Habib Bank AG Zurich

(Incorporated in Switzerland 1967)

HBZ Investment Quarterly

Life after Brexit

Q3 2016

Table of contents

Table of contents

Editorial

Dear Reader,

The world was complicated enough before 23 June, and now we are facing the uncertainty of one of the biggest political upsets since 1945. It will take months, if not years, to unscramble the implications of the British voters' decision to leave the EU. While much of this issue is given over to Brexit, we hope you will appreciate that we – like so many others – are still struggling to see through the current fog. Markets have actually showed remarkable poise since the referendum result was announced and have managed to partially reverse the initial sell-off. The pound sterling has nonetheless taken a beating and is likely to remain under pressure for some considerable time.

A shock event of this kind would typically call for some retrenchment on the investment front. However, we face a dilemma in that the assets of choice during such periods of upheaval (government securities) are currently very expensive and hence unattractive – unless, of course, you anticipate a severe recession and generalized deflation. Gold is one potential alternative, however it is only suitable for investors who can live with the metal's equity-like volatility and are in a position to deal with its negative cash flow. We are convinced that broad diversification across asset classes, regions and sectors remains the best strategy also under these circumstances.

In our Special Topic, we revisit some of the Brexit-related questions raised in our previous issue and analyze some of the likely consequences.

We trust you will enjoy reading this edition and look forward to your feedback.

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

The macro backdrop: Brexit creates new growth risks

Following the UK vote to leave the EU, new clouds are gathering over global growth. The impact may take some quarters to materialize but both the UK and Europe could slow to the point of recession. At least the US and much of the emerging world remain on a moderate expansion path.

Table 1: Real GDP growth (y/y in %)

	2015E	2016F	2017F	Short-term trend
United States	2.4	1.9	2.3	↗
Eurozone	1.5	1.5	1.6	→
Germany	1.5	1.7	1.6	→
United Kingdom	2.2	1.8	2.1	↘
Japan	0.6	0.5	0.5	→
China	6.9	6.5	6.3	→
India	7.4	7.5	7.6	→
Russia	-3.7	-1.0	1.1	→
Brazil	-3.7	-3.8	0.8	↘

Table 2: Consumer price inflation (y/y in %)

	2015E	2016F	2017F	Short-term trend
United States	0.1	1.3	2.3	↗
Eurozone	0.0	0.3	1.4	→
Germany	0.1	0.4	1.7	→
United Kingdom	0.0	0.7	1.7	↗
Japan	0.8	0.2	1.5	→
China	1.4	2.0	2.0	→
India	6.2	4.9	5.1	→
Russia	15.6	7.9	6.2	↗
Brazil	9.0	8.6	5.8	↗

Source: Bloomberg, IMF, HBZ

Key points

- Brexit heightens recession risk in Europe
- No higher US Fed rates before December
- Signs of stabilizing growth in EM

UK parts ways with Europe

Contrary to market expectations, British voters have turned their backs on the EU, rejecting continued membership by a 4-point margin in a referendum on 23 June. This outcome will create additional headaches for a continent already facing multiple stresses, not least high sovereign debt, growing income inequality and migration. Although the UK will remain a full member of the EU until at least late 2018, the untested exit procedure under article 50 of the Lisbon Treaty will result in a climate of uncertainty which will weigh on UK and eurozone growth. While Europe's central banks will do whatever they can to keep the financial system and their economies afloat, politicians will be preoccupied with preventing other EU members from jumping ship, so lower growth will be just one of the consequences of the Brexit dislocation. At least the Greek debt crisis has been defused for another two years following a comprehensive deal in May.

Waiting for the Fed

The US Federal Reserve continues to sit on the fence, unsure whether its country's economy can sustain higher interest rates. Having said this, the Fed clearly feels some urgency to proceed with rate-raising in order to create some latitude for conventional monetary policy responses when the next economic downturn rolls around. Although poor employment reports for April and May signaled a downshift in US job creation, other data has been much more robust, meaning that a recession in the coming twelve months is still highly unlikely. Nonetheless, given the Brexit vote and imminent presidential elections, the window for Fed action is closing fast. Indeed, the stronger US dollar will tighten financial conditions to such an extent that we do not expect a rate hike before December at the earliest.

