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BRIEF MARKET INSIGHTS

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The Implications of the UK Leaving the European Union

Yesterday's news on Brexit was not widely anticipated, which has resulted in heightened volatility in markets around the world. Rather than react to fluctuations in stock prices that are dominated by position-adjustments and recalibrating expectations, we believe it is far better to wait for investment opportunities that reveal themselves during these periods of uncertainty.

The British exit from the Eurozone is likely to be a greater potential risk for the UK economy than the UK stock market, given the preponderance of overseas earnings that benefit from a weaker Pound Sterling in the market participants.

Undoubtedly, a fall in the Sterling should provide a boost for UK tourism, for exporters and those who compete with imports. However, there is a risk that companies will invest less in the new UK, certainly in the short-term - and the longer-term prospects will depend on the nature of the new trade access deals that the UK can negotiate with Europe. The other side of a weaker Pound is that domestic living standards will be squeezed due to increased costs of imported goods and suppressed foreign travel. A devaluation of the Sterling most certainly negatively impacts the UK's international reputation and influence.

However, it goes without saying that the value of the Sterling can be an important shock-absorber for the UK economy. Although heightened economic and political risks put significant pressure on the Sterling, it also makes it more difficult to rebalance an economy with a structural trade deficit.

A key component of risk for our US equity exposure and for economies and markets is the ripple effects across Europe. With the majority of Europe's population holding national elections over the next year, in many cases with similar populist movements gaining support, the UK vote undermines the prospective future of holding the Euro together. Of course one has to ask the question: Does the UK vote raise the temptation for others to follow suit, or does it lead to more accommodative monetary and fiscal policies to help the peripheral countries adjust and fill the shortfall in overall demand? The bearish case for the UK's renegotiation would be that Europe takes a harder line to deter others. A more positive reaction would be to recognize the massive anti-European protest and take a more cooperative stance. We hope for the latter alternative rather than the former inflexible response.

The referendum vote that just concluded is theoretically not the end of the UK's decision on Europe. Although this may not be the focus of news commentators today, it is possible that the negative consequences of the rancorous UK break with Europe will prompt sufficient concessions to enable the UK government to make progress on border controls and a reduction in net contribution to the EU's coffers. This might be difficult to accomplish with the more hardline anti-EU conservatives. However, we are not ruling out the possibility that a broader European crisis could generate such an agreement.

Even if events move in a way that makes a "second vote" a hard strategy to initiate, the same forces might lead to an amicable deal on market access, which would dilute the negative consequences of possible exclusion from the Eurozone. This is unlikely to happen without some intervening market/economic pain, however we believe that a more rational solution will prevail.

The Brexit will induce a more stimulative policy. It is likely that the increased uncertainty, and potential negative consequences for growth, will prompt easier economic policies world-wide. Although a purely UK shock could be shrugged off by the world economy, a European-wide political and economic shock would most certainly be felt globally. Accommodative monetary policy - providing liquidity in adequate quantities at attractive costs - has stabilized financial markets in the past. However, this approach has already done most of the work in reducing the costs of debt service.

As many of you may recall, the first phase of recovery from the 2008 financial crisis involved recapitalizing the banks and implementing record low rates enabling a large amount of debt to be serviced. This served to prevent a collapse in demand. The next phase of course will be to create a source of demand. We believe this involves adopting measures not dissimilar to FDR's New Deal in the 1930s. Infrastructure spending funded by government borrowing at almost insignificant costs is already on the agendas in Canada and Japan and is central to both party platforms in the US. However, current fiscal policy in the UK and Europe is still focused on reducing deficits while hoping that other factors will support growth.

IN SUMMARY:

- The immediate impact today has so far been a 3-12% fall in global equity markets, although in Sterling terms the falls in overseas markets are less severe. Europe has been the hardest hit, with Japan also down 8%, and not helped by the reflexive buying of the yen as a "refuge".
- Whether this is the start of a major or sustained correction in markets depends on whether the ripples and the shock to confidence can be contained. How Europe handles itself will be at the center stage in the weeks to come. The US economy is relatively resilient and there are few immediate consequences from the UK's vote with the exception that the added concern that this political populism helps Mr. Trump.
- The risks of financial contagion appear manageable. The Central banks have had plenty of time to plan, as the exit camp increased in popularity over the past month. Keep in mind that most of the banking sector participants are well-capitalized in contrast to 2008 and 2011.
- Although many did not favor the "Brexit" arguments, I think it is quite possible that the post-vote mood will be less gloomy than most may feel today. Remember that half the electorate has gotten what they wanted and those who tried to deter the "Brexit" will not likely enter a long period of grieving. There will be economic costs no doubt with probably less domestic investment and some financial pressure on consumers. These negatives come with the benefit of a more competitive exchange rate. It is still not clear which will dominate the UK economy in the coming years.

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