



JULY 2016

# Britain Unfriends the EU and Blocks Brussels: The Brexit and its Implications

## Highlights

- News of the Brexit has consumed the world, and with its immediate implications, real estate and other defensive assets are the darlings of investors.
- The Brexit may have hit the UK harder than the “Leave” supporters expected, placing at risk the UK’s financial services industry, immigration system and political system.
- Markets immediately reacted to the Brexit in a sell-off frenzy. Yet, the tantalising allure of central bank intervention and lower interest rates have boosted global share markets and fuelled a post-Brexit recovery.
- The Australian property market is likely to benefit from the chaos in Europe, being perceived by investors as a safe haven with robust returns derived from rental income.

## Introduction

By a majority of 52-48 the British people voted to unfriend the European Union and block the centralised command network in Brussels. While the actual path to exit for Britain is not clear, it is safe to say that the UK has a difficult time ahead to recalibrate its relationships with the world, and in particular, to reach an agreement with the rest of the EU.

Although the financial impact of the Brexit is not nearly as profound as the global financial crisis, it does represent a significant setback to our modern economy and the process of globalisation. Moreover, it undermines decades of integration for nations in the Eurozone.

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## Response of Central Banks to the Brexit

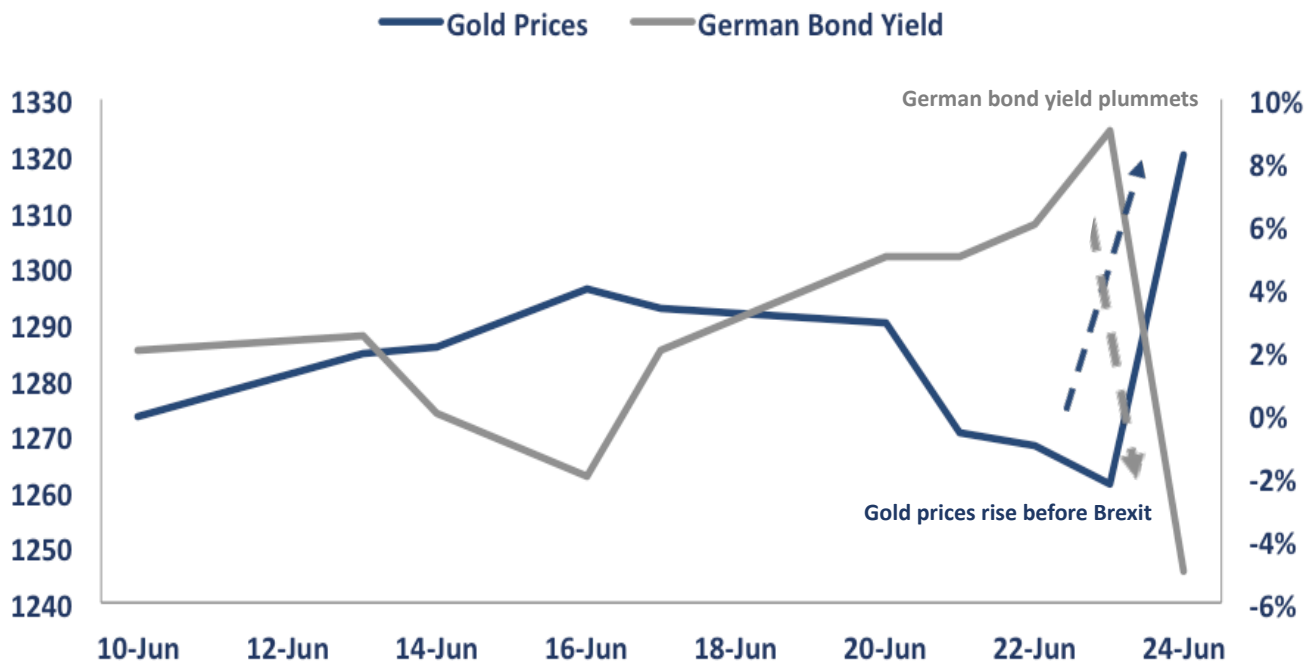
In response to the Brexit, the Bank of England has taken measures to improve liquidity in the credit and currency markets. Global monetary policy is accommodative, and in particular, we expect the Bank of England to decrease rates by 25 basis points to 0.25% when they next meet on 14 July 2016 and to inject £50 billion into the UK through quantitative easing. With this move, front end yield curves will invert as policy easing is eventually priced into the UK rates markets.

