KBank Capital Markets Perspectives

BREXIT: If UK = Lehman, then ? = AIG

Strategies on
Macro / FX/ Rates
24 June 2016

Kobsidthi Silpachai, CFA - Kasikornbank
kobsidthi.s@kasikornbank.com

Pareena Phuangsiri - Kasikornbank
pareena.p@kasikornbank.com

Nattariya Wittayatanaseth –Kasikornbank
nattariya.w@kasikornbank.com

Anchali Singh – Kasikornbank
anchali.s@kasikornbank.com

- **Life after UK without EU so far has been tough for the European markets**
- **The UK and EU officials are scheduled to meet at the EU Summit on June 28-29th**
- **The bigger problem is waiting…BREXIT is likely to be followed by more rise in separatist idea. In our view, Greece and Spain are the candidates**
- **Markets estimate that it would take at least two years to complete the exit from the EU**
- **The UK Treasury has earlier outlined the new form of the relationship into 3 ways: Membership of the EEA, Bilateral free trade agreement, and WTO membership**
- **After observing European market reaction and how Asian markets perform, we are a bit more at ease…Thai assets today seem to be resilient…yet the next big move could come when the U.S. market opened**
- **We now expect the Fed to hold off increasing Fed fund rate in 2016 or longer until more clarity is found about the new relationship.**
- **Despite the delay in Fed fund rate hike this year, we still expect the dollar to remain strong as it holds the status of safe-haven assets**
- **The ball is also now throwing to other central banks especially the ECB whose economy has a direct impact from BREXIT while BOJ is now having a hard time staving off JPY strength**
- **All in all, the monitoring milestones are three key things 1) the central banks' response 2) UK financial institutions' health and 3) the development of political and economic contagion**

So the UK leavs EU, what's next?

The UK Prime Minister earlier announced that he will be leaving the office and would step down in October. This would mean that the UK will now have to hold election and the new leader will be in place to negotiate the exit from the EU. Markets estimate that it would take at least two years to complete the process. For the exit to begin, the UK leader would have to indicate other EU leader that he/she wants to use the secession process under Article 50 of the EU treaty. **The EU summit is officially scheduled in the next 5 days during 28-29th June when policymakers from both UK and EU side could discuss on potential solution.**

The Bank of England has also tried to calm the markets today. The Governor Mark Carney stated that the Bank has been prepared for the event and it stands ready to provide additional measures if needed and that liquidity of GBP250bn stands ready to be injected. In terms of stability, the Governor suggested that UK financial system remains strong and that capital requirement is about 10x higher compared to the financial crisis.

We have mentioned before in our previous paper *"KBank Capital Market Perspectives - The Bank of England sees no benefit from a Brexit"* in May 2016 about the potential new relationship between the UK and EU according to the UK treasury department (HM Treasury Analysis: The long-term economic impact of EU membership and the alternatives, April 2016), three different positions UK can find itself under, after the "leave" vote:

- **Scenario 1) Membership of the EEA:** Under this scenario, the UK would be part of the EEA, and as such, would be able to preserve some of the benefits provided by the EU's single market. However, by 2030, the UK's GDP would likely decrease by 3.8% as compared to now, which would roughly lead to a decrease in household income by GBP 2,600 a year per household.

- **Scenario 2) Bilateral free trade agreement:** Under this situation, the UK would still be able to reap some benefits of the European single market, but the benefits would be lesser when compared to the EEA agreement. As such, the UK's GDP will decrease by 6.2% as compared to now, and household income would decrease by GBP 4,300 a year per household.

- **Scenario 3) WTO membership:** The UK would likely be the worst off under this scenario, as it would lose all the privilege that come with being an EU member, and would have no specific trade agreements with the EU. As such, the UK's GDP will decrease by 7.5% as compared to now, and household income would decrease by GBP 5,200 a year per household.

