Market comment
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The financial markets are set to remain volatile and sensitive to the impacts of displays of voter dissatisfaction, but economic fundamentals will drive long-term trends

If Europe's political leaders do not provide a clear and united response, the Brexit vote is poised to fuel widespread anxiety on the sustainability of Europe and the viability of the Eurozone.

The recovery in the Eurozone is still faced with the same external challenges (USA and China), while the impact of Brexit on the pace of the rebound remains unclear.

The European equities asset class traditionally carries the highest yield, while sovereign bonds in developed countries are increasingly becoming liquidity traps.

The Brexit referendum has tainted the European Union's image and will undoubtedly leave some scars, unless Europe's political leaders can provide a clear and united response. However, the European Union's long and abundant heritage should not be entirely underestimated. The very close and indecisive result highlights the paradoxical relationship of Great Britain with the European Union, which navigates between insularity, pragmatism and entryism among the technocratic European institutions. The referendum will have political, economic and financial repercussions. Political fallout will involve a call from the populist parties which will now be dreaming of repeating the same scenario, while other countries included under the Union Jack (Scotland and Northern Ireland) will perhaps wish to join the European Union. It will be impossible to ignore the economic consequences of the ensuing period of deep uncertainty, firstly on the UK economy and then on the rest of Europe, despite the recovery underway in the euro zone. The firm stance displayed by those in Europe is making the UK's position all the more untenable, as it must embark on the exit process before negotiations can take place. An end to uncertainties surrounding the whole process will certainly help calm investor fears.

There seems to be no doubt over growth in the Eurozone when we look at the various indicators up until the political earthquake when voters displayed their dissatisfaction during the Brexit referendum. GDP growth projections still stand at around 1.6% for 2016 and 2017, yet some forecasters are beginning to talk about a recession in the UK as early as 2017. At this stage, it is very difficult to predict the consequences of Brexit on growth in the Eurozone. The latest statistics pre-Brexit were favorable i.e. new vehicle registrations, credit provision, consumer spending, building permits and industrial investment. A UK recession would automatically trigger some negative consequences for economies across the continent but it is impossible to assess the extent of the impact with any great accuracy at this stage. To top it all off, a trio of external factors – sluggish US growth, procrastination from the Fed and the slowdown in China – will also affect European economies. The Eurozone only has itself to rely on at this stage: its robust consumer spending, its hefty savings and the benefits of its monetary policy.

In the absence of support from bond valuations, the equity markets must now prove that they can create microeconomic value by displaying true earnings growth. However, political and institutional risks are still dragging down the valuation of risky assets in the area. Interest rates have now hit a low and investors cannot hope for equity market valuations to be boosted by a further interest rate cut. The correction on the European equity markets in the immediate aftermath of the Brexit vote at least gave Eurozone equities a certain amount of leeway. However, earnings growth for European corporates is unlikely to be upgraded until political uncertainties have been resolved and investors could once again lose heart as they see yet another year of disappointment on earnings. However, some sectors are still undervalued as compared to the market (media, construction, etc.) while displaying better earnings prospects. Overall, European equities are traditionally the asset class with the highest yield (3.5-4%) while sovereign bonds in developed countries, which savers flock to, are increasingly becoming a liquidity trap.

Text completed on July 1, 2016 by Igor de Maack, spokesperson for DNCA Investments' fund management team.

About DNCA:

DNCA is a French asset management company set up in 2000 by wealth-management specialists acting on behalf of private and institutional investors. With a defensive slant, the company seeks to optimize the risk/return ratio on its portfolios. With a team of more than 98 staff, DNCA has developed expertise in European and international equities (long only and absolute return), diversified fund management, convertible bonds and Eurozone bonds. The quality of the company's investment management, which regularly wins awards from the financial press, has enabled the company to enjoy swift growth over the past fifteen years. AUM currently stand at €18.9 bn (as at 06/30/2016).

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