INVESTMENT STRATEGY RESEARCH

RBC Capital Markets

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The U.K. opts for Brexit

What's the near-term impact on the TSX and its major sectors and sub-sectors?

All values in Canadian dollars unless otherwise noted.

Priced as of prior trading day's market close, ET (unless otherwise stated).

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Key Points

- With Brexit now appearing to be a reality, we take a brief look at the major sectors and sub-sectors in the S&P/TSX and gauge the potential near-term impact of last night's surprising vote.
- While we don't think there are many recent historic parallels that fit the events of last night, we believe that the U.S. debt downgrade by S&P in 2011 might offer some guidance as to the impact on stocks.
- We believe that although direct exposure to the U.K. and Europe is not significant for the Canadian banks and Lifecos, the potential sharp decline in global bond yields and fears over financial contagion are likely to weigh on shares.
- Energy and Materials stocks (ex-gold) are likely to get hit hard as most commodities react negatively to U.S. dollar strength and concerns over global growth. Add to this the high beta nature of many of the names and we would not be surprised to see significant near-term weakness.
- Defensive sectors such as Utilities, Telecom, REITs and Consumer Staples could see positive fund flows as investors look for places to hide.
- Gold and gold stocks should also be beneficiaries as concerns over Brexit-contagion take hold.
- We re-run our list of 50 Canadian companies broken down by sector that generated at least 10% of their revenues in fiscal 2015 from the U.K. and Europe.

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Brexit appears to be a reality

Yesterday, we published a brief snapshot of those companies in Canada that generated more than 10% of their revenue from the U.K. and Europe.

In the wake of the surprising vote by the U.K. to leave the Eurozone, we thought we would re-run this table and offer some brief thoughts on the potential impact to some of the larger sub-sectors of the S&P/TSX.

Before we get into this, we would recommend reading RBC Capital Markets' in-depth piece on the potential impact of Brexit. Some of the key points are:

- A potential rate cut from the U.K. towards zero;
- A potential contraction of U.K. GDP on the order of 2-4% over the next three years;
- A potential drop of 10-15% in the Sterling (the pound hit 30-year lows overnight against the U.S. dollar)
- Significant equity market weakness caused by: 1) Sterling weakness; 2) loss of single market access; and 3) an economic downturn.

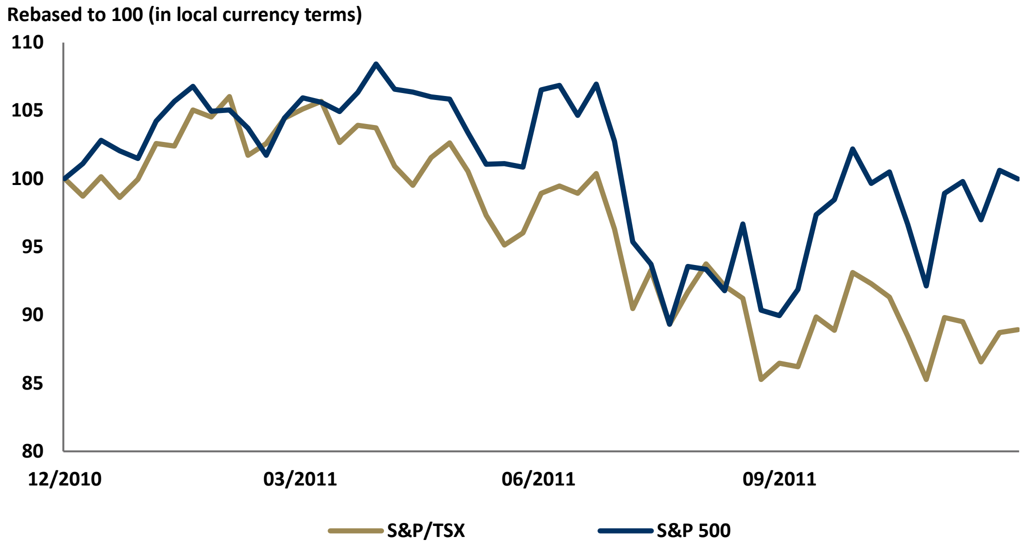
Impact on the S&P/TSX

In general, we expect the TSX to trade lower on the Brexit news along with other global markets. On a relative basis, we expect the TSX to underperform the S&P 500 largely because of the significant commodity exposure of the TSX. The challenge from our lens in making a call on how deep the impact could be is the lack of historic parallels for this sort of thing. While we have had several "near-misses" over the past 7 years, this situation is clearly "a hit" and thus extrapolating from Grexit or the other issues that have come at the market since the Financial Crisis would not necessarily be instructive in our view.

