IMPACTS OF BREXIT:
THE KNOWN, THE LIKELY AND THE UNKNOWN

The United Kingdom’s (U.K.) referendum vote to leave the European Union (EU) has unleashed a renewed spike in volatility in financial markets – and along with it, a flurry of emails and conference calls from the financial industry. We remain committed to keeping our clients updated on pertinent developments. However, as it relates to asset allocation and our overall market outlook, we believe in making disciplined, well-informed decisions.

The reality is that there is a lot to be sorted out when analyzing something that has never happened before – an EU member state leaving the economic bloc – and requires humility in forecasting. Already, we have seen a shift from a call for the U.K. to be kicked out as quickly as possible to a more reconciliatory tone being struck by the major EU powers; from markets assessing the negative tail-risk of other countries leaving the EU to the possibility of negotiations preserving the economic union between the U.K. and the EU. Most recently the markets are digesting the withdrawal of Leave-proponent Boris Johnson from consideration for the Prime Minister slot. Given this uncertain outlook, we assembled our senior investment professionals this week to analyze the evolving situation – breaking it down into what we know, what is likely and what we don’t know.

WHAT WE KNOW

Consequences we can anticipate with a high degree of confidence.

- **Interest rates will remain low – and they could go lower.** The May U.S. jobs report took the prospect of a Fed rate hike in June off the table; now Brexit has removed that prospect for the rest of the year. The markets believe the U.S. 10-year will remain below 2% for the next five years. We believe rates will be even lower – a result of slow growth, low inflation, uncertain politics and the gravitational pull of accommodative global monetary policy.

- **A “flight to quality” bias will remain for the foreseeable future.** In the current skittish market environment, investor bias will be toward high-quality assets. Beyond the insatiable demand for U.S. and other safe-haven government bonds, there will be a continued desire to own high-quality companies – both equity and debt issues – and less-volatile risk assets.

- **Political uncertainty will continue.** Given the rise of populist politics, financial markets will need to be on constant watch over ongoing political evolution and the impacts those changes have on the global fundamental growth outlook. We are not certain what these changes will be or when they will occur – just that they will continue to impact financial markets.

- **This is not another “Lehman” moment.** Despite the legitimate concern over economic activity as a result of political uncertainty, we are not on the verge of financial market collapse. There is not a direct risk of severe market dislocations arising from the U.K. deciding to leave the EU; global financial institutions are much better capitalized and more closely regulated than in 2008; central banks are on the case; and credit markets are functioning in an orderly manner.
WHAT WE BELIEVE IS LIKELY
Consequences that are less clear, but we can anticipate probable outcomes.

• **Global economic growth will not be uniformly impacted.** Clearly, we will see economic disruption across Europe, with the U.K. at high risk of entering at least a shallow recession. The impact is less direct on the United States and China, the world’s two largest economies. The United States is a fairly self-sufficient economy, with low export dependence and even lower European dependence. China has greater exposure to Europe, but also a greater ability to offset export weakness through stimulus.

• **U.S. earnings will see only modest direct effects.** Britain’s vote to leave coincided with a sharp upward move in the U.S. dollar versus other major currencies, which we expect to hit next-12-months earnings by 1.5% due to the translation impact (earnings outside the U.S. translated to back U.S. dollars). Indirect impacts are less certain, dependent on changes to the growth outlook. To that point, Europe makes up about 15% of U.S. company revenues.

• **Political policy will pivot away from austerity.** Politicians, pressured by their constituents for “something new” and aided by the low interest rate environment, have new incentive to look to create demand through fiscal stimulus. Brexit became mainly an immigration referendum, but it was also a broader indictment of EU policy of which austerity was a key tenet.

WHAT WE DON’T KNOW
Consequences that remain unclear, and force us to rely on reasonable assumptions.

• **Resulting arrangement between the U.K. and the EU.** The overall political rhetoric has shifted from “leave means leave” to “can’t we all get along.” The EU needs to walk the line between maintaining economic ties with an important trading partner and dissuading other member states from seeking their own deal. The U.K. needs to balance what’s best for Britain with a respect for the vote of the people. A reasonable base case expectation would be for a “Brexit-lite” arrangement – continued close economic ties without formal EU membership.

