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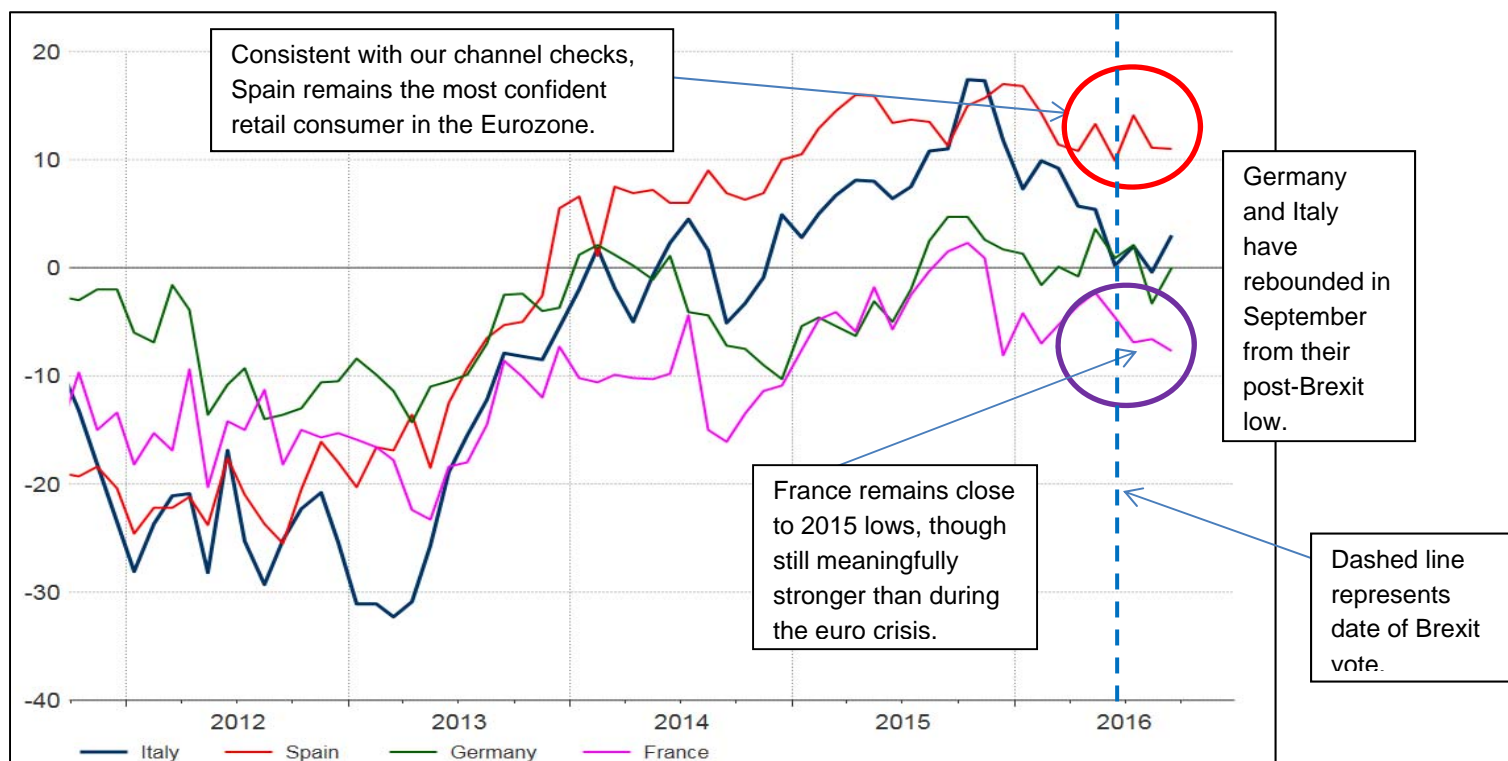
Keep Calm and Carry On: Post-Brexit Takeaways From Our UK Trip

I recently returned from a two-week visit in the UK, meeting with strategists, economists and the management teams of over twenty public European consumer companies in banking, automotive, food, retail, media, travel, real estate and construction. My purpose was to divine what sort of changes in behavior the British referendum vote has wrought, as well as to get a ground-level view of how consumers across Europe are faring in this tumultuous year. Given our portfolios' preference for consumer stocks within Europe, we view the findings as an incrementally positive indicator for our current positioning.

