Investment Insights

Brexit: Reality and Aftermath

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Highlights

- One of the key event risks for financial markets, which was also motivation behind us reducing risk in client portfolios, has come to fruition: on Thursday, U.K. citizens voted to leave the European Union.
- Markets reacted swiftly, with the pound suffering its biggest one day move ever. Investors moved out of global equities and into safe haven assets like bonds, the yen, and gold.
- The aftermath of Brexit will include a new prime minister in the U.K.; a likely spread of "Euroscepticism" to other member countries, some of whom are holding elections in the coming months; and potential further easing from central banks as they work to ensure ample liquidity and support economic growth.
- While Brexit was not our base case, it was a risk factor we highlighted in our recent asset allocation shift to more bonds. At this time, we are not making a significant change to our asset allocation. Looking ahead, we will continue to evaluate the ramifications of Brexit and other risk factors.
- We remain comfortable with our underweight position to U.K. and European equities.

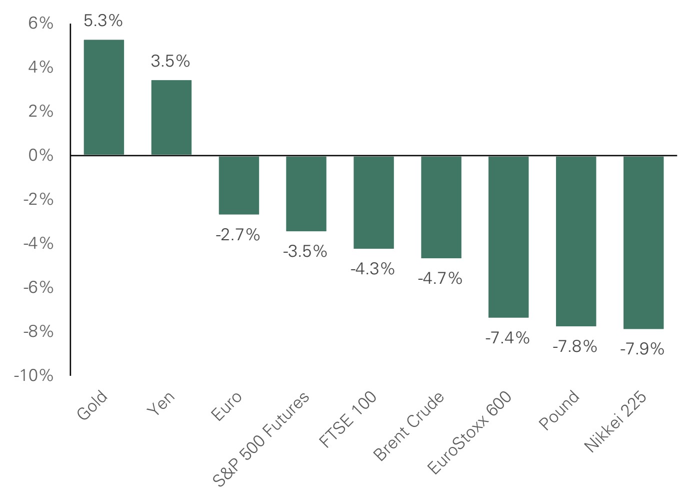
One of the key event risks for financial markets, which was also motivation behind reducing risk in client portfolios in May, has come to fruition. On Thursday, U.K. citizens voted to leave the European Union (EU), catching financial markets more broadly off guard. The decision has wide-reaching implications for the U.K., EU, and others. While there are many questions at this point as to what an EU without the U.K. will look like and vice versa, in this piece we provide an update on our views surrounding this very fluid situation.

Market response: Large moves in currencies and global equity markets

After opening significantly weaker, global markets have bounced off the bottoms reached immediately after the release of the official vote (Exhibit 1). The response to U.K. stocks and currencies has been quite negative.

Exhibit 1: Market Reaction to Brexit

U.S. close June 23, 2016 to U.S. open June 24, 2016



Data are as of June 24, 2016. Returns are price only.

Source: Bloomberg

At the time of writing, the pound is down around 6.5% year-to-date. U.K. equities are currently down around 2.5% today and roughly 1% year-to-date (price return in local currency; after factoring in the fall in the currency, the FTSE 100 is down over 7% year-to-date).

The worst of the spillover has been to European and Japanese stocks. While the euro is holding up relatively well, European stocks are down over 7% today and almost 14% year-to-date (local currency) through early Friday. Japanese stocks are down a similar magnitude today but are suffering even worse, down over 21% year-to-date.

Investors have piled into safe-haven assets, causing the yen to strengthen to below 100 yen per dollar at one point. Some of that strength has been given back, but the dollar is now almost 17% weaker versus the yen year-to-date. Ten-year Treasury yields have declined to 1.58%, the lowest level since 2012. Consistent with the risk-off mode, German 10-year bund yields are trading back in negative territory, while gold is up almost 5% versus yesterday.

The one bright spot (more of a glimmer, really) in an otherwise very bleak day for financial markets are U.S equities, which seem to be holding in relatively well compared to global counterparts, down roughly 2%.

Policy response: Damage control from central banks

Global policy makers have already started to respond to the near-term threats that Brexit poses to markets and the financial system. In light of tight liquidity and erratic market moves, various central banks should be providing liquidity throughout the day. The Bank of England's (BoE) Mark Carney has already announced that it is making £250 billion available to banks. More central bank action is likely to follow. It is possible officials intervened in currency markets overnight, most likely the Bank of Japan (BoJ) trying to stem strength of the yen. We would note that Chinese officials have been focused on Brexit as a risk for months and have significant reserves at their disposal should volatility in their currency markets escalate.