More stable emerging markets

The slow pace of Fed tightening and a rebound for commodities have helped to stabilize activity in many EM economies. While we are acutely aware of the structural challenges facing EM and of the potentially negative fallout from Brexit on global growth, we foresee modest improvements in China and continued expansion in India. Even the downturn in Brazil and Russia appears to have slowed.

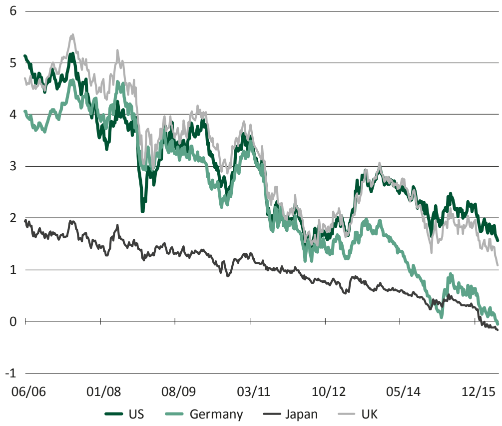
Investment strategy: Rising uncertainty

Markets could have done without the British vote to leave the EU. Now growth fears are back with full force and the ability of central banks to quell them is increasingly limited. We recommend caution but recognize that depressed interest rates mean some risk-taking is unavoidable.

Fed checked by Brexit

For months now, the Fed has wanted to raise rates but has again and again found some excuse for not doing so. In the aftermath of Brexit, we expect Fed rates to remain at current levels into Q4 – and possibly beyond. Global rates will thus remain low and may even fall further, depending on how other central banks respond. The worrying truth is that any further monetary action will do little to lift growth – and for investors, the options are few and far between. In practice, retrenching means piling into overpriced risk-free assets with pitiful returns; taking risks, on the other hand, can expose them to excessively fickle markets. Overall, we still consider the global backdrop to be growth friendly and see the recession risk as contained. While Brexit will weigh on the income of companies exposed to the UK, the earnings recession in the US should ease as the bulk of USD strength is behind us and commodity prices have stabilized. Thus, a cautious approach need not imply withdrawing from all risk assets; however, we should be more circumspect in selecting them.

Chart 1: Global 10-year sovereign rates: Expensive government bonds (% p.a.)



Source: Bloomberg, HBZ

Current positioning

We have maintained our cautious investment stance in recent months although we have increased our equity exposure marginally, principally to emerging markets. This last move has paid off, at least in relative terms, as EM equities held up better than developed markets during the initial Brexit sell-off. We have also increased our exposure to microfinance – an asset class that is only minimally correlated with public markets and generates stable returns.

What to watch

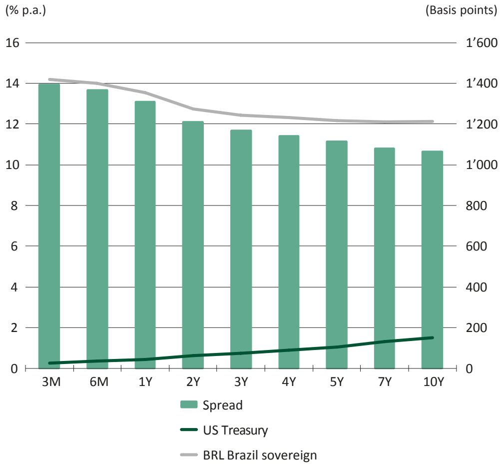
We will be focusing on events in Europe as the UK and the EU begin untangling their relationship. The path to the British exit is fraught with perils as the EU will have to defend its core principles in order to contain centrifugal forces. We will also be following the US presidential election campaign which enters the home straight after the party conventions in July. Hillary Clinton currently has a solid lead in the polls but November is still too far away to make any plausible predictions. Finally, the US earnings season for Q1 will set the tone for markets in the second half of the year. A major miss could prompt us to review our constructive stance on equities.