The outcome today is probably setting the platform for the other EU members who may want to leave too. If we compare the UK to Lehman Brothers, several countries can be seen as the next AIG. The separatist movement is seen to gain some momentum after today's event. Particularly, the second Scottish referendum is likely to be put on the global calendar. At the same time, Greece and Spain are the potential candidates. Greece has been pressured by its creditors for years to tighten fiscal spending but for general public, the fiscal tightening has always meant worsened living condition. Unemployment in the country remains high and is expected to record 24.8% in 2016 compared to the peak in 2013 at 27.5. Spain is another potential candidate especially people in Catalonia who does not see eye to eye with Spanish government. Its unemployment rate also remains high at around 20% compared to the peak in 2013 at 26.1%. Following the voting outcome today, below are the comments made by those who favor leaving the EU:

- **France:** "The liberty of peoples always wins in the end! Bravo to the United Kingdom," echoed Le Pen's deputy, Florian Philippot. "Our turn now".
- **Italy:** "Hurrah for the courage of free citizens! Heart, brain and pride defeated lies, threats and blackmail. "THANK YOU UK, now it's our turn." From Matteo Salvini, leader of Italy's anti-immigration Northern League
- **The Netherlands:** Geert Wilders, the leader of an anti-immigration party, called for a referendum on the Netherlands' EU membership following the British result. "We want be in charge of our own country, our own money, our own borders, and our own immigration policy," he said.

- **Scotland:** Scotland's First Minister Nicola Sturgeon says a second independence referendum for #Scotland "is on the table" after referendum results

Fig 1. The potential candidates for more exit are GREECE and SPAIN

UNEMPLOYMENT, %	2008	2009	2010	2011	2012	2013	2014	2015	2016E	2017E
EU	7.0	8.9	9.3	9.3	10.1	10.4	9.9	9.2	8.6	8.3
AUSTRIA	4.1	5.3	4.8	4.6	4.9	5.3	5.6	5.7	5.8	5.6
BELGIUM	7.0	7.9	8.3	7.2	7.6	8.4	8.5	8.5	8.4	8.0
BULGARIA	6.3	7.6	9.5	10.1	11.1	11.3	11.2	10.1	9.0	8.5
CROATIA	13.4	14.9	17.5	17.9	19.1	20.3	19.7	17.7	16.4	15.9
CYPRUS	3.7	-2.0	1.4	0.4	-2.4	-5.9	-2.5	1.6	15.0	14.0
CZECH	4.4	6.7	7.3	6.7	7.0	7.0	6.1	5.1	4.7	4.6
DENMARK	3.5	6.0	7.5	7.6	7.5	7.0	6.5	6.2	4.2	4.1
ESTONIA	-5.4	-14.7	2.5	7.6	5.2	1.6	2.9	1.1	6.2	6.7
FINLAND	6.4	8.2	8.4	7.8	7.7	8.2	8.7	9.4	9.3	9.1
FRANCE	7.4	9.1	9.3	9.2	9.8	10.3	10.3	10.4	10.1	9.8
GERMANY	7.8	8.1	7.7	7.0	6.8	6.9	6.7	6.4	6.2	6.4
GREECE	**7.8**	**9.6**	**12.7**	**17.9**	**24.6**	**27.5**	**26.6**	**25.0**	**24.8**	**24.6**
HUNGARY	8.4	10.7	11.1	11.1	10.9	8.7	7.3	6.1	6.1	5.9
IRELAND	6.4	11.8	13.6	14.3	14.7	13.1	11.3	9.6	8.3	7.5
ITALY	6.7	7.7	8.3	8.4	10.7	12.1	12.6	11.9	11.5	11.0
LATVIA	7.7	17.6	19.5	16.2	15.0	11.9	10.8	9.9	9.5	9.0
LITHUANIA	5.8	13.8	17.8	15.4	13.4	11.8	10.7	9.1	8.4	7.6
LUXEMBOURG	4.2	5.5	5.9	5.7	6.1	6.9	7.1	6.9	6.2	6.1
NETHERLANDS	3.7	4.4	5.0	5.0	5.8	7.3	7.4	6.9	6.5	6.2
POLAND	7.1	8.1	9.7	9.6	10.1	10.3	9.0	7.5	9.2	8.5
PORTUGAL	7.6	9.5	10.8	12.7	15.6	16.2	13.9	12.4	11.8	11.1
ROMANIA	5.6	6.5	7.0	7.1	6.8	7.1	6.8	6.8	6.5	6.3
SLOVAKIA	9.6	12.1	14.5	13.7	14.0	14.2	13.2	11.5	10.4	9.7
SLOVENIA	6.7	9.2	10.7	11.8	12.0	13.1	13.1	12.3	8.6	8.3
SPAIN	**11.3**	**17.9**	**19.9**	**21.4**	**24.8**	**26.1**	**24.5**	**22.1**	**20.0**	**18.6**
SWEDEN	6.2	8.3	8.6	7.8	8.0	8.0	7.9	7.4	6.9	6.7
BRITAIN	5.6	7.5	7.9	8.1	8.0	7.6	6.3	5.4	5.1	5.0