The European Central Bank has responded by noting that it would continue to ensure price and financial stability in the Euro area; we expect further rate cuts to stimulate the economy. Interestingly, German 2 year government bund rates hit their all-time low of -0.65% on Monday 27 June 2016 following the Brexit announcement.

In the US, Treasury and bond yields have declined following the Brexit result. The US Treasury rate dropped to below 1.5% and 10 year yields are threatening historical lows. Given the heightened state of uncertainty and the lengthy negotiation process ahead for the UK, it is most likely that the Federal Reserve's stance on tightening monetary policy has come to an abrupt halt. However it is too soon to predict whether the Fed will reverse its course and begin monetary easing, yet this remains a possibility should prolonged market dislocation and uncertainty impact economic growth.

Unsurprisingly, 'safe haven' asset prices have surged as demand for certainty rises. Gold prices have risen 3.0% to their highest since the GFC, at \$1,311.11 USD/oz, and had soared in anticipation of the Brexit vote. Gold and other defensive assets are expected to outperform fixed income assets in the short term as the rush to safety accelerates and the hunt for yield dissipates.

Figure 1. Gold is inversely correlated with bond yields. Whilst German bond yields drastically fell, gold prices surged in anticipation of the Brexit vote.



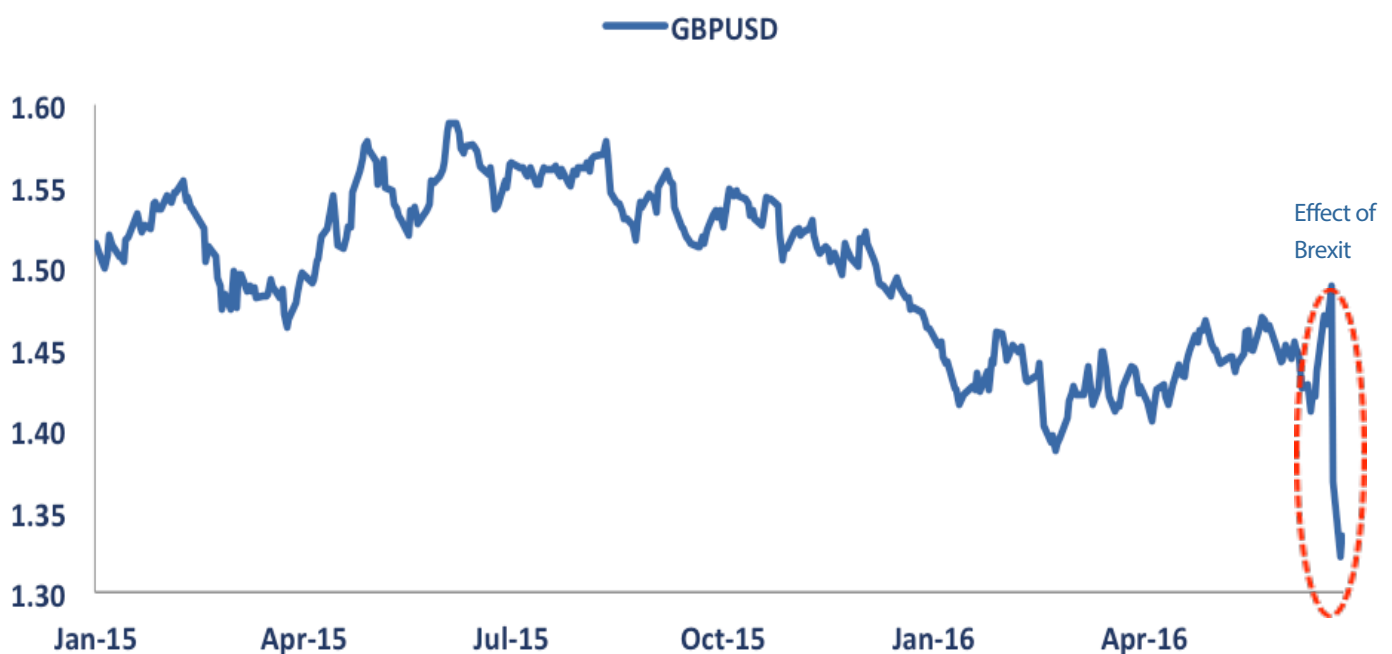
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It is anticipated that given the turbulence in the market, record low interest rates in G7 countries will continue to prevail. We now have an unfortunate scenario where Central banks have mostly used up their firepower having very little room to further reduce rates. The recent Brexit shock has importantly highlighted that central banks will lack the ability to combat events like the Brexit in the future. The importance of central banks to help further stimulate economies going forward is undoubtedly undermined.