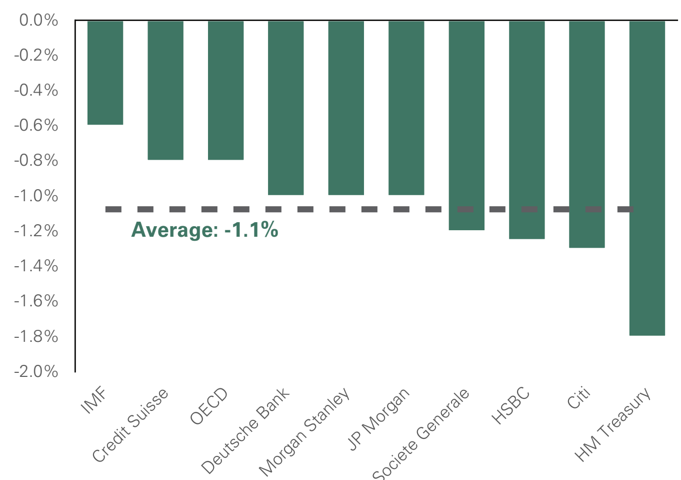
Meanwhile, we would expect both the BoE and the European Central Bank (ECB) to cut rates in the coming months. The BoE had been on a path more similar to the Fed's than the ECB's. Given that its assessment of Brexit was dire to begin with, it is quite likely that it will change tack aggressively and move to a supportive stance. While the ECB has already been easing aggressively, there is room for them to prolong the quantitative easing program and potentially push policy rates further into negative territory.

The Federal Reserve (Fed) has noted that it is monitoring developments in cooperation with other central banks and is prepared to provide dollar liquidity through existing swap lines with central banks (put in place during the financial crisis to provide liquidity in U.S. dollars to overseas markets). Meanwhile, in light of tighter financial conditions and a higher U.S. dollar, it is likely that the Fed will not raise rates in the coming months.

Economic implications

In our note from March, we discussed that the uncertainty from Brexit would likely hamper U.K. growth in the near term (Exhibit 2). The BoE and other

Exhibit 2: Economist Estimates for Short Term Impact of "Brexit" on U.K. Real Annualized GDP Growth



Data are as of June 24, 2016. Estimates are annualized but reflect various short-term periods.

Source: Bank of England, Citi, Credit Suisse, DB, HM Treasury, HSBC, IMF, JP Morgan, Morgan Stanley, OECD, Societe Generale

Political ramifications: Monitoring the political minefields

Brexit has now opened the door for the spread of, so called, "Euroscepticism" across the region. Already on Friday morning, France's far right National Front party is calling for a similar referendum on France's inclusion in the EU ("Frexit"). The likelihood of similar events across Europe may very well hinge on the path paved by the U.K., in terms of both short- and longer-term economic consequences. There are several key dates to watch as the situation unfolds across the U.K. and European Union.

Friday, June 24 – Meeting of key EU Finance Ministers (Donald Tusk, Jean-Claude Juncker, Mark Rutte, and Martin Schulz)

Saturday, June 25 – Meeting of the "Inner Six" founding members of the EU (Belgium, France, Italy, Luxembourg, Netherlands, Germany)

This could be the first of many meetings within the remaining members of the EU to decide on the future path of the bloc. There may also be an emergency meeting of finance ministers over the weekend.

Sunday, June 26 – Spanish Parliamentary elections

The country has been without a formal government since December 2015. Despite economic progress from Spain, the unemployment rate remains high, which has encouraged the rise of the anti-austerity Podemos party.

June 27-29 - ECB Forum on Central Banking

The ECB will meet, and Janet Yellen will speak, with the focus of the meeting to be on the future of the international monetary and financial architecture.

June 27-28 - European Union Council Summit

Cameron will meet other leaders to communicate the U.K.'s decision and his own decision to resign.

July 14 – Bank of England rate decision

While an emergency meeting/announcement is possible, the next set meeting for the central bank will dictate the BoE's policy response. It is likely that they ease policy and lower the official bank rate below the current 0.5%. However, it will be important to watch for signs of inflation over the coming months from a weakening currency, which along with slower growth, could present challenges for policy response.

July 21 – ECB rate decision

We would watch for the ECB to ease in order to relieve any sustained tightening of financial conditions.

July 27 – Fed rate decision

It is unlikely that the Fed will hike in July, given the outcome of Brexit.

July 29 – BoJ rate decision

A stronger yen poses challenges for Japan's already-struggling economy, so we would look for the BoJ to announce additional easing, possibly in the form of ETF purchases.

August 25 – Fed's Jackson Hole Conference

This meeting will be key to gauge the likelihood of a 2016 hike. Currently, markets are pricing in about a 12% probability of a hike in December.

Political ramifications: Monitoring the political minefields continued

October 2016 – New U.K. Prime Minister

David Cameron has said he will step aside for a successor at some point before the Conservative Party's October conference. The process of electing a new PM will involve a series of ballots within the parliamentary Conservative party. At this point, Boris Johnson, champion for the "Leave" campaign, is a likely candidate. Once a new PM is elected, by receiving a majority of support, Article 50 will be initiated. This is the legal means of seceding from the EU and essentially starts the clock on the two-year negotiation period. Extension beyond the two-year mark would require buy-in from all EU members, at which point the U.K. would lose a significant amount of bargaining power. The U.K. will continue to be a member of the EU in the interim period, subject to all EU legislation and rules.