Key points

- Lower rates for longer favors some risk-taking
- Monitor UK's disentanglement from the EU
- US earnings season key risk for equities

Fixed income: Good times for credits

Chart 2: Much higher yields in Brazilian real



Source: Bloomberg

Key points

- Yield will stay low for longer
- US high-yield most attractive
- Positive view on selected EM credits

Low yields for longer

Yields declined further following the Brexit vote, with those for the 10-year US Treasury dropping to 1.43%. While we see some risk to the upside in USD, in Europe and Japan we expect yields to stay at historically low levels for longer given the economic backdrop. This warrants taking some – limited – duration risk.

Attractive US high-yield

In general, credit spreads widened only slightly in the wake of the Brexit vote. In the investment-grade universe we favor plays in the US housing sector. Some financials continue to look attractive after the recent sell-off and we prefer bonds issued by national champions. In the UK, a rate cut is on the cards, and generally GBP credits – especially exporters and solid financials – stand to do well in the near future. High-yield bonds posted a strong performance after the drop at the beginning of the year. In Europe, the high-yield segment benefited greatly from the ECB's corporate bond purchase program but most of the positive dynamic has already been priced in and we do not expect the ECB to extend its program. US high-yield looks more appealing. These securities offer higher yields and are less exposed to the UK economy. Current spreads look attractive compared to the expected default rate.

Positive environment for EM credits

Although most EM were negatively affected by the Brexit vote, we remain positive on EM credits. The Fed will not hike before December and even China could extend stimulus if the world were to slow down due to Brexit. We expect sovereigns in USD to be attractive in this environment. We also take a favorable view of sovereigns outside Europe. In particular GCC countries have issued significant volumes of debt this year and there is more to come. Investors should wait for Saudi Arabia and others to come to the market as the large supply could drive yields to more attractive levels. Recent market turmoil hit sovereign debt in local currency harder given that local debt typically reacts most strongly to global risks. In this segment, we recommend being highly selective; notwithstanding this, some currencies, such as the Brazilian real and the Russian ruble, are trading at attractive valuations given the high yields on offer. Funds are the most suitable instruments for playing this theme.

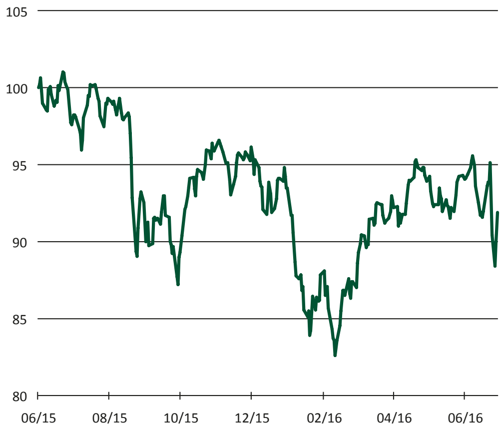
Equities: Consolidation continues

Equity markets have been trending sideways or lower for more than a year now and the Brexit vote will only reinforce this state of affairs. While the framework for risk assets remains intact, higher volatility will be with us for the rest of 2016.

A wave of risk

Energy and defensives have been driving global equity performance year-to-date. While outperforming, defensive sectors have generally shown decent earnings growth and moderate volatility, energy stocks have merely adjusted to the prospect for a higher oil price. Financial stocks have been the laggards mainly due to Brexit. Despite the fact that consumer, healthcare and IT stocks have delivered solid earnings growth amid a softer global economy, these stocks sold off. The Q2 earnings season will begin soon, and another fall in earnings would be the fifth consecutive quarterly decline. Although the energy sector continues to be a big drag, the earnings trend for the market could be in negative territory even if energy stocks are excluded. From this we can only conclude that equity prices have largely decoupled from fundamentals and are being driven by sentiment and fear of economic or tail-risk events. As anticipated, the Brexit vote triggered turmoil in equity markets, where prices plummeted; financial, UK domestic and IT stocks were particularly hard hit. Going forward, we remain skeptical of these stocks until the magnitude of the economic shock associated with the UK leaving the EU becomes clear.

Chart 3: Global equities in consolidation mode
(100 = June 2015)



Source: Bloomberg, HBZ

It's the uncertainty, stupid!