## The Effect on the UK

Figure 2. The pound fell from 1.50 to 1.35 GBPUSD on Friday, reaching a 31 year low.



The exit from the EU is a marked regression in the process of globalisation and 40 years of integration of the nations in the Eurozone.

## Real Estate and Financial Services

Banking, accounting and law firms in the financial and professional services industry contribute significantly to Britain's GDP (around 12%). The bulge bracket banks typically set up shop in London and "passport" through the other EU countries. Following the Brexit, professional service firms are scoping out options such as Paris, Frankfurt and capital cities in other EU countries to relocate their offices, to obtain new legal homes through which they would continue to have the authorisation to exercise business in other EU countries. Should this eventuate, rental markets will experience a vacuum, particularly in areas in south-west London such as South Kensington and Chelsea. These areas should see a reduction in demand for rental properties, causing an eventual reduction in rent, albeit limited by tight supply.

The impact of the currency swing on UK property assets is twofold. Over half of the value of commercial property purchases are accounted for by foreign investors in the UK. Currency devaluation will hurt operational results of foreign REITs that collect rents in pound sterling and pay out dividend in their respective local currencies. On the flip side, the currency swing means that UK property is now much more affordable for foreign purchasers albeit the long term impact of the Brexit may undermine this affordability. Furthermore, those foreign purchasers who have their loans denominated in pound sterling will enjoy devalued mortgages.

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We believe overseas investors should take a long-term view of the UK economy. Recent events may result in excellent bargains, given the depreciation of the Sterling and skittish investors postponing investment decisions. Notwithstanding, opportunities will abound for real estate investors with local knowledge and relationships and access to capital.

### Immigration

In a recent meeting with EU leaders before standing down as Prime Minister, David Cameron has said that the main reason voters supported a Brexit was the belief by voters that the country has no control over its borders. It is still unclear as to what agreement the EU and UK will arrive at in connection with immigration. David Cameron's successor may look to end free movement, and take back control of the UK's borders. This xenophobic approach will not sit well with the rest of the EU in the upcoming negotiations. In addition, the UK may have a more challenging time accessing a supply of skilled labour resulting in higher wage costs and reductions in efficiencies. If the financial service firms vacate London, and the borders are closed, the UK will need to rely more heavily on their domestic supplies of labour. The growing popularity of protectionism would seem outdated and at odds with modern economics.

### Trade and Economic Concerns

Notwithstanding the UK's imminent exit, the country must consider how to maintain close economic ties with the EU. The 'Leave' view argues that as an independent economic entity, the UK could do away with much of the red tape hindering business. There were many concerns in the EU about small businesses being subject to overly onerous EU manufacturing requirements, such as regulations to reduce carbon emissions and burdening waste disposal restrictions.