The U.S. debt downgrade by S&P in August of 2011 may offer the best historic parallel as that was not a near miss (although in the long run it appears not to have had a lasting impact). In that instance, the TSX traded down about 13% over a short period of time and lost about 10% for the year.

We would caution that while the U.S. debt downgrade may offer the best recent historic parallel it is hardly an apples-to-apples comparison and we would not be surprised if Brexit differed significantly in its ultimate impact on the market. That said, we find it somewhat instructive to trace how the TSX and some of its sectors and sub-sectors performed in the lead up to and in the wake of the U.S. debt downgrade.

Exhibit 1: The U.S. debt downgrade hit markets hard in 2011



Source: Bloomberg Sector thoughts

In general, we expect fund flows to shift toward defensive areas of the market, while beta plays are likely to face near-term outflows. Making this potentially more acute is the sharp rally over the past few months in some of the higher beta areas of the market.

Likely to be negatively impacted

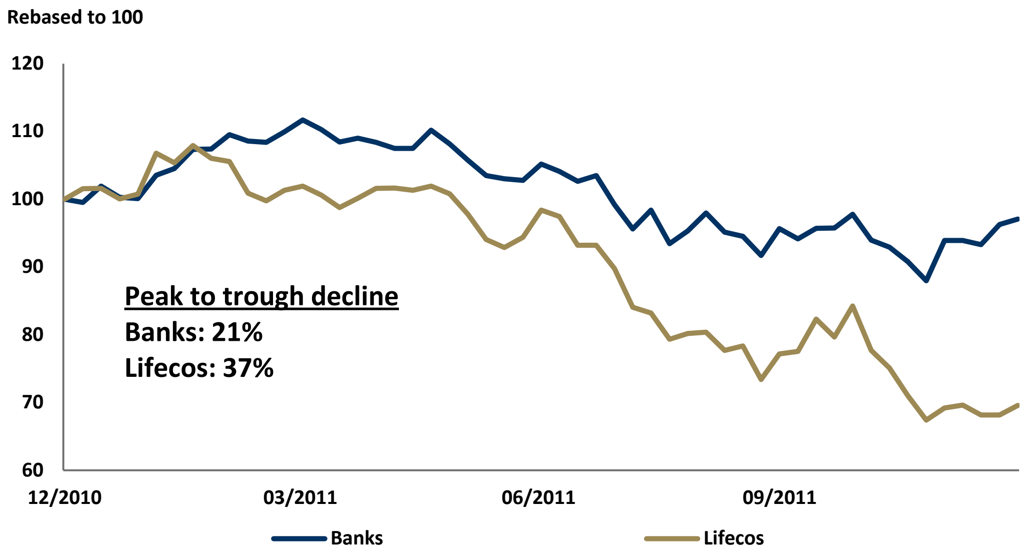
The Banks: The Canadian banks have limited direct exposure to the U.K and Europe; however, they are likely to be negatively impacted in two ways:

1. Interest rates are likely to fall in the wake of Brexit, compressing net interest margins;

2. Fears over financial contagion and potentially further exits from the Eurozone could take hold for a time.

Lifecos: Direct exposure across the group is generally low save for Great West Life (GWO). However, lower interest rates would be negative for the Lifecos and thus we would expect some weakness outside of the normal market noise.

Exhibit 2: During 2011, the Canadian banks and Lifecos fell sharply peak to trough