• **Timing of political policy responses.** The more complicated question is the timing of this “new deal” and, also any other policy responses (e.g., fiscal stimulus). Formal negotiations on the U.K. exit only occur once Article 50 of the Lisbon Treaty is invoked; this starts a two-year negotiation period (which could be extended). A drawn-out process seems reasonable to assume. Any decisions to reverse course on austerity will also likely be drawn-out and reactive to the economic fallout from the current political crisis.

• **Implications for global political structures.** How many other political shoes will drop? Several other countries have demanded similar referendums, mostly called for by minority parties. Most are unlikely, but Scotland and Northern Ireland should be taken seriously given their strong desire to remain in the EU. The June 26 election in Spain and the recent polling for the July 3 election in Australia exhibited a move back toward “establishment” candidates, presumably due to heightened risk aversion in the aftermath of Brexit. This is reassuring – but could also be fleeting, subject to ongoing political and economic developments.
CONCLUSION

Markets have stabilized in the wake of Brexit, but news on the situation continues to evolve and new risks could appear (e.g., a Scotland or Northern Ireland vote to leave the U.K.). History shows that markets tend to overestimate near-term impacts from geopolitical (and other market-moving) events but then underestimate the potential for longer-term consequences. We need to be mindful of both of these biases – not getting caught up in near-term conjecture while also appreciating the unprecedented nature of what has occurred. Our initial conclusions are that market volatility will remain high and interest rates will remain low – and possibly go lower.

During periods of extreme and/or prolonged volatility, we like equity strategies that combine high quality with other factors in an effort to smooth out the effects of volatility. We think value strategies are at risk of underperformance in the short-term, but they are very attractively priced. As such, we expect valuation support for this risk factor that already has exhibited long-term outperformance.

We believe the U.S. high-yield market is very interesting as interest rates remain low. We view high yield as a risk asset with less volatility than equities – and it may continue to present opportunities for superior risk-adjusted returns in a slow growth, high volatility environment. Along with high yield, we remain overweight U.S. equities funded through our current underweight to investment-grade fixed income and modest underweights to developed ex-U.S. equities and natural resources. We also believe in a cash position in-line with meeting near-term liabilities, but nothing more given the costs of holding cash in a low rate environment. In aggregate, our current tactical allocations represent a modest overweight to risk assets, but with our primary overweights in the “less risky” areas of the risk asset markets.

Overall, this period of uncertainty should require higher expected compensation to take on new risk positions. Instead of making any immediate changes in tactical recommendations, we prefer to leverage our deliberate and prudent approach to asset allocation through our monthly asset allocation meetings. We will next review our tactical asset allocation recommendation policy at our July 14 Investment Policy Committee meeting. In the meantime, be sure to watch for our more detailed analysis of Brexit and its consequences to be issued next week.
IMPORTANT INFORMATION: This material is provided for informational purposes only. Information is not intended to be and should not be construed as an offer, solicitation or recommendation with respect to any transaction and should not be treated as legal advice, investment advice or tax advice. Current or prospective clients should under no circumstances rely upon this information as a substitute for obtaining specific legal or tax advice from their own professional legal or tax advisors. Information is confidential and may not be duplicated in any form or disseminated without the prior consent of Northern Trust. Northern Trust and its affiliates may have positions in, and may affect transactions in, the markets, contracts and related investments described herein, which positions and transactions may be in addition to, or different from, those taken in connection with the investments described herein. All material has been obtained from sources believed to be reliable, but the accuracy, completeness and interpretation cannot be guaranteed. Information contained herein is current as of the date appearing in this material only and is subject to change without notice. Indices and trademarks are the property of their respective owners. All rights reserved.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. Periods greater than one year are annualized except where indicated. Returns reflect the reinvestment of dividends and other earnings and are shown before the deduction of investment management fees, unless indicated otherwise. Returns of the indexes also do not typically reflect the deduction of investment management fees, trading costs or other expenses. It is not possible to invest directly in an index. Indexes are the property of their respective owners, all rights reserved.

No bank guarantee | May lose value | NOT FDIC INSURED

© 2016 Northern Trust