

Brexit: the seismic shock has subsided, what now?

The initial Brexit shock to markets has subsided and liquid asset prices have rapidly adjusted to the new reality. In general there has been a flight to safe haven assets whereas investments most directly exposed to the UK economy have suffered falls, in some cases substantial. However, market moves so far have been less violent than many doomsters' predictions ahead of the poll and there are few if any signs of a market crisis, global contagion or systemic drying up of liquidity. Other than in the immediate post poll trading, when some UK stocks and European financials fell precipitously, the market reaction is typical of moves following a shock outcome to a key decision, which in the case of the UK referendum was regarded by many commentators as globally significant.

Currency markets have seen the most dramatic moves, with sterling falling sharply as investors fear long term deterioration in the UK's trade account and foreign investment flows. Against the US dollar, sterling immediately fell from \$1.49 ahead of the poll to around \$1.32, a drop of over 11% to a 31 year low. It has subsequently recovered modestly as markets regain a degree of stability, but remains at \$1.34. The pound fell somewhat less against the euro, by about 8%, but by an extraordinary 15% versus the yen, which is seen as a safe haven in periods of market stress. Gold rose by 5% to \$1,324 which translates to a 19% rise in sterling terms.

Equity markets fell, with the heaviest losses in UK domestic stocks, best represented by the FTSE 250 index, down by 14% in the two days after the poll, as well as financials across Europe. In fact European stocks suffered generally, with the MSCI Europe ex UK index down by close to 10%. In contrast, the index of leading stocks in the UK, FTSE 100, fell by a relatively modest 5.6% and has since recovered all the ground lost; it has been substantially protected by the dominance of companies which derive most of their revenues and profits outside the UK. Many of these stocks have moved to new all-time highs. The S&P 500 also fell initially by 5% but has subsequently recovered most of the ground lost.

Bond markets reacted broadly consistently with any 'risk off' period. Government bond yields fell significantly, by about 20bps in Germany, 30bps in the US and 45bps in the UK. As well as attracting safe haven funds they also discounted slower growth, especially in the UK and Europe and the likelihood that central banks everywhere, but most importantly the US Federal Reserve (Fed), will defer any interest rate rise for a considerable time in the face of a new threat to growth and stability. In the case of the UK there is now no prospect of an interest rate rise for several years ahead, indeed there is a much greater chance of a rate cut to zero (but not into negative territory, the Bank of England remains unconvinced of the merits of such a move).

What next? In a febrile political atmosphere in the UK and Europe, and with high levels of uncertainty surrounding the implications of Brexit for the UK and the EU we provide the following perspective:

1. Brexit will ultimately happen. There is a growing body of opinion suggesting it will never be implemented. Yet the turnout in the poll was high at over 72% and the margin of the outcome was close but decisive. While there is a history in the EU of electorates suffering a second referendum when the first answer they gave was 'wrong' (i.e. not in support of ever closer political union) the UK has an immensely powerful democratic tradition and it is inconceivable that Parliament would ignore the will of the people (which in a referendum is advisory rather than being legally binding in and of itself).