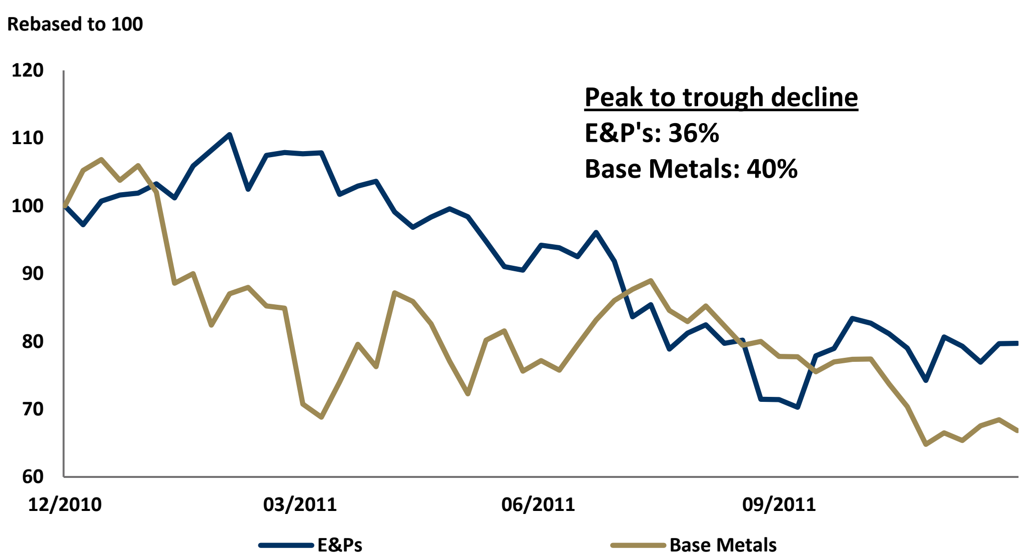


Source: Bloomberg

Energy producers: Direct exposure to the U.K. and Europe is low; however, the combination of a stronger U.S. dollar and potential concerns over global growth are likely to weigh on commodities at least in the near term. We would add that E&Ps have been strong performers in recent months, which could contribute to losses in the near term.

Materials (ex-gold): Similar to energy, the negative correlation of most commodity prices to the U.S. dollar coupled with the higher beta nature of the group could potentially lead to a sharp pullback in shares.

Exhibit 3: E&Ps and Base Metals fell sharply in 2011



Source: Bloomberg

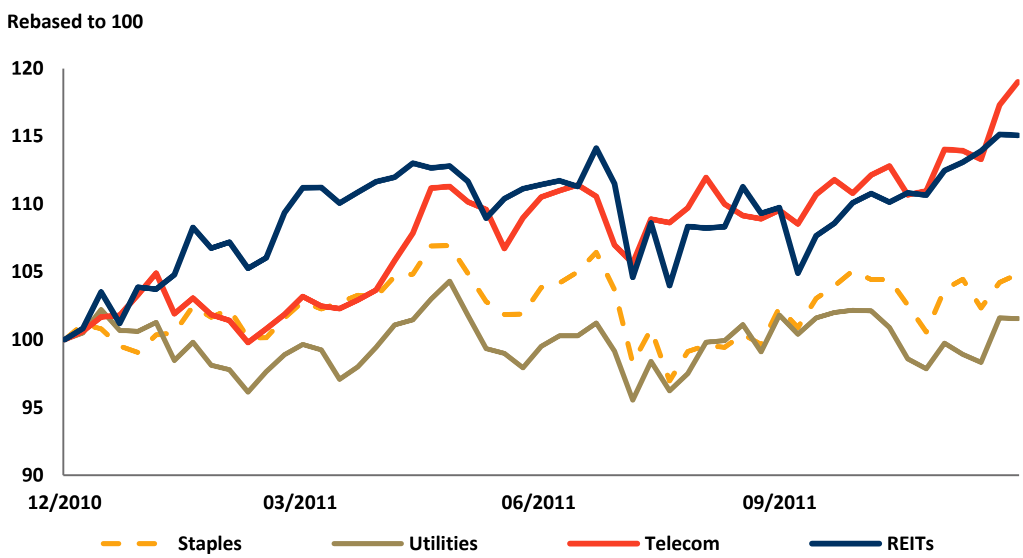
Auto Parts: In addition to their economic sensitivity, we would note that both Magna (MG) and Linamar (LNR) have significant direct exposure to Europe and the U.K. (see Exhibit 5).

Rails: To the extent that global economic activity is negatively impacted by Brexit, rail shares could come under pressure. RBC Capital Markets believes that growth in the U.K. could be 2-4% lower over the next 3 years as a result of Brexit. While this would take some time to play out and the direct exposure of the rails to Europe or the U.K. is minimal, negative sentiment toward the global economy could be transmitted through share values in the near term.

Potential for positive fund flows

Utilities/REITs/Telecom/Consumer Staples: Investors are likely to seek places to hide in the near-term and these sectors are likely to see some benefit. Lower rates should help flows into the more rate-sensitive sectors, while Consumer Staples have become the go-to defensive group for Canadian portfolios over the past few years.