October 2016 – Italy constitutional referendum

Recent local elections do not bode well for the "establishment" parties ahead of Italy's fall referendum on Senate reform. Prime Minister Renzi has mentioned multiple times that the success of his premiership is linked to October's referendum. Given the recent success of the anti-establishment, euro-skeptic Five Star Movement, forming a stable government after a rejection of Senate reform could prove challenging if not impossible.

November 7, 2016 – U.S. elections

The results of Brexit have brought to light the rise of an anti-establishment movement that has not necessarily been properly reflected by conventional polling methods. While the upcoming U.S. election is very different from the U.K.'s referendum, it does raise the question of whether the market is properly assessing the risks around the U.S. election.

March 15, 2017 – Dutch general elections

Populism is gaining support through the Dutch Freedom Party, and support is building for the Netherlands to have their own referendum on EU membership.

April/May 2017 – France general elections

August 27, 2017 – German general elections

institutions have agreed with expectations that growth would suffer longer term in light of lost trade- and labor-related synergies with the European Union, among other factors. We think the longer-term view is complicated by so many uncertainties that may not become clear for several years. Specifically, it will be key to see how the U.K. would establish trade ties with other countries in the EU and beyond.

Focusing just on the short-term outlook, we believe it is reasonable to expect U.K. GDP growth to fall to 1.0% over the following year, trimming about 1% from prior estimates. A mild recession scenario is a definite possibility. The primary driver of the weakness is the uncertainty related to the Brexit scenario: firms are likely to put plans for hiring or capital expenditures on hold. For the Eurozone more broadly, the effect may be about half as much (-0.5%), taking overall GDP growth to 1.4%. There are downside risks to these forecasts, as slowing momentum can increase the odds of further disappointment. When we look at global GDP, the effect should be much more muted, only on the order of -0.10-0.20%. A realistic estimate for global growth this year is around 3-3.5%.

In terms of the spillover to U.S. growth, we estimate smaller effects, as trade linkages with the U.K. remain somewhat limited. However, there are risks of a bigger

knock-on effect, as this estimate is highly dependent upon the depth of the market weakness and dollar strength in coming weeks. Specifically, we estimate a sustained 10% equity correction could create a 0.2% drag on real GDP growth, with the Fed's own estimates that a 10% dollar rally could present a larger 0.4% annualized headwind. We continue to view the U.S. as being in the latter part of its economic cycle, and various risks factors are relevant for specific timing. At this stage, we do not think that Brexit is enough to trigger a meaningful U.S. slowdown. Further, it is still quite possible that the Fed could hike rates this fall amid an uptick in U.S. price pressures.

Portfolio positioning and implications

While a Brexit vote was not our base case, the risks around it were part of the reason we shifted client portfolios to have a more defensive tilt in early May. In Balanced Growth portfolios with a 70/30 stock/bond risk profile, we moved 4% from Strategic Opportunities to fixed income and also added to our U.S. overweight (to take European equities more underweight) versus our benchmark. At the same time, some equity managers reduced volatility. We also continue to hedge a portion of our international currency exposure.

Bessemer portfolio managers have been prepared for a potential Brexit and are currently examining lists of companies to which they may want to add or reduce exposure. In general, we see opportunities in sectors that are not significantly exposed to the U.K. or European cyclical growth story or where valuations appropriately reflect the risks. These are companies that we have already examined for long-term attractive qualities that may be trading at a discount amid volatile conditions.

In fixed income, we are looking at opportunities to extend duration given the 20 basis point decline in U.S. 10-year yields is actually relatively muted in light of heightened global uncertainty, other market moves, and an increased likelihood that the Fed remains on hold for the foreseeable future.

We acknowledge the heightened uncertainty that the Brexit outcome and surrounding risks present and will continue to monitor developments going forward. This is especially important given our view that the U.S. is in the later stages of its economic cycle. However, given we do not believe a U.S. recession is imminent, nor is Brexit likely to trigger this, and we are comfortable maintaining equity exposure broadly, with the important point that we are underweight the U.K. and Europe. We will continue to keep you updated on developments in markets and portfolios as this fluid situation continues.

Our Recent Insights

Countdown to Brexit — Investment Insights (June 2016)

Bonds and Late-Cycle Investing — A Closer Look (May 2016)

Building Our Defenses — Investment Insights (May 2016)

Brexit: A Conversation with Holly MacDonald and Alex Lloyd (May 2016)

"R & R" — Quarterly Investment Perspective (Second Quarter 2016, **Video Available**)

Boosting Emerging Markets Exposure to Neutral on Improved Outlook — Investment Insights (March 2016)

Coordinated Currency Policy is Back — Investment Insights (March 2016)

A Briefing on Brexit: Evaluating the Risks of the U.K. Leaving the EU — A Closer Look (March 2016)

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