If the EU and UK fail to come to a post-Brexit agreement, the UK would still retain links to the EU as members of the WTO. However, there is a real possibility that higher tariffs and quotas will be put in place for trade. For example, the UK car industry, which relies heavily on imported parts, would suffer from significantly higher costs of inputs, labour and tariff impositions. The UK may well respond with tit-for-tat tariffs, but in the long run, this is not a real solution to its problem.

### Political Instability

In a frenzy of resignations, and pressure on Jeremy Corbyn to resign, the Labour party and Tories parties are in disarray. David Cameron's successor must be able to unite the country. In the meantime, Boris Johnson plays down the hard work and uncertainty ahead, appearing on the media playing golf and other routine activities. His view is that the appetite in Scotland for a second referendum is low, but we consider that such a referendum is now highly probable. On Monday 27 June, Boris Johnson proposed that Britain may enjoy access to the European single market and also restrict immigration as it pleases, but as the common cliché goes, you can't have your cake and it eat too. The leaders of Germany, France and Italy have refused to informally negotiate on relations with the UK until it formally invokes Article 50 of the Lisbon Treaty. The full scale of the task facing Whitehall remains unclear. The UK has a mammoth task ahead. Over 80,000 pages of EU agreements need to be renegotiated. Some British officials have explained that the process of divorcing from the EU may 'clog up parliament for years'.

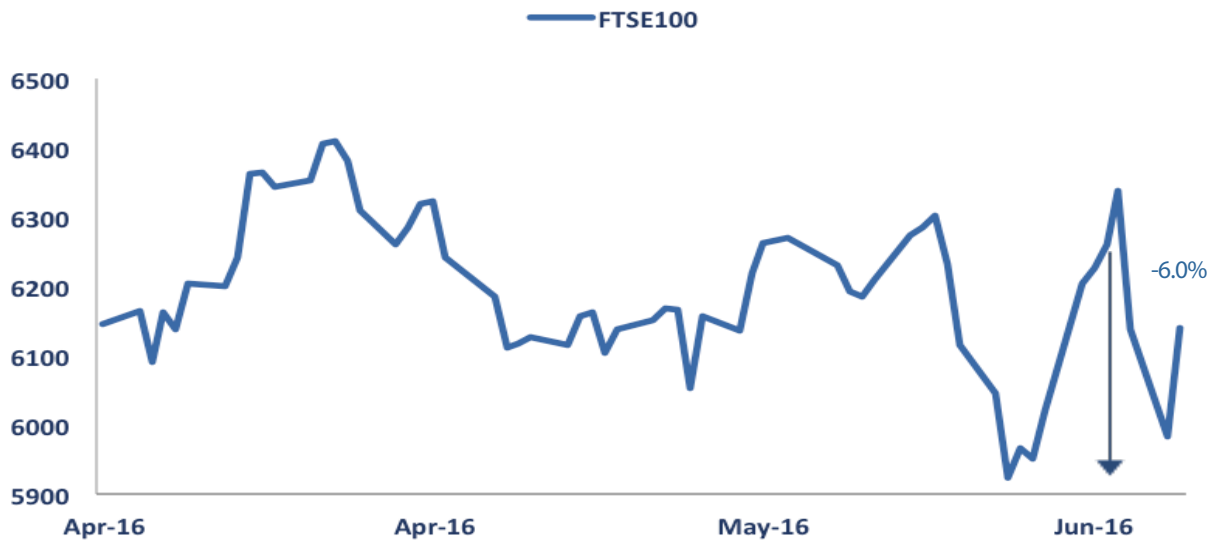
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## Equity Markets and Investor Sentiment

Equity markets around the world suffered after the announcement of the Brexit as investors were spooked into a selloff.

Figure 3. The FTSE100 plummeted 6.0% 4 days after the Brexit vote



At its low point, the FTSE100 dipped to 5,788.70, down 8.7% and the Dow Jones dropped to 17,356.34, down 3.6%. Likewise, the ASX200 dropped to 5080.0, down 3.8%. The Brexit outcome came as a complete shock to markets – some betting agencies estimated the probability of the “Leave” outcome to be less than 10%. In all, global stock markets lost \$2 trillion in value on Friday 24 June.

