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By E-lodgement

## RE: UNITED KINGDOM REFERENDUM - MARKET UPDATE VIDEO

Following a market release on Monday 27 June 2016 with regards to the United Kingdom Referendum, PM CAPITAL's Chief Investment Officer, Mr Paul Moore has provided a further video update which can be accessed here:

[http://www.pmcapital.com.au/news/webinars\\_and\\_videos/paul\\_moore\\_provides\\_an\\_update\\_on\\_the\\_united\\_kingdom\\_referendum262.aspx](http://www.pmcapital.com.au/news/webinars_and_videos/paul_moore_provides_an_update_on_the_united_kingdom_referendum262.aspx)

### TRANSCRIPT STARTS (Market Update by Paul Moore, 30 June 2016)

"As I noted on Monday, today I was planning to give a brief synopsis of both the pre and post Brexit world.

Only last week, it would appear that the basic macro backdrop of slow, but continuing economic growth was on track.

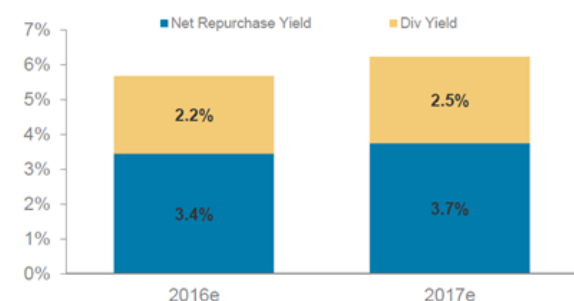
In the US, the latest initial unemployment claims declined to a 43 year low and has been below the threshold associated with a strong job market for 68 weeks, the longest streak since 1973. Job openings are in fact, at a record high in the US [Image 1].

Vacancies rose in April to most in records back to 2000



**Image 1:** Source: Michelle Jamrisko, June 9 2016, Bloomberg.com, Job Openings in U.S. Rose in April to Match Highest in Records, <http://www.bloomberg.com/news/articles/2016-06-08/job-openings-in-u-s-increased-in-april-to-5-79-million>

Median Capital Return Yield



**Image 2:** Betsy Graseck, May 26 2016, Morgan Stanley Research – North America, "Large Cap Banks Discussion Slides".

In addition, sales of existing homes rose to their highest level in nine years and on Thursday the US regulator released the results of their latest bank stress tests highlighting that bank balance sheets had never been stronger. According to the regulators, The US banking system has the financial strength to withstand an economic meltdown — and negative US interest rates. Each of the 33 banks tested survived the toughest test designed by the regulator. Under the simulation, which lasts for nine quarters, stock prices drop about 50%, unemployment reaches 10% and gross domestic product declines sharply.

What this would mean is that US banks could again increase the effective dividends to shareholders both in absolute dollars and as a percentage share of profits. The dividend story was well and truly playing out as noted in these slides [Image 2].

The same story, with a lag was emerging in Europe, and European bank stocks were selling at two standard deviations below their historic relative lows.

Underlying fundamental themes were playing out and price action was reflecting a closing of relative valuations gaps between economically sensitive sectors (such as banks) and the defensives which were at their highs. In fact, on Thursday night, post the release of the US bank tests, futures were indicated higher and bank stocks were bid up in post market trading. And immediately, post, closing of the polls, prior to the initial results being announced, bookmakers were reflecting a 90% probability of remain\*. Financial markets, including ourselves, had made the mistake of assuming a logical outcome and the evidence appeared to support that.

Then came probably, the most dramatic turn-around in financial markets I have ever witnessed and we all know what has since transpired. It would appear that a protest vote had gone wrong and as Google search analytics suggested, many of those who did vote to leave had no idea what they were actually voting for. In fact, I suspect if there was a second referendum this weekend, we would have a different result. As I have noted before, just when you think you have seen everything, something new comes along.

So post Brexit, there is no point in repeating what is well covered in the media; the obvious is well known. Unlike normal macroeconomic events that cause investors to wax and wane on future growth sentiment, Brexit is a political issue that markets believe will create enormous uncertainty, and may set off the end of the European Union and/or the end of the United Kingdom if Scotland and Northern Ireland vote for independence.

So the fear is years of political uncertainty and thus economic uncertainty.

Long term I doubt it will make a lot of difference. There is no reason for countries not to continue to trade relatively freely with each other. Only politics can genuinely interfere with that, and it will come down to if they want to act with retribution as opposed to a rationale resolution of administrative issues. If it actually forces Europe to genuinely integrate and reform, it could actually be a big positive. But short term, there will enormous uncertainty and markets will be very wary and liable to excessive discounting of business fundamentals. Earnings (real and perceived) will be the key driver of short term price action.

European Banks are clearly the most impacted due to fears of recession and thus a bad debt cycle, as well as issues related to dealing with the legalities of the new order. This has had a significant short-term impact on our global portfolio due to our investments in a number of domestic European banking stocks, which we owned for their evolving long-term dividend story.

Due to the chaos created by a situation where it appears nobody, including the leave campaigners, were actually expecting a leave result, markets have been savage in their discounting of short term fear. Short

term, bank earnings will no doubt be negatively impacted by even lower interest rates in the UK and lower loan growth. Ultimately, the stock price impact will be a function of future earnings and dividend levels and from that perspective, the reaction does look excessive. Short term, it will take time for markets to truly assess the long term impact and the key is not to jump to any irrational short term conclusions. Economic uncertainty and thus growth will be impacted, but one should also note that the first, the depreciation of the pound will ultimately be a positive stimulus for the UK economy and second, the balance sheets of banks such as Lloyds, Bank of Ireland and ING are dramatically stronger than they were some five years ago.

One should also note that European banks are selling at a discount to book, which theoretically suggests that they should be wound up and an indication that valuations may be excessively discounted.

The overall situation is very different to previous growth scares as it is a political event as opposed to normal economic cycle issues playing out. So one does have to think through the issues, but again, the real trick as we often note, is to make sure one is looking forward and assessing current dynamics as opposed to reacting and making decisions based on what has happened, not what will now happen.

One of the key issues will be if governments and regulators finally realize that if they wish to sustain economic growth, they now need to focus on fiscally driven capital works. This is particularly so for the Europeans. As noted by the head of the European Central Bank, Mario Draghi, "central banks would achieve goals quicker if there was help from fiscal and structural policies".

In summary, Brexit is obviously an outcome we did not expect or welcome. Our focus is on assessing if underlying fundamental themes have changed and thus warrant changes in our portfolio and/or different opportunities. Short term, uncertainty is obviously high and the political scene chaotic. Many will question if the UK has shot themselves in the foot and the European Union is at the beginning of the end. Personally, I believe the chaos has been overly discounted but will obviously take time to resolve.

The uncertainty will be longest in duration in Europe and the UK and it is likely that the US will soon switch its attention towards June quarter earnings results. From the perspective of Australia and Asia, I suspect the impact will be minor.

We will further update our thoughts in our June quarterly video and reports in mid-July."

*\* Source: William Hill, May 20 2016, "Bookmakers cut Remain odds despite narrow polls", Financial Times, <https://next.ft.com/content/e4f4cb5c-1dd5-11e6-a7bc-ee846770ec15>*

**TRANSCRIPT ENDS**

Yours faithfully  
**PM Capital Global Opportunities Fund Limited**

  
Richard Matthews  
Company Secretary