2. The key question is the form that Brexit will take. Markets are not interested in issues of sovereignty and control, merely economics, and that means access to the EU's single market. It is in the interests of neither the UK nor the EU for the UK to lose access to the single market. Although the proportion of the UK's total trade that takes place with the EU has fallen over the past 20 years it still represents 53% of UK imports and 44% of exports. Exports to the EU are worth 12% of UK GDP. Although exports from the EU to the UK account for a smaller proportion of EU GDP, at 3%, the EU runs a substantial trade surplus with the UK of some £70bn and will be reluctant to risk undermining that.
3. The process for Brexit can only be triggered by the UK, by invoking Article 50 of the Treaty of Lisbon. While the EU is pressuring the UK to start the process neither the UK government nor the leaders of the Leave campaign are in any rush. Cameron has already said he will not invoke Article 50, leaving that to the new PM, who will be in place only by September 9th, and it is clear that none of the candidates for the role of leader of the Conservative party (and hence new PM) will be in any hurry. The UK needs time to work out its negotiating stance and is aware that once Article 50 is invoked it becomes practically irreversible and all the negotiating cards will then rest with the EU. It is becoming increasingly likely that formal notice of exit will only be given by year end at the earliest, following which there is a fixed period of 2 years to complete the withdrawal negotiations.
4. It is very difficult at this early stage to predict the outcome of the negotiations but the most likely stance of the UK is to maintain access to the single market but with limits on the freedom of movement of people (the UK has no issues with the other 3 freedoms, of goods, services and capital). Although the stance of EU leaders so far in public announcements is that freedom of movement of people is inviolable there is likely to be recognition as negotiations proceed that some compromise will be essential to strike a deal, given the importance attached to this issue by the UK electorate. Speculating on the outcome of negotiations which have not yet begun and could drag on for at least 2 years is risky but continuing access to the single market would be a very market friendly outcome. However the UK faces an extended period of uncertainty until the outcome of the negotiations becomes clear. The same applies but to a much reduced extent to the EU, which faces the threat of losing its second biggest member and of other electorates following in the footsteps of the UK; the ECB has forecast that Eurozone growth could be hit by a cumulative 0.3 - 0.5% over the next 3 years.
5. UK politics are in disarray following the referendum, increasing short term uncertainty. The next PM will be in place by early September. Following Boris' decision to not stand for Conservative party leadership, the frontrunner appears to be Theresa May, Home Secretary and somewhat reluctant Remainer. Boris perhaps stood back because while he is the favourite among the constituency members, he is much less popular among the Parliamentary party. On balance the worthy and safe May would be a sound leader until the next general election, due in 2020. Given the complete disarray in the opposition Labour Party, which is heading rapidly towards self-destruction and with a wholly incompetent leadership the new PM may be tempted to seek a new mandate from the electorate by calling a snap general election to provide a larger majority for the Conservatives than the current 12 seats. Given the over-riding priorities for the new government to focus on Brexit negotiations and the need to heal the divisions across the country, the last thing the electorate needs is another election so we suspect the government will carry on until 2020, the end of the fixed 5 year term. The domestic political uncertainty could persist for some months but will quickly fade and is unlikely to have any lasting impact on financial markets; it certainly pales into insignificance compared with the deep uncertainties created by the forthcoming exit negotiations. Longer term, there is a growing probability that the UK government will respond to the message of disillusion from large parts of the electorate by shifting its fiscal stance more towards increased spending and redistribution; while this would play out over the medium term it would have important implications for markets, especially for bonds.
6. While the uncertainties in the UK and Europe are intense and likely to hit confidence and growth over the next 2 to 3 years, it is becoming clear that Brexit is not a globally systemic event. It has a modest negative impact on global growth but there is no financial crisis, markets are orderly and functioning normally. The pre-poll predictions of a global collapse are far from the mark. Arguably the most significant impact is on the thinking of the Fed, which is now highly unlikely to risk

another interest rate rise until late this year at the earliest, more likely well into next year, while the ECB and Bank of England will not be thinking of raising rates for many years. In the UK there could be a small increase in inflation as a result of sterling's sharp fall but it is extremely unlikely that this would change inflationary expectations at a time when growth is likely to be under pressure. The Bank of England is more likely to cut rates than consider an increase and the market is discounting a cut within the next 6 months.

7. Markets have begun to settle down after the initial shock of Brexit; the irrational price moves in the early hours after the poll have been largely corrected. UK based international stocks have performed well, benefitting from their activities outside the UK and the positive translation effects of sterling's weakness, while UK domestic stocks have fallen in response to the near certain negative impact to UK growth of a lengthy period of uncertainty. While it is extremely unlikely that companies based in the UK will shift activities to other EU countries, at the very least until clarity has been reached on the exit terms, it is likely that new investment will be constrained until the full implications of exit become clearer. Even longer term it is very unlikely that companies would leave the UK for the EU, given that many of the reasons for choosing the UK in the first instance remain firmly in place and could well be enhanced by Brexit (fewer regulations, reduced bureaucracy, better access to non EU markets). This would be even more likely if the UK strikes some form of compromise to retain access to the single market. Some parts of the financial services industry could relocate to the EU but this will be at the margin, given the huge competitive advantages enjoyed by London as the preeminent global financial centre.
8. The main sustained impact on markets is likely to be weakness in sterling through the period of uncertainty, especially against the dollar. Although sterling is now approaching undervalued levels the probability of loose monetary policy in the UK for years ahead and the increased risk, of recession in the short term will keep the currency under pressure (to the benefit of the trade account and longer term rebalancing in the economy). The greatest uncertainty in the next few years surrounds the UK's future trade arrangements and foreign investment flows.
9. Government bond yields have rightly ignored the downgrading of the UK by the rating agencies post Brexit. The UK is sound financially and will always control its own currency; it has a flexible, open, free market economy which will be successful longer term.
10. We reiterate our view that we strongly believe the UK will thrive and prosper whether in or out of the EU. The inevitable rise in uncertainty over an extended period will push the risk premium on UK assets higher but much of this has been priced into markets. There will be an increase in volatility in financial markets until there is some degree of clarity on the form which Brexit will take but we believe the chances are that the final outcome will be broadly market friendly. We therefore are seeking to use periods of weakness to accumulate assets on more attractive longer term valuations than we have seen for some time. We note that, for overseas investors, UK assets are considerably cheaper today than a week ago, following the sharp fall in sterling, and we expect to see increased foreign investment interest in due course.

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