Exhibit 4: “Defense” reigned supreme in 2011



Source: Bloomberg

Gold: Gold was up sharply in the overnight and we would not be surprised to see further strength in the near-term as contagion fears take hold. Gold briefly crossed over $1,300 per ounce on June 15th when Brexit fears were greatest, before trading sharply lower over the ensuing week when fears subsided. With Brexit now apparently a reality, it would not be surprising to see gold challenge its recent highs or even exceed them.

On the next page, we provide a list of 50 companies in RBC Capital Market’s coverage universe broken down by sector that had at least 10% of combined revenues from the U.K. and Europe in fiscal 2015.

Exhibit 5: Exposure of RBC CM's Canadian coverage universe to the U.K. and Europe

Company	Sector	% of Revenue from U.K.	% of Revenue from Europe	Notes
Brookfield Property Partners LP	Financials	23%	N/A	Taken as % of net equity - hedges would lower to ~10%
Brookfield Asset Management Inc	Financials	15%	N/A	Currency hedges may lower exposure.
Granite Real Estate Investment Trust	Financials	0%	45%	
Onex Corp	Financials	<5%	10%	Based on Net Asset Value (NAV) of select investments
Great West Lifeco	Financials	20%	23%	
Power Corp. and Power Financial	Financials	N/A	N/A	Great West represents ~70% of Power Financial's NAV and ~60% of Power Corp.'s NAV
Aimia Inc	Financials	20%	5%	
Points International Ltd	Financials	5%	10%	
Colliers International Group Inc	Financials	10%	10%	
Northland Power Inc	Utilities	0%	60%	
Brookfield Infrastructure Partners LP	Utilities	20%	10%	Indicated amounts are % of pre-tax FFO.
Boralex Inc	Utilities	0%	45%	
Just Energy Group Inc	Utilities	10%	0%	
BRP Inc.	Consumer Discretionary	N/A	19%	
Linamar Corp	Consumer Discretionary	N/A	23%	
Magna International Inc	Consumer Discretionary	1%	33%	
Martinrea International Inc	Consumer Discretionary	N/A	18%	
Hudson's Bay Co	Consumer Discretionary	0%	33%	
Dorel Industries Inc	Consumer Discretionary	7%	14%	
Spin Master Corp	Consumer Discretionary	5%	14%	
Performance Sports Group Ltd	Consumer Discretionary	2%	15%	
Thomson Reuters Corp	Consumer Discretionary	15%	10%	
Alimentation Couche-Tard Inc	Consumer Staples	1%	25%	
Concordia Health Care	Health Care	40%	10%	
ATS Automation Tooling Systems Inc	Industrials	N/A	38%	
CAE Inc	Industrials	11%	20%	
Lumenpulse Inc	Industrials	15%	20%	
WSP Global Inc	Industrials	15%	9%	
Stantec Inc	Industrials	10%	5%	
Finning International Inc	Industrials	15%	2%	
Air Canada	Industrials	6%	6%	Approximations based on % of TransAtlantic revenue
Bombardier Inc	Industrials	10%	30%	
Avigilon Corp	Technology	5%	21%	
EXFO Inc	Technology	4%	22%	
MacDonald Dettwiler & Associates Ltd	Technology	N/A	23%	
Sandvine Corp	Technology	N/A	36%	
Enghouse Systems Ltd	Technology	18%	43%	
CGI Group Inc	Technology	13%	40%	
Open Text Corp	Technology	10%	24%	
Mitel Networks Corp	Technology	10%	38%	
BlackBerry Ltd	Technology	9%	N/A	
Descartes Systems Group Inc/The	Technology	N/A	37%	
Constellation Software Inc/Canada	Technology	N/A	29%	
Sierra Wireless Inc	Technology	N/A	19%	
Inter Pipeline Ltd	Energy	6%	7%	
ShawCor Ltd	Energy	N/A	36%	Includes EMAR - Europe, Middle East, Africa and Russia
Mercer International Inc	Materials	<5%	75%	
Norbord Inc	Materials	17%	27%	
Tembec Inc	Materials	<10%	30%	
WestRock Co	Materials	<8%	15%	

Source: RBC Capital Markets, Company Reports.
Note: N/A indicates a lack of information available to differentiate European geographic breakdown.

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