1. EUROZONE CONSUMER: ENCOURAGINGLY RESILIENT (MOSTLY)

The biggest takeaway from my trip was the resilience of the European consumer, with particular strength noted in the UK and Spain, and stability in Germany and Italy. With all four regions reeling over political and banking concerns, we find our positive channel checks encouraging (see Appendix on page 3 for more specific color from our meetings). We think this resilience is related to improving employment, low oil prices, and cheap available credit. France was clearly where commentary was most pessimistic, likely related to terror events and a general malaise in the economy. Our findings are corroborated by strong post-vote retail sales volume growth in the Eurozone and September readings of retail confidence surveys taken by The European Commission (see chart below).

EURO AREA RETAIL CONFIDENCE (NET BALANCES, AS OF 9/30/16)



Source: Thomson Reuters Datastream, RiverFront Investment Group. Past performance is no guarantee of future results. Data is provided for illustrative purposes only and not intended as an investment recommendation.

2. THE UK CONSUMER: KEEPING CALM AND CARRYING ON

Given the fallout over Britain's unexpected vote to exit the EU, the strength of the UK consumer this summer is downright surprising to many. Consumers appear to be "keeping calm and carrying on." While sentiment has been damaged by the referendum vote, actual British consumer demand for goods appeared to be robust, according to our channel checks. Why? More than one executive I spoke with reminded us that outside of London, the rest of Britain essentially voted for Brexit, suggesting many consumers are not fazed by the vote's outcome. Prime Minister Theresa May's quick appointment was also seen as a positive, as she is generally viewed as pragmatic and level-headed (in contrast to some political leaders in the "Leave" camp). Other potential factors include favorable summer weather in Britain leading to greater foot traffic, continued low UK unemployment levels, and increasingly accommodative policy by the Bank of England.

Another factor to consider is the effect that a weak pound has had on inbound tourism. The New West End Company, representing Oxford, Bond and Regent Street retailers in London, reported spending from the US and Chinese tourists increased 74% and 65% month-over-month, respectively, in August. Average Chinese spending was an eye-opening £1453 per person, with luxury sales up 19% year-over-year. However, weak currency can also impact margins, and we expect this current environment will prove to be difficult for many smaller UK retailers who cater domestically and are sourcing product in USD.

3. UK REAL ESTATE: MIND THE GAP (DOWN)

In contrast to retail spending, however, UK real estate appears to us to be a pressing concern. London housing, cooling even before the vote due to stamp tax hikes, now appears to be in a bear market in certain segments, though lack of supply probably means less extreme downside than mega-bears believe. UK commercial real estate trends so far appear more resilient than residential, as rents haven't moved much yet (See comments in Appendix on page 3). However, commercial real estate is likely to come under greater scrutiny in 2017 when actual Brexit negotiations start to profoundly color business sentiment.

To that end, data suggests that business sentiment in the UK has recovered after a sharp spike down right after the vote. But if I hoped to return stateside with uniformity around how businesses were thinking about Brexit risk, I left empty-handed. To paraphrase the European head of one of the world's largest corporate banks, "no one actually knows what it means...but when [Article 50] gets signed, it will be a different story". Analyzing PM May's unequivocal statements on immigration policy over the weekend and movements in sterling, it would appear the market believes the likelihood of a hard Brexit (i.e., Britain leaving the customs union and single market) is increasing. But, we would caution drawing too many conclusions yet, with so many chapters yet unwritten. It's probable that the definitive answer to what Brexit will actually look like will take years to reveal.

4. EUROPEAN BANKING RISKS: POOR FUNDAMENTALS... BUT UNLIKELY TO BE SYSTEMIC, IN OUR VIEW

As bears on European bank equities (see *Weekly Views* from 8/30/16, 7/11/16 and 6/13/16 for more on our view of European banks), perhaps we are just indulging in confirmation bias, but I found very few encouraging data points on financials during my trip. A bitter cocktail of negative interest rates, slow economic growth and the continual need for increased capital buffers have made bank valuations a moving target. One banking analyst I spoke to said that current fundamentals of the European banks reminded him of the Japanese "zombie" banks of the 1990's, and he believes that earnings revisions should stay solidly negative for the foreseeable future.

