UNDERSTANDING THE BREXIT: WHAT’S NEXT?

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- British voters surprised the markets by voting “Leave” (52-48)
- Vote has triggered global risk aversion and a flight from risk assets
- Exact process and timing for Brexit is not clear

The markets were unprepared for the results of the U.K.'s European Union Referendum (Brexit), and the majority vote (52-48) to “Leave” the European Union (EU) has been met with a bout of global risk aversion across markets and risk asset classes. The United Kingdom is very much in uncharted waters: although the rules for leaving the Union are spelled out in Article 50 of the Treaty of Lisbon, the rules are vague and no precedent for doing so actually exists. As a result, a relatively prolonged period of negotiation lies ahead. Clearly it is much too early to be definitive around any lasting implications; however here is what we do know:

BE CAREFUL WHAT YOU WISH FOR … SERVED TWO WAYS

British Prime Minister David Cameron set up the referendum as a result of a campaign promise made to U.K. voters, and as a means to unite factions in the Conservative party. He has been a vocal and passionate supporter for “Remain,” and has stated that he will resign, likely during the October timeframe, as a result of the Referendum results. This increases the political uncertainty post-Brexit because the negotiations will be left to the successor Prime Minister, who has yet to be determined. It also pushes out the timetable for beginning discussions with the EU and formally triggering Article 50 to begin the negotiations for the terms of withdrawal. This process could take as long as the two years allowed by Article 50. In other words, everything has changed, but nothing will change … just yet.

The majority “Leave” voters have sent a clear message: they believe the EU benefits more from the United Kingdom's inclusion than U.K. citizens benefit from EU membership. They have also signaled strongly an opposition to EU policies around immigration and regulation. At the end of the day, however, we believe that the United Kingdom is stronger being part of a large and powerful economic block. It benefits from the freedom of movement of capital, goods, services and people that is inherent in EU membership. By voting to leave, the United Kingdom has effectively “poked the bear,” and is unlikely to find the exit negotiations overly favorable. EU officials will be loath to make the exit attractive lest other members choose to opt out.
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DEEP IMPACT

The increased uncertainty will have a tangible near-term impact on U.K. growth. Estimates of the magnitude vary; however there is near unanimity that the hit to gross domestic product (GDP) will be immediate and material. U.K. growth had already slowed during the Referendum cycle, and the combination of the “Leave” vote and the lengthy timetable associated with negotiating an exit will significantly dampen appetite for foreign direct investment, and will present obstacles to U.K. corporate growth plans.

- The Sterling’s post-Referendum drop made history, dipping 10% at the low point, which will drive inflationary pressures.
- The United Kingdom went into the vote as the fifth largest economy in the world, but this morning ceded that position to France based solely on the currency devaluation.
- Standard & Poor’s announced a review of the country’s AAA credit rating, suggesting that it was incompatible with the increased level of uncertainty.
- Finally, both Northern Ireland and Scotland voted overwhelmingly to “Remain.” The Brexit has presented an opportunity to rekindle their independence movements — again, exacerbating the general sense of uncertainty.

WHAT HAPPENS IN EUROPE STAYS IN EUROPE?

While the vote clearly affects the United Kingdom, investors are worried about the knock on effect across Europe and beyond. Shortly after the votes were counted, Marine Le Pen, French presidential hopeful and leader of the far right National Front party, has rallied around a “Frexit.” With a number of meaningful elections across Europe in 2016 and 2017, the growing populist momentum is a concern. In the United States, the concern is equally acute. The message U.S. voters are sending mirrors that of voters in the United Kingdom and throughout Europe: the status quo is unacceptable.

In a world where economic growth is dear and fragile, and where investor confidence is vulnerable to shocks, we expect the rise of populist politics to remain a key risk scenario for us globally. While these are geopolitical issues, the danger is that they translate to economic policies that hurt macroeconomic fundamentals and, ultimately, corporate earnings.

As the global capital market reaction to the Brexit vote shows, what happens in Europe most assuredly does NOT stay in Europe. Investors need to recognize, once again, that global risk asset markets correlate very strongly during times of market stress — at exactly the time that investors rely on the diversification benefits of a globally diversified risk asset portfolio. This is predictable, and heightens the utility of a “risk control” portfolio of high quality fixed income — even at these low yields. This risk control portfolio continues to offer true and robust diversification benefits during times of market stress.
CENTRAL BANKS: WHAT’S IN YOUR QUIVER?

Central banks have been consistent in their overall message that they have multiple arrows in their collective quiver, and are willing to use all available tools to provide liquidity as needed. This is particularly important in the United Kingdom where the banking sector is facing tremendous stress with sector equities falling 30%. So far, we have not seen any monetary policy changes; however we do expect that the Bank of England may ease policy if the economic consequences of the Brexit impair growth significantly. We will be watching any changes to central bank policies closely. The successive use of policies that include low or negative rates and quantitative easing have been met with diminished effectiveness. For the U.S. Federal Reserve, the Brexit vote presents yet another complication to its stated goal of policy normalization. Affirming our lower-for-longer perspective on U.S. rates, we believe that the Fed will hike rates only once during the next 12 months.

Is this a “Lehman Brothers moment”? No. The Brexit does not represent a global systemic risk, and it is important to note that many of the post global financial crisis regulatory changes have prepared the global banking system to withstand periods of stress.

MOVING INTO UNCHARTED TERRITORY

This divorce will likely be messy and take quite a bit of time. If Cameron leaves office in October, the new administration will probably wait before activating the time clock toward Brexit. The complexity of the process, combined with the long negotiation period, may create an extraordinarily long period of heightened headline risk, and will exacerbate investor concern about the Brexit aftermath.

It almost feels quaint to say that markets don’t like uncertainty. Today it feels like quite an understatement. What we are seeing now in risk asset markets is actually a very rational response to the increased level of uncertainty created by the Brexit vote:

- How will this affect global growth?
- How will this affect investor confidence?
- What are the implications on the sanctity of the “irreversible” European Union?
- Is Brexit a symptom of a broader political wind shifting?

The answers to these questions require time. Right now, investors are repricing assets to reach a level where there is adequate compensation for these heightened risks. From a fundamental standpoint, the S&P 500’s direct exposure to the United Kingdom is relatively small at only 4%. However, the exposure to broader Europe (17%) coupled with the effect on earnings from a meaningful strengthening of the U.S. dollar is much larger and potentially problematic.

The strength in the U.S. dollar is a headwind to S&P 500 earnings, and it is something we have been watching closely. The dollar was quite strong early in 2016, and this was reflected in some challenged results for U.S. multinational companies in the first quarter. This pressure abated during the second quarter as investors readjusted their expectations for the Fed’s rate hike path to late 2016 and beyond, so this renewed strength is an unwelcome development.

Making significant portfolio changes during heightened volatility is rarely a good idea. We are staying the course at this time, preferring to rely on a more fundamental analysis of the potential outcomes over an emotional response. We expect that global capital markets will remain volatile over the short, and perhaps even intermediate terms, as investors continue to assess the various impacts of Brexit.
THE BOTTOM LINE

We are monitoring conditions closely. We recognize that the surprise “Leave” vote presents a clear headwind to investor confidence, and perhaps will have a more tangible impact on the global economy and on corporate earnings. We are maintaining our portfolio positioning at this point. However we will be watching the transmission mechanisms of this historic vote carefully, and will communicate any changes to policy directly.