Investors have always disliked uncertainty – yet in todays' world, global capital flows are more fickle than ever. But Brexit and the poor earnings outlook are not the only burden weighing on equities. Historically, stock performance has often been negative during US presidential election years, and the current election is no exception; indeed, it ticks all the boxes when it comes to unsettling investors. None of the candidates has emerged as a clear favorite in the eyes of the financial markets due to the opaque and erratic policies of their platforms. Fed policy is another wildcard. The hesitant stance of chair Yellen has led some to believe that the Fed has fallen behind the curve – in other words, that its policy has been too loose for too long. If this is true, interest rates could rise from their depressed levels and, under such circumstances, utilities and telecom stocks could find it hard to continue outperforming. If not, the S&P may yet test its recent highs once more. The fact that emerging markets have proved fairly stable is a sign that investors have not yet given up on growth.

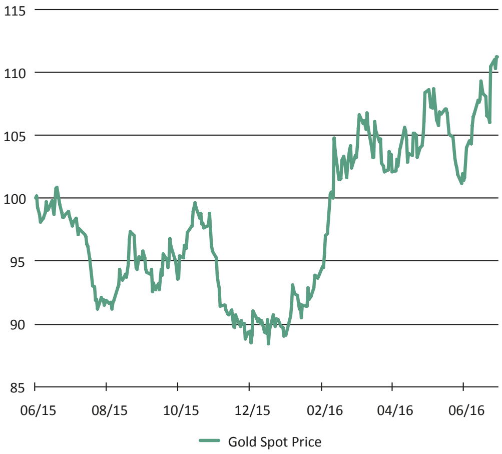
Key points

- Equity markets still trending lower in technical terms
- Post-Brexit economic woes could darken the outlook for equities
- Earnings remain under pressure

Commodities and FX: Resilient so far

Commodity prices have continued to advance in recent months and have digested market turmoil relatively well. FX markets have surprised investors, with emerging-market currencies and the yen gaining and many other developed-world currencies – most noticeably the GBP – weakening significantly.

Chart 4: Gold: Stronger for longer (100 = June 2015)



Source: Bloomberg, HBZ

Commodities: Still standing

Crude oil markets have come through Brexit volatility relatively unscathed and a barrel continues to trade at close to USD 50. Nevertheless, the softer outlook for the global economy could pose a risk to global oil demand and could weigh on the oil price. This, as well as stabilizing supply from the US, could cause crude oil to trade sideways in Q3. Gold has soared after the UK vote as investors seek a safe haven while they contemplate the possible long-term implications of the decision. While most industrial metals weakened, gold bulls continued to push the recent rally, advancing the spot price to its highest level in two years. The gold rally could continue and forecasts have become increasingly bullish, not least because USD interest rates remain at rock bottom. Silver and palladium also posted decent gains earlier in the year, only to come under pressure in June. The slower pace of global economic growth will probably cap the advance of base metals.

FX: Emerging markets rule

Over the last three months, the performance table of currencies has changed fundamentally, with EM currencies coming out on top. Besides the strongly advancing JPY, the BRL, the RUB as well as some other South American currencies stand out as winners. The USD has been in consolidation mode for over a year as hesitant Fed policy triggered a re-rating of the currency. After seven years of economic expansion, the risks of the US economy entering a cyclical slowdown and employment peaking are increasing. In such a scenario, the Fed would be unable to continue tightening which would put the USD at risk. The USD only has significant upside potential in the event of a generalized flight to safety. Unsurprisingly, the pound sterling has lagged all majors as it served as the main shock absorber before and after the Brexit vote. Since 23 June, the GBP has depreciated by some 11% against the USD and only slightly less against the EUR. Heightened market uncertainty will keep the GBP exposed. Investors will watch UK economic data closely to determine the possible ramifications of Brexit. The JPY finally has surged on higher risk aversion. If the Japanese authorities are serious about lifting both growth and inflation, they will need to act to curb their currency's rise

Key points

- Energy and gold show continued strength
- Gains for EM currencies and JPY
- Outlook for GBP remains skittish