We find it ironic that Germany, an outspoken critic of bank bailouts for countries like Italy, may be forced to witness one of their own making. Despite Deutsche Bank's well-publicized failings in capital adequacy, we don't believe that German banks will cause a systemic meltdown of the global financial system, a la Lehman Brothers in 2008. Why?

- European Central Bank (ECB) is now the banking regulator/lender of last resort, which was not the case during the global financial crisis. In our view, Deutsche Bank is likely too big to fail, so we believe the ECB would likely backstop.
- We believe, based on recent reports, that the US DOJ settlement for Deutsche Bank's residential mortgage-backed securities lawsuit is likely to be significantly less than the \$14 billion initial headline number (AFP report on Friday suggests a number more in the range of \$5.4 billion, though this is not substantiated yet).
- Counterparty risk management processes have learned from the Lehman meltdown – collateral on derivatives are now standard operating procedure, so contagion risk from a global investment bank is likely lower, in our view.
- We predict that the German government is more likely to go for a "bail-in" (shielding depositors at the expense of shareholders and some bondholders) than a bail-out. The key here is preventing a run on consumer deposits.

APPENDIX: SIGNIFICANT MACRO COMMENTARY FROM MY MEETINGS

UK bicycle and auto parts retailer	"Sales in the UK have grown nicely since Brexit, but not necessarily because of Brexit...it will take time to read properly."
Spanish retail REIT	"Spanish consumer confidence and growth still improving...we have record tourism."
UK retail REIT	"Short-term Brexit effect very limited. Consumer surveys show limited impact, in fact strong momentum... weather has also been a positive factor"
UK/European retail analyst	"Spanish consumer very strong... Italy and France muted, but no longer decelerating. In UK, lackluster overall but no negative impact since Brexit, in fact consumer has actually improved"
UK banking analyst	"Banks nowhere close to solving non-performing loan problem.... earnings revisions should continue to come down."
European beverages analyst	"Demand is actually surprising to the upside...UK, Spain doing quite well. Very good summer last year, but this this summer has been even better on consumption."
European luxury goods analyst	"Actually, local Europe to Europe demand is OK. Actually up slightly year-over-year, albeit off of a small base. Germany has taken a turn for the worse, France awful, Spain is much better, leading in tourism, and Italy has no real consistency but some brands are saying it remains very strong. UK has been buoyant, and Japan has been struggling with the strong yen."
European airline	"Terror events in Europe have hurt our growth. Europe is still growing, with pockets of strong growth. Germany and Spain very strong, France and Italy weaker, but still positive rates of growth, Netherlands relatively robust. UK pretty strong" .
UK cinemas operator	"UK is a mature market but healthy...people are spending."
European food catering/concession services	"We are assuming a very weak economy in France for the next five years. However, Spain has already started its recovery and is doing great. In Italy the environment is improving, much more like Spain than France. Seeing a little wage pressure in Spain, but not in France or Italy."
European economist	"(European) sentiment readings show initial resilience to Brexit shock... leading indicators consistent around GDP growth around 1.5%, close to its potential. Job growth has been very good."
UK property manager	"London high-end residential is, candidly, not a great place to be right now... but supply is still pretty limited. In commercial, volume down 30% but that is coming off three straight years of record volume, which was unsustainable. What is absolutely certain is that there is no distressed selling happening."
UK residential real estate brokerage	"Really quite tough...the horror of Brexit has eased a bit outside of London, slowly. Transactions outside of London likely to be down 10-12% year-over-year, in London it could easily be 30%... buyers haven't disappeared but they aren't willing to commit yet. Hasn't been enough of an actual price correction yet, no vendors have been discounting yet ."

Important Disclosure Information

Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.

High-yield securities (including junk bonds) are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities. In a rising interest rate environment, the value of fixed-income securities generally declines.

Mortgage-backed securities are subject to prepayment and extension risk; as such, they react differently to changes in interest rates than other bonds. Small movements in interest rates may quickly and significantly reduce the value of certain mortgage backed securities.

Using a currency hedge or a currency hedged product does not insulate the portfolio against losses.

There are special risks associated with an investment in real estate and Real Estate Investment Trusts (REITs), including credit risk, interest rate fluctuations and the impact of varied economic conditions.

Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

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