

Brexit Voted For - The Implications

Following the realization of the Brexit - an event that the majority really didn't think would come to pass - we would above all counsel our clients not to panic as they pour over the huge amount of comment and analysis that is being generated. In a situation where the UK electorate voted 48.1% to Remain, the legitimacy of the result is being called into question. We feel, however, that there will be no going back on the result, despite Scottish voices saying they can derail the whole thing. The voting turnout in the UK was a high one, at 72.2%, and the background was almost as emotive as it could have been. The UK, in whatever form it settles at i.e. if and when Scotland and Northern Ireland decide to remain in it or not, will move on. We expect the current dislocation in markets generally to subside, although caution remains the watchword in terms of allocation to many risk assets.

'Scotland can now be expected to once again go for independence'

It has become very clear that Scotland can be expected to return to the polling booths during the next year or so to vote once again on the issue of independence. Nicola Sturgeon, the Scottish First Minister, has made it clear that her electorate voted to remain in the EU in 2014, and that is what they expected to see. The goal-posts have just moved substantially, and anecdotal evidence suggests a clear change in voting intentions in a future referendum. This amounts to an added complication for holders of, or potential investors in, British assets, as - in addition to having to compute the effects of leaving the EU - investors will have to once again do their 'Scottish exit' sums, but as part of the overall exercise.

Many of us who have followed the history of periodic agricultural surpluses resulting from subsidies, petty regulations and requirements, Brussels bureaucracy et al, suspect that the UK will successfully adjust to Brexit in the longer-term, once the many months of exit negotiations and

trade renegotiations have taken place.

However, it will all take time, and in the meantime many investment decisions (both incoming foreign direct, and domestic) will have been put on ice. This has a high probability of causing a great deal of short-term economic pain, indeed a recession, and during the next few weeks corporate earnings estimates and macro growth forecasts will be adjusted downwards. We will be tracking these very closely, expecting to see some stabilization over time. All these factors will suppress UK equity P/E ratios, as will necessary developments on the UK political scene; Mr Cameron knew that had he not resigned as PM he would have faced a lack of confidence motion in fairly short order. We are less concerned about the transition to a new Prime Minister (a General Election is unnecessary), however any sound democracy needs a reasonably effective opposition, and we expect Jeremy Corbyn, the leader of the Labour Party, to come under great pressure; he has been criticized for a distinct lack of involvement during the referendum, and it looks as though he will have to face a party leadership contest. Whichever Conservative becomes the new PM might well go to the country soon afterwards, to refresh and lengthen the mandate. Boris Johnson is in pole position for this, having been handed the opportunity of taking David Cameron on, and having beaten him as leader of the Leave campaign. Mr Johnson is very, very popular with the UK electorate, who seem not to care about his faults. Otherwise, the closest contender for the job of PM would probably be Teresa May, who although being highly respected was on the Remain side of the campaign, and who probably lacks the perceived power that the Conservative Party needs at this time.

'Going long volatility has worked out very well'

In the markets, sterling took an immediate 8% hit, and settled just below \$1.37 at the close of the week. The FTSE 100 index, however, closed only 3.2% lower on the day, having been almost 9% lower at one stage



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earlier in the day, pressured lower by bank stocks. The S&P500 closed 3.6% lower, signaling a degree of concern on one hand (perhaps also partly due to dollar strength), but by no means the end of the world. Safe-haven assets such as gold, the dollar, the yen (in the case of the latter we continue to scratch our heads as to why), and quality sovereign bonds all rallied in an almost 'instant' risk-off environment. The markets were illiquid to start with entering this period, and this exacerbated price moves. We recently argued the case for going long 'volatility' itself, highlighting the VIX, and this has worked well, with that metric rallying from the 12-13% range when we made the recommendation, to just below 25% as we go to press.

As many commentators have pointed out, the root causes of such an electoral result against the establishment are part of a global trend. Politicians are deemed to have failed to deliver properly distributed growth, and to have wasted resources. In the case of the Brexit, this will be seen to have accelerated the disintegration of the European Union, although this could still take some time. During the last few days commentators have said that the Swedes, the Danes, the Netherlands, and nationalist elements in France have raised

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the prospect of their own countries' EU referendums. Such opinions need to be tracked very closely. We expect the EU authorities will not allow the UK to depart on easy terms, and indeed something of an example could be made of it to prevent other potential exits.

'We were impressed by the ability of UK gilts to rally'

The yield basis on UK 10-year gilts fell a huge 29 basis points last Friday after the Brexit result became clear, and closed at a record low of 1.09% (having traded as low as 1.02%). With some expectation that the Bank of England could reduce its bank rate from 0.50% to zero, together with the probability of a recession mentioned above, gilt yields could fall still further, providing a worthwhile investment opportunity from what is in other respects a very difficult local investment environment. We are impressed by the ability of UK gilts to rally at all on a day like last Friday, although perhaps of most importance here was the excellent performance given by Mark Carney, the Governor of the Bank of England, who made it clear the BoE will act to stabilize the markets, and has the financial firepower to do so.

ASSET ALLOCATION SUMMARY:

'The EMs will grow by trading more with each other, than with developed countries'

Our major investment recommendation during recent months has been to stay structurally friendly towards Emerging Market assets, especially sovereign bonds, and the Brexit does not change that.

Although dollar strength will at the very least hold back commodity prices (these still being very important to emerging nations), we would emphasize that while the developed world is trending towards lower growth, the average growth rate in

emerging countries is likely to remain 200 basis points or so above that in developed countries. Emerging countries are trading more with each other, and this is key. The MSCI Emerging Market equities index closed 3.6% lower last Friday, and emerging market currencies were lower as well (as one would have expected). We remain happy with the outlook for this asset class, and probably even more so for EM bonds. Should EM bond spreads go out further we expect EM bonds would find willing buyers.

Readers will be aware that our overall tactical asset allocation has been neutral, for instance regarding bond vs. equity weightings, and that will remain in place until market conditions stabilize. Taking US equities as an example, it had begun to look as though January's 'flash' bear market (the worst January equity performance on record) had provided the correction that many professionals had been arguing for. The conundrum then became that although equity valuations looked very stretched, huge amounts of corporate liquidity (especially in the technology sector) and continuing stock buybacks were supportive. Investment sentiment indicators were looking very bearish, but the markets could not fall further because of that; above-average cash positions had been built, and hedge fund short positions were progressively being covered because the S&P was threatening to go to new highs. We appreciate the theoretical bearish arguments, but try not to ignore the weight of money factors. Despite sentiment indicators already being close to extremes, we recommend investors fully hedge long-term positions in case further unexpected adverse events occur.

'Potential investors in UK property will not be put off'

From what we have said above, it will be clear that investors should avoid UK equities in absolute terms, and be careful in European equities, if one has to be involved at all. UK property, however, is a different animal, whose investors tend not to be short-term in nature, but rather 'buy-and-hold'. Holders of UK assets who were

not currency-hedged have taken a quick and sizeable hit, but we suspect that won't actually matter to many of them. In fact, we expect those able to do so will be more inclined to add to those portfolios.

'The US dollar should continue to be a safe haven'

We emphasize that the US dollar should continue to be a safe haven. So should gold (although the latter will continue to be highly volatile, so good short-term timing is crucial).

For some months we have emphasized the importance of balancing investment portfolios with full positions in quality bonds, preferably sovereigns. For the moment we have high yield bond weightings under review, in the meantime favouring investment grade until market volatility abates, as the latter should outperform the former.

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