Investment Management Review

The people have spoken and the UK will leave the EU after 43 years of membership. The outcome is a shock to the City of London, which, ahead of the poll, had confidently expected a Remain outcome and this had been largely discounted financial markets.

The instant market reaction has been a sharp fall in sterling, especially versus the US dollar, falls in stock markets globally of 5-10%, sharp falls in government bond yields, including those in the UK where the 10 year gilt has fallen to new all-time low yields of close to 1%, and a flight to other safe haven assets such as gold. In the UK, domestically exposed companies such as banks, house builders and retailers have fallen particularly steeply. But beyond the immediate market shock, what does the vote mean for investors longer term?

1. Nothing changes immediately in that the UK remains a member of the EU until it triggers the formal exit process, following which it remains a member for at least 2 years.

2. However the UK faces an extended period of uncertainty as it renegotiates trade agreements, legislation and regulations arising from its membership of the EU. The uncertainty is likely to result in reduced confidence and spending by businesses and to a lesser extent consumers. This means growth will be lower in the next 2 years than previously expected, perhaps by as much as 1% per annum.

3. The UK also faces a period of political uncertainty as Prime Minister Cameron has resigned with effect from October 2016, the time of the Conservative Party conference. However, this is unlikely to have a material impact on confidence as a general election is not due until 2020 and it is highly improbable that the new leader would call an election. It remains the case that there is no effective or credible opposition to the government, so political uncertainty is likely to be minimal and have no bearing on markets. Given that Scotland voted substantially in favour of remaining in the EU there is now a real possibility of a second Scottish independence referendum and Scotland leaving the UK, which would enable Scotland to become an independent member of the EU. Should this eventuate we see no material risks to the economy of the rest of the UK, given that Scotland represents only 8% of UK GDP, and no significant lasting impact in financial markets (as we saw with the Scottish referendum in 2014).

4. The UK exit is the biggest shock to the EU project since it began in 1956 with the Treaty of Rome. The UK is the second largest economy in Europe and the most open, free market and liberal, as well as having the longest and most robust democratic traditions. Its presence in the EU will be sorely missed and its exit could trigger reappraisal of membership by other countries. It will be incumbent on the EU leadership to listen to the voices of the people and react appropriately. The risk is that the whole EU project unwinds but this is highly unlikely given the strength of the political will underlying it; even if other countries do leave it would happen only over a long period of time. The more likely outcome is that the EU will attempt to strengthen its centralisation and harmonisation, but its ability to do so will be constrained by domestic politics. This suggests that growth in Europe will remain sluggish over the longer term as much needed structural and labour market reforms will be deferred. The shock of Brexit and concerns that other members might follow could well lead to the EU Commission taking a hard line approach to the UK’s exit negotiations, potentially prolonging the uncertainty of the transition period.

5. Contrary to the way many commentators and markets have reacted we do not believe that Brexit is a globally systemic event. The UK economy is less than 4% of global GDP so even a very sharp fall in UK growth has no material impact globally. To put it in perspective China, growing at

6-7% per annum, is adding an economy the size of the UK to the global economy every 4 to 5 years. Furthermore, UK banks are very well capitalised and have much greater capacity to absorb shocks than during the global financial crisis. Any implications for the remainder of the EU are uncertain but they will play out only over a very long period. In the meantime both the Bank of England and the European Central Bank have made it clear that they are ready, willing and able to support markets with ample liquidity and will maintain a highly accommodating monetary policy.

6. Interest rates in the UK, which we expected to stay at current levels for the next year at least even in the event of a Remain outcome, will now stay close to zero for as far ahead as we could realistically forecast. The same applies in Europe. It is increasingly likely that the Bank of England will cut rates from current levels of 0.5%, although the benefits to economic activity are unclear.

7. We have always felt that the biggest risk for investors in the event of Brexit is sterling, because the greatest uncertainty surrounds the UK’s future trade arrangements and foreign investment flows. Since the UK is already running a current account deficit of over 5% of GDP any damage to trade and foreign flows would be unwelcome and put pressure on sterling. The immediate falls in sterling, if sustained, would help the UK in this respect, as long as they did not feed through into higher inflation expectations. There is a strong likelihood that sterling will now be weaker against the dollar in the medium term, but less so versus the euro given the damage to the EU from Brexit.

8. Government bond yields in the UK have fallen significantly in the immediate post Brexit market reaction. The prospect of slower growth in the UK in the next year or two and the heightened level of uncertainty, together with the prospect of near zero short term rates for years ahead, are likely to offset concerns that sterling weakness might lead to higher imported inflation and we expect bond yields to stay low. They remain very poor long term investments as current yields provide no protection from even a modest uptick in inflation.

9. Risk assets globally have sold off to a degree which we believe is irrational and unjustified by the fundamentals. We see no reason why, for instance, US equities or corporate bonds generally should fall as sharply as we have seen. We do not believe Brexit increases credit and default risk, especially outside the UK, and the falls to date are creating opportunities on a longer term view. In the case of UK equities they are firmly underpinned by reasonable valuations, a good dividend yield and by the fact that UK FTSE 100 companies in aggregate derive over 75% of their sales and profits from outside the UK.

10. We strongly believe that the UK will thrive and prosper whether in or out of the EU. Once we are through the short term period of adjustment and uncertainty, and this will be priced into markets very quickly, we are confident that the UK will continue to benefit from its structural strengths, open and dynamic economy and flexible labour market. The UK remains open for business and its inherent and well established attractions means that it will remain a destination for substantial inward investment.

11. A momentous decision such as the one now taken by the UK invariably creates short term concerns and raises many questions as the status quo of the past 40 years is broken. This will undoubtedly raise volatility in financial markets in the short term, especially in the UK and Europe, as the implications are fully digested. However the UK has a strong, open and resilient economy, and markets will settle down to the new reality after a short period of adjustment. We believe that now is the time for a considered, measured approach, maintaining broad diversification in portfolios and using short term volatility as an opportunity to buy assets at attractive valuations.