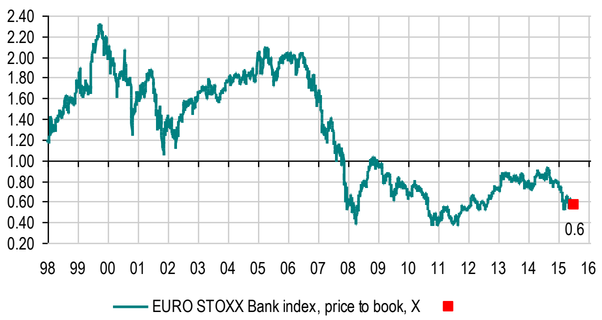
Source: Bloomberg, KBank

Market reaction: Asian markets have been more calm while European markets took a hard hit

Fig 2. The factor to closely follow is the development of UK financial sector

Source: Bloomberg, KBank

Fig 3. The factor to closely follow is the development of EU financial sector



Source: Bloomberg, KBank

The European market has taken a hard hit after the voting concluded. One of the most concerning sector is financials. The vote to leave the EU should adversely affect the UK's status as the financial center in Europe. Today, while the European stocks fell almost 10%, the financial stocks dropped more around 15% so far. Financial institutions are the hearts of both UK and European economies; the malfunctions will definitely have an impact on the broad economy. The factor to watch in our view is price-to-book ratio as shown in the graphs above; the ratio below 1 should indicate the poor outlook on banks and the need for recapitalization. In the event that financial institutions face difficult time, we expect the central banks to respond very quickly via the supply of liquidity into the system.

After observing European market reaction and how Asian markets perform, we are a bit more at ease as Thai assets today have proven to be more resilient. Thai market equities moved lower less than 2%. In fact, all Asian markets except the Japanese ones have seen more limited fall. Nikkei ended the day down by 7% compared to other Asian markets of 0-3% for equities. For FX, USD/THB has been one of the stickiest in the session among Asian FX. This morning, it had opened at 35.18; BREXIT fear has pushed the pair to touch the highest in the session at 35.56 before edging down towards 35.30. The next big move could come from the U.S. where Dow Jones futures indicate a significant fall of -400pts (as of 1630).

Fig 4. Cross asset performance at the end of Asian trading session (as of June 24th at 17.00)

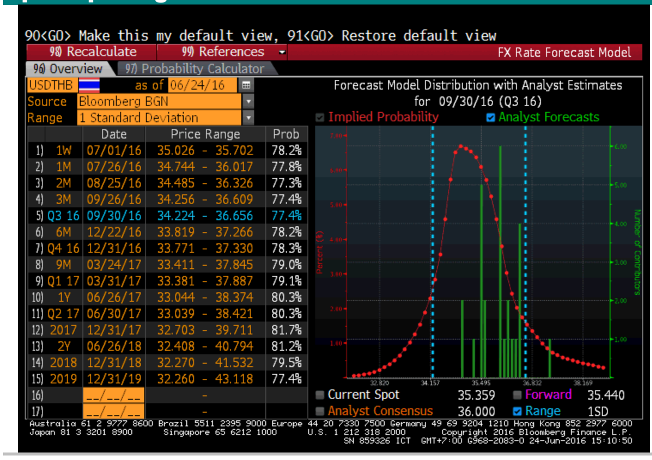
	Previous session close	Current	% Change in price	52-week high level	52-week low level
Gold	1,260.24	1,316.97	4.50%	1,358.5	1,046.4
WTI	50.11	47.86	-4.49%	61.6	26.0
USDJPY	105.73	103.02	-2.56%	125.3	99.0
EURUSD	1.14	1.11	-2.57%	1.2	1.1
GBPUSD	1.49	1.39	-6.75%	1.6	1.3
USDTHB	35.18	35.34	0.45%	36.7	33.7
GBPTHB	52.40	49.10	-6.30%	56.6	46.9
EURTHB	40.11	39.26	-2.13%	41.8	37.0
JPYTHB	33.27	34.31	3.11%	35.5	27.3
SET index	1,436.40	1,405.11	-2.18%	1,524.6	1,221.0
Dow Jones	17,780.83	18,011.07	1.29%	18,167.6	15,370.3
S&P500	2,085.45	2,113.32	1.34%	2,132.8	1,810.1
Nikkei	16,238.35	14,952.02	-7.92%	20,952.7	14,864.0
FTSE 100	6,338.10	6,020.49	-5.01%	6,873.4	5,499.5
DAX	10,257.03	9,569.62	-6.70%	11,802.4	8,699.3
CAC	4,465.90	4,106.90	-8.04%	5,217.8	3,892.5
Hang Seng	20,868.34	20,259.13	-2.92%	27,470.5	18,278.8
KOSPI	1,986.71	1,925.24	-3.09%	2,110.8	1,800.8
Shanghai Stock	2,891.96	2,854.29	-1.30%	4,720.7	2,638.3
10y US Treasuries	98.90	101.09	2.22%	102.0	97.6
5y US Treasuries	100.66	102.00	1.33%	102.5	99.8
2y US Treasuries	100.20	100.61	0.42%	100.7	99.9
10y LB25DA	114.64	115.37	0.64%	120.8	106.6
5y LB206A	103.13	103.45	0.30%	104.7	101.0
3y LB196A	106.43	106.56	0.12%	107.9	106.1