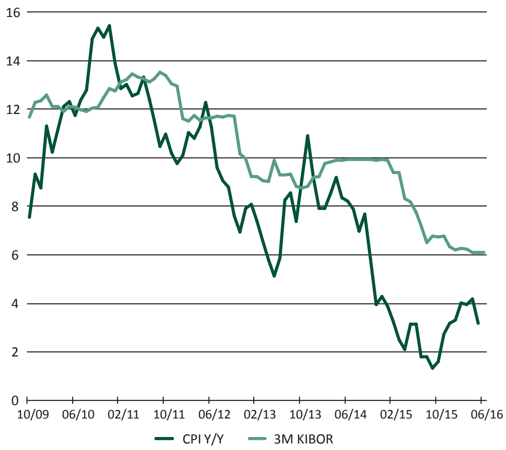
Key markets: Looking through the cycle

While the UK starts to sort through the rubble after its decision to quit the EU, Pakistan and UAE, are confronting more mundane but no less challenging issues: keeping growth on track and pushing ahead with structural changes.

Pakistan: Frontier no more

Record-low interest rates, depressed oil prices and a stable currency have supported strong economic performance this year. The new budget adopted in early June intends to build on the progress made under the three-year IMF program; reforms and the pursuit of macro-stability will continue beyond the end of the program in September. The massive inflow of Chinese investment to build the China Pakistan Economic Corridor (CPEC) and more private ventures in the energy sector will put the ambitious growth target within reach. The index provider MSCI meanwhile acknowledged major improvements in Pakistan's financial architecture and elevated the stock market from frontier to emerging-market status. Over time, this upgrade will bring Pakistan into the focus of international investors who until now paid little attention to the country. Resulting capital inflows should lend further support to the PKR, although the significant overvaluation will continue to depress exports. Nevertheless, the outlook for local equities remains very positive.

Chart 5: Pakistan: Low inflation, low rates positive for growth (%)



Source: Bloomberg, HBZ

UAE: Boost from higher oil price

The recovery of the oil price provides welcome relief to the UAE and the Gulf region as a whole. Various measures to raise new revenues and cut spending have already reduced the UAE's fiscal break-even for the oil price to some USD 60/bbl. With the immediate fiscal pressures contained, the government can now focus on further diversifying its economy.

UK: Managing Brexit

The next prime minister will certainly have plenty on his or her plate. First, a strategy is needed to guide the exit talks with the EU. He or she will also have to come clean with the public: The picture painted by the 'Leave' camp of post-exit Britain is largely fantasy. Once the negotiations start, markets will respond to facts and rumors alike. The Bank of England's steady hand will be needed to calm any undue fears. This will start with a rate cut within a month or two. Nevertheless, UK assets will be volatile (including Gilts due to the lower sovereign rating and the risk of a higher deficit) and they will be more interesting for traders than for investors for some time. With risk hovering over the GBP, investors are advised to either hedge their exposure or stay away from the currency until the fog starts to lift.

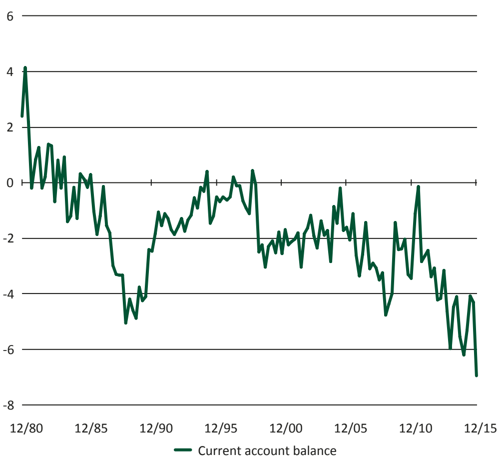
Key points

- Pakistan to attract more foreign investment as stock market is upgraded to emerging market status
- Higher oil price buys time to implement reforms in UAE
- UK assets to remain volatile as country splits from the EU

Special topic: Investing after Brexit

The UK voters' decision to leave the EU marks a historical watershed. While it is impossible to determine the long-term consequences at this stage, it is not too early to assess the investment implications for the coming months.

