case of Bremain is now off the table and, given the proximity of elections, the Fed is unlikely to hike before December, and might even opt for no hike at all this year, depending on financial and real economy developments.

Negative impact on real economies, in Europe at least, but no global recession in sight

Leaving the EU will certainly have negative consequences for the UK economy, in the short and medium term. While the depreciation of the sterling may give some relief to exporters' margins, the combined confidence and inflation factors will hit real domestic demand even harder: consumers' real income will be hit and corporate investment plans are likely to be postponed until the negotiation dust settles. Going forward, we expect a significant slowdown in the UK, starting to materialize in the third or fourth quarter, a recession being a possibility.

The euro area economic outlook will also be darker, first because of the volatility in the financial markets which is raising the cost of capital, but also because of the uncertainty surrounding the political consequences of the UK vote. Companies are likely to take a cautious stance regarding their investment plans. Yet, the growth momentum seen so far this year is likely to prevail and we would expect only a marginal slower outcome by the end of this year and next year, although conceding that uncertainties around this forecast are higher than before.

Neither the US or Asia are likely to be significantly hit by the UK vote. In the US, the recovery is mostly driven by household spending (consumption and housing investment) and looks thus robust. Paradoxically, emerging markets may benefit from a more dovish Fed, conducive to capital inflows.

Markets will unavoidably ask the question: is this exogenous shock going to trigger a global recession? At this stage, our answer is, probably not, but, again, it is fair to say that uncertainties have increased.

Check political developments in Europe

We will learn more on this front in the next hours and days, starting with the UK. Beyond official statements by EU leaders doing their best to reiterate their commitment to the EU, the key risk factor is the rise of popular rejection of European and national elites, seen as unable to prevent income and employment stresses. We will look at Italy with particular attention. PM Renzi is planning a referendum to reform the Italian Constitution (reducing the power of the Senate) in October, but, the UK vote might increase the popular anger against the euro, raising the risk of political instability. Beyond Italy, there are significant risks of EU referenda in other constituencies, starting with Hungary. We see a lesser risk of such referendum in the Netherlands or Finland.

All in all, political, financial and economic uncertainties are now significantly higher than they were yesterday morning. We look forward to the EU Summit beyond the Spanish elections to get more political reactions, as commitment toward the European construction with concrete decisions will be key to calm markets.

Equities

Index	Last price	Today's change (%)	5-day change (%)	YTD change (%)
Euro Stoxx 50	2807.27	-7.59	-1.47	-14.09
FTSE 100	6044.51	-4.63	0.39	3.17
S&P 500	2034.4	-3.39	1.70	3.39
TOPIX	1204.48	-7.26	-3.71	-22.16
HANG SENG	20259.13	-2.92	0.44	-7.55

Source: Bloomberg and AXA IM Research – As of 24/06/2016

Sovereign yields (10 years)

Country	Current yield	Today's change (bps)	5-day change (bps)	YTD change (bps)
United States	1.51	-0.24	-0.10	-0.76
United Kingdom	1.08	0.29	-0.06	-0.88
Germany	-0.08	-0.18	-0.10	-0.71
France	.033	-0.12	-0.10	-0.66
Italy	1.49	0.009	-0.02	-0.11
Japan	-0.17	-0.03	-0.02	-0.44

Source: Bloomberg and AXA IM Research – As of 24/06/2016

CDS

Index	Current spread	Today's change (bps)	5-day change (bps)	YTD change (bps)
Main	93.10	23.82	9.00	20.48
Xover	396.10	22.89	5.59	25.90
FinSen	127.17	33.05	12.99	65.57
SinSub	269.47	31.34	12.11	75.54
CDX.IG	87.93	14.52	6.21	-0.50
CDX.HY	459.79	8.68	2.38	-2.62
CDX.EM	291.28	4.68	-3.37	-18.95

Source: Bloomberg and AXA IM Research – As of 24/06/2016

Currencies

Currency	Price	Today (%)	5 day (%)	YTD (%)
GBP / USD	1.39	-6.11	-3.16	-5.63
EUR / USD	1.11	-2.05	-1.39	2.34
JPY / USD	10.06	2.60	1.07	16.63

Source: Bloomberg and AXA IM Research – As of 24/06/20161.07

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