Source: Bloomberg, KBank

Truly a world of Chess move: BREXIT as a game changer

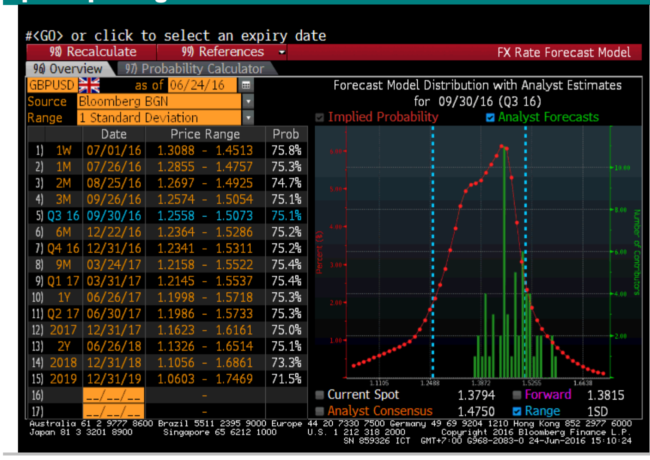
BREXIT has become the game changer as more uncertainty is now leaving the Fed with no choice but no more move this year. We now expect the Fed to hold off increasing Fed fund rate in 2016 or longer until more clarity is found about the new relationship. Despite the delay in Fed fund rate hike this year, we still expect the dollar to remain strong as it holds the status of safe-haven assets. The uncertainty created by the UK today will create premium for holding the dollar. From Bloomberg option pricing, markets see USD/THB movement in the range between 34.77-36.01 over the next month.

Fig 5. The potential USD/THB range from Bloomberg option pricing



Source: Bloomberg, KBank

Fig 6. The potential GBP/USD range from Bloomberg option pricing



Source: Bloomberg, KBank

The ball is also now thrown to other central banks. The ECB will now have a harder time to recover its economy with the Eurozone having a direct linkage to the UK. Furthermore, a flight to safety caused the yen to shoot up significantly and the movement surely would obstruct the country's economic recovery and its goal to arrive at 2.0% inflation target. **All in all, the monitoring milestones are three key things 1) the central banks' response 2) UK financial institutions' health and 3) the development of political and economic contagion**

As for Thailand, several officials have come out and tried to calm the market. Finance Minister stated that the Ministry has been preparing for the event and the fall in both Thai equities and Thai baht are not beyond the expectation. From the BOT, the Governor suggested that both BOT and financial institutions have been anticipating the event; big exposure on FX has been effectively hedged. Anyhow, the BOT expects the implication to be translated through more fragile global recovery which could have impact on Thailand. We expect the BOT to remain on the sideline to further assess the total impact on the Thai economy. For now, we still hold on to our call on repo at 1.50% for the rest of 2016.