Chart 6: UK: A large current account deficit to finance (% GDP)



Source: Bloomberg, HBZ

Key points

- GBP most at risk during the exit period
- Exposure to the UK as a negative for any asset
- Long-term damage as the UK become less attractive for investors

GBP as the weakest link

The pound sterling has been the principal victim of the UK's shock decision to 'Brexit'. The currency remains vulnerable, as it is the core channel through which investors can articulate their views on the financial and economic consequences for the country. While the full fallout will only become visible with a considerable time lag, one key vulnerability is already apparent: The current account deficit. The capital flows needed to finance it will probably ebb as the uncertainty surrounding the future status of the UK vis-à-vis the EU remains in limbo. Moreover, given that a marked slowdown and possibly a recession will likely cause the Bank of England to cut rates over the summer, it is easy to see that something has to give. The GBP is the weakest link.

Collateral damage

Whereas the fall in value of UK assets is totally self-inflicted, the correction in EU and eurozone stocks is a perfect example of collateral damage. Given the level of uncertainty surrounding the consequences of Brexit, European stocks are condemned to suffer in sympathy with their British peers. Fixed-income assets are less exposed since the ECB has established itself as a voracious buyer, keeping yields and spreads in check. However, this does not apply to the same extent to bonds from the Southern peripheral countries with their shaky fundamentals.

To whose benefit?

Our base scenario proceeds on the assumption that the world will weather this latest shock without a recession. In principle, the further away from the UK – or, for that matter, Europe – an asset market is, the less likely it is that it will be seriously impaired by the cross-Channel divorce. The US and EM (and even Switzerland) suffered considerably less during the initial sell-off than any of the EU-28. So over time, who stands to benefit from a potentially diminished UK? Foreign direct investment, which has traditionally poured into the UK as an entry point into the EU, will probably seek a home elsewhere on the continent. With lower domestic growth and possibly higher taxes, UK assets will also look less attractive for investors, and, in particular, UK commercial real estate could lose their appeal. And finally, EM capital could seek out other destinations or simply stay put.

Market data summary

As of 4 July 2016

Equity indices	Last	-3M %	YTD %	-3YR %
MSCI World USD	4'060.4	1.9	1.1	21.6
S&P 500	1'896.0	1.8	2.9	30.2
EuroStoxx 50	3'038.9	-2.8	-11.9	8.8
FTSE 100	5'891.5	6.7	5.3	2.4
SMI	8'291.6	4.6	-8.3	3.2
Nikkei	16'958.5	-2.2	-17.1	12.5
MSCI EM USD	296.2	2.5	7.1	-2.2
Sensex 30	24'435.7	7.4	4.4	40.5
KSE 100	30'949.0	13.5	15.7	80.7
Hang Seng	19'080.5	2.7	-3.9	1.2
Russia RTS	689.9	9.3	24.4	-26.4
Brazil Bovespa	38'235.0	7.1	20.5	14.1

Bond indices	Last	-3M %	YTD %	-3YR %
Citi US gov	1'449.30	2.3	5.4	10.7
CIti US HY	1'934.07	4.1	8.3	17.5
CIti US Corp	756.51	6.5	10.0	11.6
Citi Euro gov	225.57	2.2	5.5	22.3
CIti Euro Corp	223.32	1.6	4.3	14.5
CIti EM Sov	677.79	5.5	11.1	21.7
DB EM Local USD	133.33	2.3	12.0	-6.1

Currencies	Last	-3M %	YTD %	-3YR %
DXY	94.51	1.2	-3.0	15.0
EUR/USD	1.14	-2.3	2.5	-13.8
USD/CHF	0.96	-1.6	2.8	-1.8
GBP/USD	1.43	-6.8	-9.8	-11.8
USD/JPY	111.34	8.5	17.2	-2.5
AUD/USD	0.76	-1.0	3.3	-17.7
USD/CAD	1.31	1.7	7.5	-18.3
USD/ZAR	14.78	1.7	6.4	-30.9
USD/INR	66.21	-1.5	-1.6	-10.6
USD/PKR	104.68	0.0	0.0	-4.9
Gold oz	1'215.59	11.2	27.3	8.1

