Perspectives from PGIM Fixed Income

- We believe that the policy responses that follow the Brexit vote consist of monetary policy accommodation and rhetoric regarding political cohesion considering that the Brexit result may embolden populist political movements in Europe and elsewhere. The policy responses will likely blunt the effect of the risk-off sentiment in the short term, and the longer-term duration of the risk off environment will depend on the overall effectiveness of these responses.

- Arriving at a precise estimate of the macroeconomic effects is fraught with difficulty. The channels for any spillover from the UK to the rest of the world are primarily via trade flows, financial flows, and confidence effects. The IMF currently estimates that upon exit from the EU in 2018, output in the EU could fall by 0.2 to 0.5 percentage points and up to 0.2 percentage points globally.

- Within the EU, Malta, Ireland, Cyprus, the Netherlands, and Belgium are the most exposed to the UK via trade linkages. However, the effect on France, Germany, Italy, and Spain would likely be below the EU average. Outside the EU, the U.S. and China are the most exposed. Financial links show that Luxembourg, the Netherlands, Cyprus, Malta, and Ireland are the most exposed within the EU and the U.S., Switzerland, and Iceland outside the EU.

- As it pertains to the UK, the country faces a prolonged period of uncertainty, which is likely to hamper business investment and consumer spending in the near- to intermediate-term.

  - Precedents for leaving the EU include Denmark's negotiation of Greenland's exit, which took two years and only included fisheries. The EU-Canada trade deal has taken seven years, does not include financial services, and has yet to be ratified.

- The UK is currently running a record high current account deficit of nearly 7% percent of GDP and a large fiscal deficit, both of which point to considerable financing needs. Longer-run, however, the Brexit economic implications are less clear. Growth would likely be hampered if Brexit results in curtailed trade over the longer-run. But it is also conceivable that the UK might negotiate trade deals and adopt internal regulations that are more beneficially tailored to its economy and thus positive for long-term growth prospects.

- The volatility in UK-related assets, Europe, and financial spreads will likely be longer lasting and harder to predict than the general selloff in risk assets. Indeed, we believe that the selloff may have created buying opportunities in the U.S. spread sectors, particularly structured product, as well as other fundamentally less affected assets, such as emerging markets debt, which may be bolstered by accommodative central bank policies and the reach for returns.

- "Orderly selling" was a common theme that emerged from the spread sectors during the selloff. For example, in European investment grade corporates, investment banks were still under selling pressure on Monday, but the sector did see some buying as spreads continued to widen. The U.S. and European high yield markets were both said to be more resilient than anticipated, with the latter declining 0.73% and the U.S. market actually ending last week with a slight gain of 0.13%.

- As the spread sectors sold off, it was also noted that buyers started to emerge in some sectors, yet the general lack of sellers kept trading volumes muted. See the following table for market returns through mid-day Monday.

Market reaction: June 23 close vs June 27 at 12 pm EST.

Equity	S&P 500	Dow Jones	Euro Stoxx	FTSE 100
6/23/2016	2113.32	18,011.07	3,037.86	6,338.10
6/27/2016	2000	17,178.80	2,696.69	5,980.29
Change	-5.36%	-4.62%	-11.23%	-5.65%

Rates	U.S. 10 Yr	UK 10 Yr	German 10 Yr	Japan 10 Yr
6/23/2016	1.75	1.37	0.09	(0.14)
6/27/2016	1.47	0.95	(0.11)	(0.19)
Change	-0.2777	-0.425	-0.202	-0.05

Spreads	CDX IG	CDX HY	ITRAXX-IG	ITRAXX- HY
6/23/2016	76	421	75	320
6/27/2016	89.875	472	97.25	414
Change	13.875	51	22.25	94

FX	GBP	EUR	JPY	USD
6/23/2016	1.49	1.14	106.16	93.53
6/27/2016	1.32	1.10	101.67	96.40
Change	-11.17%	-3.23%	4.23%	3.07%

Source: Bloomberg.

- The major central banks have made clear that they will take all necessary steps to ensure financial stability and are likely to undertake growth-supporting measures as needed.
  - The **BoE** is providing £250 billion of additional liquidity and also offering banks substantial liquidity in foreign exchange, if needed. If banks in the UK begin to retrench, the BoE is likely to ease further, possibly via additional direct credit provisions to banks, QE purchases, and/or cuts to the policy rate (currently at 0.50%). The BoE may initially rely more heavily on the first option, as it will likely want to avoid creating additional volatility in GBP that could be generated from rate cuts, or possibly QE. That said, a lower GBP could ultimately help the UK in its transition out of the EU over the next several years.
  - The **Federal Reserve** is now likely to be on the side-lines for a prolonged period—very possibly for the rest of this year if not longer. Following the vote, the market indicated a terminal Fed funds rate of about 65 bps, indicating the possibility of only one additional rate hike in this cycle. The Fed is expected to be appropriately cautious in light of the current combination of: 1) volatile global financial markets, 2) mixed U.S. economic data 3) prospects of persistently low global inflation pressures, and 4) its more limited ability to react to downside shocks at this point.
  - The **BoJ** may be more likely to ease further in July. While the USD/JPY exchange rate may be tolerated in a range of 100-125, intervention—the effectiveness of which remains uncertain—may become a factor should the yen appreciate further.
    - Commodity exporters that were biased to ease before the vote—**Norges Bank, Reserve Bank of Australia, Reserve Bank of New Zealand**—may now be more inclined to ease.

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Source(s) of data (unless otherwise noted): Bloomberg as of 06/27/2016.

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