Equity markets have continued to remain highly volatile following the announcement of the Brexit; the VIX index surged nearly 50% on Friday 24 June.

Figure 4. The VIX index soared nearly 50% in just one day following the Brexit vote, as markets remain extremely volatile.



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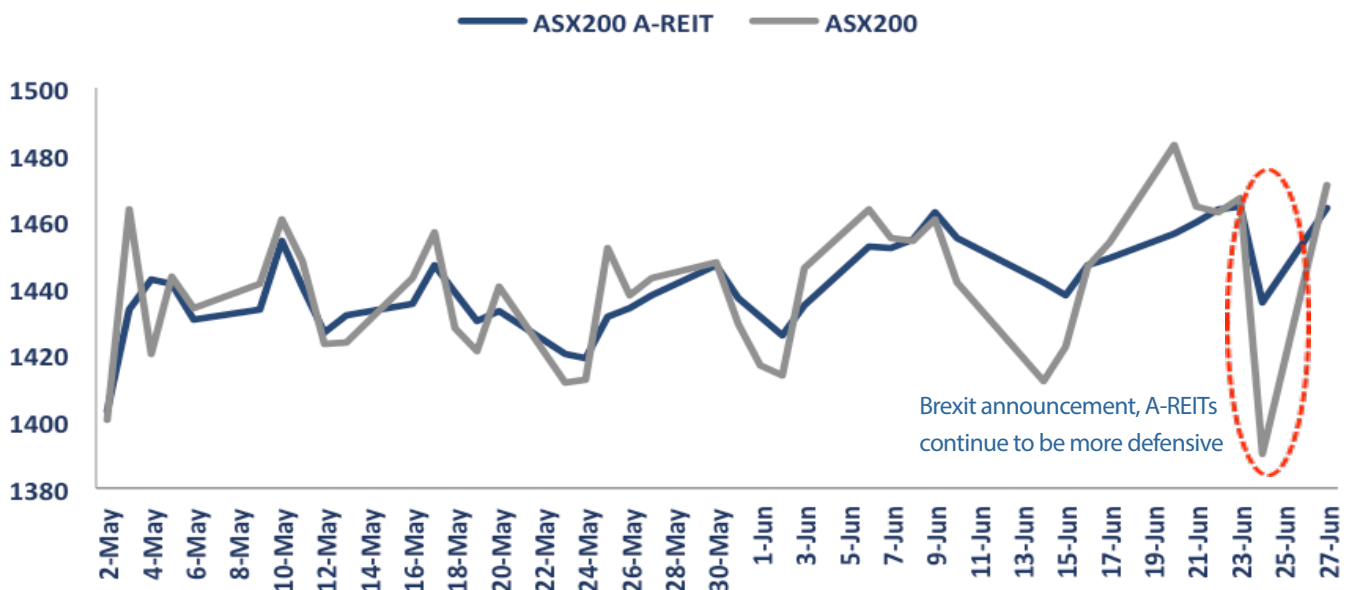
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Following the Brexit, investors remain skittish and uncertain. There are a multitude of uncertainties regarding: the activation of Article 50 of the Lisbon Treaty, political leadership in the UK, the negotiations between the EU and UK, and the wider economic and political environment.

Volatility ironically seems to be the only certainty. Such market conditions will ensure healthy demand for defensive assets such as gold and government bonds. We expect the market to rally and recover some (but not all) of its recent losses in anticipation of monetary policy intervention and further possible quantitative easing by central banks. Investors must remember to stay rational at these times, and consider investment as the fundamental consideration of value versus price. For the investors who take a long term view of the market, the news of the Brexit should be nothing more than part of the vicissitudes of life.

