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EU Referendum: Investec's Views

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Simon Brazier, Philip Saunders and Ken Hsia give their views on the EU Referendum result.

The views expressed are those of the Portfolio Manager at the time of publication. They may not reflect the views of all the portfolio managers at Investec Asset Management. Any opinions expressed are honestly held but are not guaranteed and should not be relied upon.

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June 24th will now be remembered in the annals of financial history and the key dynamic that this vote brings is uncertainty. That uncertainty is both short term and long term. In the short term, David Cameron’s intention to resign before the year end provides further political instability. Over the longer term uncertainty will persist as Britain renegotiates its trade position in both Europe and the rest of the world.

Implications

Economic

From a simple UK perspective, a UK recession is now a significant reality. There is limited support for GDP from here. Business investment which was -0.4% in the last quarter will remain negative. The CEO of Publicis has already stated today “setting up more UK centres is out of the question”. Household consumption that is the largest component of GDP will reduce. The consumer hates uncertainty and the inherent risks to unemployment, house prices and the fact that the savings ratio is already back to the lows of 2008 means there is little room for manoeuvre. Weak sterling will provide some support for exporters but unfortunately net trade is such a small component of UK GDP, this will provide limited support. However, the economic implications resonate much further than the shores of the UK. Concerns about a break-up of the Euro area will now resurface and financial conditions could tighten materially. Economic weakness in the UK is certain to spill over to Europe. Furthermore, US$ strength, would also put further pressure on global growth.

Political

The UK electorate has rejected the policies and ambitions of the political establishment, whether European or UK. This sentiment of disillusionment with both political and business leaders is not reserved for the British and there will now be calls across Europe from anti-EU parties for their own referendums. European politicians will be very concerned that this could be the catalyst for the break-up of the EU and herein rests the interesting issue. Do they close ranks and take a hard line with the UK to deter other dissenters, or will they try to work a reconciliation. History would suggest the latter and Europe has always worked a solution, whether renegotiating with Denmark in 1992 when they initially rejected the Maastricht treaty or providing Margaret Thatcher with her rebate in 1984. To assume that the UK will now definitely leave the EU, despite the referendum result, may be presumptive and a second referendum on significantly improved terms may be a possibility. On the domestic front, we have had David Cameron’s intention to resign but critically we do not know if and when Article 50, that starts the process for EU withdrawal, will be invoked.

Equity Markets/UK Alpha strategy

This result does impact all equities as growth prospects in the UK and globally are revised downwards. The UK Alpha strategy is focused on high quality companies that generate cash and have opportunities to reinvest that cash. In terms of sector positioning, the largest underweight is banks and we have been reducing domestic cyclicals over the last year. We invest on a three to five year time horizon and we will not be making significant changes to the portfolio. A large focus of the portfolio is on globally diversified companies such as Unilever, BAT and Reckitt Benckiser who should continue to deliver growth. In addition, we have been increasing exposure to overseas earnings such as Visa, ADP, Checkpoint and Verisign which have limited European revenue and GDP exposure. We will need to factor in the lower GDP growth numbers into our company forecasts. However, we will see significant volatility in the days ahead and with that will be opportunities for us to add to positions that become oversold.

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Philip Saunders

Co-head Multi-Asset Growth

The result of yesterday’s referendum on whether the UK should stay within the EU led to a narrow victory for the Leave campaign. Whilst the polls had indicated that the voting would be close, there had seemed to be a growing consensus that the result would be to Remain and this seemed to be priced in to stock, bond and currency markets. We, therefore, feel that there may well be

considerable short-term volatility in the wake of this surprising outcome. We believe, in the near term, markets will be pre-occupied by the following issues:

- **Will 'out be out'?** Uncertainty will continue with the possibility of a further referendum. The actual exit process will not start until Article 50 of the Treaty on European Union is triggered.
- **Currency volatility:** Sterling has fallen sharply from levels that were effectively discounting a sufficiently convincing remain result. UK fundamental factors, chiefly a yawning current account deficit and a struggling property market are becoming less supportive[1]. Central Banks are likely to step in quickly to prevent excessive turbulence.
- **Populist backlash:** The euro and indeed European assets reflected little in the way of EU fragmentation risk, but the populist backlash is clearly not a purely UK phenomenon.
- **UK equity market turbulence:** UK equities have weakened sharply on the futures market and continued uncertainty will depress multiples and valuations. It will be important to discriminate between stocks that are likely to be affected by largely domestic cyclical factors, which need not be long lasting, and companies, such as banks, which may be affected more structurally. The market is unlikely to discriminate at first and hence, for those able to adopt a company by company approach, this would represent a longer-term advantage. Many UK-listed companies would actually benefit from sterling weakness either through improved competitiveness or from the translation of overseas earnings.
- **Downturn in UK property:** Listed UK property assets, which had been particularly adversely impacted from the last quarter of 2015 on Brexit concerns, are likely to reverse their recent gains. With much of the re-rating due to structurally lower long-term interest rates 'in the price', further weakness is possible.
- **Depressed credit markets:** European credit markets are likely to be negatively impacted in the short term, with credit spreads moving wider. Sterling denominated issues and UK bank credits are likely to particularly adversely impacted.
- **Macroeconomic stability & dovish Fed:** We believe that globally investors are generally cautiously positioned given growth concerns. The removal of referendum related uncertainty, although a continued problem for UK assets in particular, makes this a less comfortable position given recent macroeconomic stability and a softer rates stance on the part of the US Federal Reserve Board. Defensive assets, such as government bonds, may rally temporarily and riskier assets will arguably be negatively impacted in the short term. Thereafter, both will be impacted by global fundamentals and investor positioning.

Markets tend to adjust rapidly and sometimes overshoot. Investors are generally better off not reacting to the outcome of the referendum over the short term. Over the longer term economic and corporate fundamentals will drive investment returns.

Note 1

- *At 4.3% of GDP (IMF's 2016 projection) the UK has the largest current account deficit of any advanced economy*
- *At 3.6% of GDP (Economist) the UK's budget deficit is the third largest among advanced economies, topped only by Japan and Greece*
- *The UK has a trade deficit of US$190 billion, the second largest in the world after the US*
- *The UK has US$2.2 trillion debt outstanding, the third largest in the world after the US and Japan.*

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Ken Hsia

Portfolio Manager, European Equity

The electorate voted for the UK to leave the EU in yesterday's referendum. We will watch the initial reaction of capital markets with interest. However, we believe currency movements are likely to be more significant, as we have seen already in the immediate reaction to the referendum result. In the aftermath of the referendum we note:

- In the short term we expect to see elevated volatility in the equity markets as a whole, not just in the UK but across Europe (with similar shockwaves across other regions of the world). Given the lack of economic understanding of the real medium to long term effect of Brexit on trade agreements and company fundamentals, this short term volatility will be more based on reactionary sentiment based trading.
- We await the real impact on trade agreements to unfold. There are indications that all existing trade agreements may hold for at least two years until new agreements come into effect. We believe, the sectors most likely to be impacted by changes to trade tariffs are agriculture and manufacturing, as services see no industry-specific export. Both the agriculture and manufacturing sectors are small on a UK basis (0.7% and 11% of GDP respectively). However, we believe that uncertainties will lead to investment and purchasing decisions being delayed by consumers and corporates.
- As regards capital markets we will await the reaction of the European sovereign bond market as well as the UK and European central banks. With quantitative easing in Europe in place since March 2015, we would be surprised to see yields expand and hence stability should remain on that front.
- Overall the degree of pragmatism will dictate near term developments. The UK people have given their message and we will observe the pace at which this new agenda is embraced. It would be a surprise to see obstructions to the economic recovery Europe is experiencing. With easy monetary policy, there is upside as well as downside risk within the stock market. With equity markets yielding in great excess of bond markets, we believe, there are sectors which can grow dividends even in a tougher environment.

European Equity Strategy:

We have raised the hurdles for investments into UK stocks and have explicitly considered the risks an out vote poses to individual companies as part of our research process. We continue to run a balanced portfolio and will rebalance when necessary according to our 4FactorTM investment process.

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