Market
INSIGHTS

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Brexit Reality

As discussed in last month's Market Insights there was a possibility of the British exit (Brexit) from the European Union. Global and U.S. markets are facing turbulence today as the possibility of a LEAVE vote had been underestimated in financial markets in the week leading up to the vote. The apparent emotional decision by the voters leaves investors to wonder what's next.

Not surprisingly, the outcome of yesterday's referendum has sent the pound significantly lower and equity prices are plummeting on a global basis. This initial knee-jerk reaction reflects the fact that investors were positioned for a REMAIN vote.

It also reflects the fact that those who have been campaigning for a REMAIN vote have warned about the very dire consequences of Brexit in an effort to instill fear among UK voters. We now expect the very same voices to try to play down the economic consequences of yesterday's vote.

From a purely economic point of view, we don't believe that Brexit will have a significant impact on global growth. The sharp drop in the GBP will soften the blow for UK exporters although UK domestic demand will suffer from weaker consumer and business confidence and the uncertainty of what comes next. As indicated last month, article 50 of the European Union Treaty will be triggered and this will open up a period of up to two years to negotiate the terms of the divorce and agree on new trade relationships, which will probably lead to something similar to the relationships of Norway and Switzerland with the European Union.

Political Consequences

The longer term political consequences are more worrying. Brexit is a blow to institutions and the so-called political and economic elites. It is a clear sign of a rising populism, nationalism and anti-globalization mood among voters which is not only a UK phenomenon. As we have argued, these feelings are also what has propelled Donald Trump during the Republican primaries and helped Bernie Sanders be such a challenge for Hillary Clinton.

We therefore expect investors to increasingly focus on this theme in coming months with a particular focus on a potential Trump presidency and growing pressures in several other European countries to organize their own LEAVE referendum. Although the UK has often been perceived in other EU countries as a major obstacle for more integration and the anti-EU sentiment is much less pronounced on the continent, this rise in populism and the appeal of regaining one's full sovereignty will be a constant dark cloud hanging over markets in coming months and years. Our feeling remains that this is not the beginning of the end for the European Union and some of the countries seen as the next shoe to drop (Italeave, Portugo…) are not in a similar position where they could afford to leave (in particular, the fact that they share a single currency will result in much more significant headwinds).

Market Consequences

We have repeatedly argued that markets have entered a much more turbulent risk-on/risk-off phase with limited potential for prices to trend higher amid significantly higher volatility. We have reduced the risk in our portfolios earlier this year, being underweight equities, investing in low volatility strategies, focusing on income strategies and extending the duration of our bond holdings. We have also argued that monetary policies will have to stay extremely accommodative for even longer than most investors believe. We now fully expect the Fed to be on hold for the next few months and to see more easing coming from Japan, the ECB and the U.K. In this environment, the path of least resistance is for the dollar to appreciate and for bond yields to remain very low. For equity markets, it means one has to buy on weakness and sell on strength. A bear market will only become a major concern if we get indications that the US and global economies are heading toward a recession. The Brexit vote is unlikely to lead to such an outcome, but it does lead to higher risk premiums and act as headwind for valuations. It might be tempting to walk away from international equities altogether, but we don't recommend this strategy as this is exactly where valuations are still attractive and we fully expect policy makers to come up with additional measures to support markets and economies (both on the monetary and fiscal fronts).

In summary, the Brexit vote is not the disaster or the Armageddon that some fear it is, but it will lead to ongoing uncertainties in coming months. We recommend investors to avoid panicking when everyone is running for the exit, and become more tactical in how they approach their investments, i.e. selling on strength and buying on weakness. Volatility is definitely here to stay.

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