## The Australian Property Market

Figure 5. The leading property index in Australia, the S&P/ASX 200 A-REIT index, dropped 1.95% on Friday 24 June 2016, compared to the S&P/ASX 200 which dropped 3.1%. A-REITs proved to be more defensive than equities, outperforming them by 1.3% after the Brexit.



Investors must see through the noise and search for investment opportunities that may arise in this oversold market. Despite the fallout from the Brexit, over the weekend of 25-26 June 2016, the Australian real estate market was right on track, with auction clearance rates at 77% and 68% in New South Wales and Victoria respectively, according to CoreLogic RP Data. This reflects a wider confidence in Australia's real estate market, as property remains a defensive asset class following the Brexit.

Figure 5 above shows that the ASX200 A-REIT outperformed the ASX200 by 1.3% after the Brexit announcement. A-REITs have become attractive to investors for being domestically focused and therefore more insulated from the volatility in the wider market. A-REITs represent the best of both worlds providing healthy yield and safety. They are naturally risk-diversified as an index, but in addition, their value is derived from rental income, which is pre-determined in lease agreements over fixed periods of time. REIT balance sheets following the GFC have significantly deleveraged on the whole and the cost of equity is at historic lows. Unsurprisingly, demand for property has remained consistent in the wake of the Brexit.

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The RBA is expected to drop interest rates in August 2016, influenced not only by the recent market chaos following the Brexit but also low inflation data and easing monetary policy globally (the global currency wars would seem to continue). As debt becomes less expensive we expect to see a further hike in investment into Australian property. Moreover, the uncertainty and volatility in equities markets may mean investors opt to enter the property market rather than expose themselves to the vicissitudes of the stock market.

Following the Federal election last Saturday, 2 July 2016, the country is in a state of limbo with the Liberal-Nationals Coalition and Australian Labour Party claiming 68 and 67 seats respectively (according to ABC), with 76 seats required to form a majority. With 79.2% of votes already counted, a hung Parliament is a very real possibility. It is likely that Malcolm Turnbull will be able to form government, but it may well be that to do so, he will have to make concessions in order to win the support of the Independents. The election of the Liberal party would mean the end of Labour's proposed reforms to negative gearing, which has been described by Stockland's Mark Steinert as a policy that could 'change risk recession and destabilise the economy.' However, the consequences of a hung Parliament could be severe – there are concerns that Australia may lose its AAA credit rating, as a lack of bipartisanship will mean a government which does not have the ability to repair the budget deficit or carry out necessary economic reform.

### Implications of BREXIT

The long term implications of the Brexit are still unclear. The "Leave" majority vote does not mean that the UK will immediately leave the EU. The final decision to leave must be made pursuant to Article 50 of the Lisbon Treaty, which requires for the EU to negotiate and conclude a withdrawal agreement with the UK.

Critics of the EU will assert that the first domino has fallen, and that the EU had it coming. After all, with 27 (remaining) members typically finding it difficult to make unanimous decisions, along with inconsistent fiscal policies among members, the EU has always had functional issues. The Brexit may just be the beginning, foreshadowing the exit of the PIGS and other countries throughout the Eurozone. This uncertainty may result in investors losing confidence in the Eurozone and beginning to reallocate their capital to markets outside of Europe. The UK is arguably no longer the quality investment hub it was. Standard & Poor and Fitch have recognised this sad fact with a downgrade of the UK's sovereign credit rating to AA negative.

Investors may begin their search for a new source of quality investment. Australia is isolated enough to be seen as a safe haven away from the chaos in Europe. The Australian economy continues to experience stable growth, and to be a source of consistent returns for investors. Perhaps the Brexit presents an opportunity for Australia to shine as a destination for new foreign investment!

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### Our Team

Trident Real Estate Capital is a real estate investment and advisory firm which is active in the Australian commercial and residential property market. We draw upon 30 years of real estate market experience and utilise an advanced suite of property data and analytical tools to provide client tailored specialist real estate advice including market assessments and forecasts, due diligence and location analysis to a variety of corporate, investor and institutional clients.

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