Interest rates	3M interbank %	10YR government %
USD	0.65	1.44
EUR	0.06	-0.13
GBP	0.52	0.87
CHF	-0.78	-0.58
JPY	-0.02	-0.24
AUD	2.96	2.01
CAD	1.17	1.06
ZAR	7.36	8.68

For your notes

For your notes

For your notes

Authors

- Dr. David Wartenweiler, Chief Investment Officer (d.wartenweiler@habibbank.com)
- Angelika Stückler, Senior Portfolio Manager, Equities (a.stueckler@habibbank.com)
- Stefan Wüthrich, Senior Portfolio Manager, Fixed Income (s.wuethrich@habibbank.com)

Contact for Switzerland

- Nasir Ahmad (n.ahmad@habibbank.com)

Contact for UK

- Miguel Sanchez (m.sanchez@habibbank.com)

Contact for UAE

- Kamran Ahmed Suhrwardy, Private Banking (k.suhrwardy@habibbank.com)

Layout

- Pascale Manga, Communication Support (p.manga@habibbank.com)

Printing

- Theiler Werbefabrik GmbH, Rütenenstrasse 6, CH-8102 Oberengstringen (werbefabrik@bluewin.ch, www.werbefabrik.ch)

Editing

- MOTIF Executive Communications, Kämbelgasse 4, CH-8001 Zurich (www.motif.ch)

Price data as of 4 July 2016

Disclaimer

This report is for distribution only under such circumstances as may be permitted by applicable law. It is expressly not intended for persons who, due to their nationality or place of residence, are not permitted access to such information under local law. Neither this report nor any copy thereof may be sent, taken into or distributed in the United States or to any U.S. person. The information contained herein has been prepared from sources believed reliable but is not guaranteed by Habib Bank AG Zurich (HBZ) and is not a complete summary of statements of all available data. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial and/or tax situation or specific needs of investors. Employees of HBZ or its affiliates may, at times, release written or oral commentary, technical analysis or trading strategies that differ from the opinions expressed within this report. HBZ and/or its employees involved in the preparation or the issuance of this report may have positions in the securities or options of the issuer/s discussed or recommended herein. Securities identified herein are subject to availability and changes in price. They may not be eligible for sale in all jurisdictions or to certain categories of investors. For additional information on investment risks (including, but not limited to, market risks, credit ratings and specific securities provisions), contact your HBZ financial advisor. The information and material presented in this research note are provided for information only and are not to be used or considered as an offer or solicitation to buy, sell or subscribe to any securities or other financial instruments. This note does not take into consideration the specific investment objectives, financial situation or particular needs of any person who may receive this note and invest in any financial instrument. HBZ has not taken any steps to ensure that the securities referred to in this document are suitable for any particular investor. This brochure is not to be relied upon in substitution for the exercise of independent judgment. HBZ strongly recommends to interested investors to independently assess, with a professional advisor, the specific financial, legal, regulatory, credit, tax and accounting consequences prior to any investment decision. The value and income of any of the securities or financial instruments mentioned in this document can go up as well as down. The market value may be affected by changes in economic, financial or political factors, time to maturity, market conditions and volatility, or the credit quality of any issuer or reference issuer. Many factors may affect the value of a financial instrument, and accordingly, investors effectively assume all risk and may receive back less than they had originally invested. Any investors interested in buying a financial instrument should conduct their own investigation and analysis of the instrument as to the risks involved with transactions on such instruments. Past performance should not be taken as an indication or guarantee for future performance. IIn Switzerland, this report is distributed by Habib Bank AG Zurich, authorized and regulated by the Swiss Financial Market Supervisory Authority (FINMA). In the United Arab Emirates, this report is distributed by Habib Bank AG Zurich, UAE Branches, authorized and regulated by the Central Bank of the United Arab Emirates. In the United Kingdom, this report is distributed by Habib Bank Zurich Plc, authorized by the Prudential Regulation Authority and subject to regulation by the Financial Conduct Authority and the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request.

Habib Bank AG Zurich

(Incorporated in Switzerland 1967)

Habib Bank AG Zurich

Private Banking
Weinbergstrasse 59
P.O. Box 225
CH-8042 Zurich
Tel: +41 44 269 45 00
Fax: +41 44 269 45 18