The post-Brexit investment landscape – June 2016

In a surprise to investment markets the UK has voted to leave the European Union (EU). We have seen a fall in share markets and bond yields along with significant moves in currencies. So, where to now?

The investment lowdown post 'exit'

With the exit vote winning the day 51.9% to 48.1% the reaction has been large as markets had moved to expect a more likely 'remain' outcome over the past week.

Some points to consider:

- Under Article 50 of the EU Treaty there is a two-year negotiation period on the UK's departure. Until Article 50 is triggered the timing of the UK's exit will remain uncertain. Realistically, even if Article 50 is invoked, negotiations are likely to take much longer than two years. Adding to the uncertainty, UK Prime Minister David Cameron has resigned with a new leader set to be in place by October. The current lack of certainty and stability means that the markets are likely to remain volatile.
- The Bank of England (BoE), the UK Treasury, International Monetary Fund (IMF), National Institute of Economic and Social Research (NIESR), and private sector analysis predicted that leaving the EU would cause a downturn in the UK economy. Over two years most analysis suggests that the UK economy could contract by around 3-4% of GDP and possibly by as much as 5-7% of GDP over the medium term.
- While Brexit will likely be a significant headwind for the UK there may be a relatively small impact on the global economy, perhaps a drag of around 0.2% from global growth over the next year or so. That said, with global growth already soft the impact on market sentiment will not be a positive.
- Importantly, possible contagion to the rest of Europe could continue to erode confidence. Markets will now assume that the risks of other EU members either exiting or re-negotiating EU membership are substantially higher. That said, in contrast to the UK where the referendum was called by the ruling conservative government, other EU political parties that could favour an EU 'exit' are not in a position to call a referendum for now.

Market implications

- We have already seen the pound sterling, UK domestic orientated stocks and UK financials swing lower. Assets that usually weaken when markets are more uncertain, such as the Australian dollar (AUD), European shares (particularly in peripheral markets like Italy and Spain), Japanese shares and emerging market currencies, have also moved down.
- To date financial stocks have borne the brunt of the adjustment, particularly European bank and financial stocks across European peripheral markets. Over the week to 24 June Italian bank stocks are down around 13%, Spanish banks by around 11% while German banks are down by around 3%.
- UK banks and stocks more broadly have been somewhat better supported, possibly reflecting the large fall in pound sterling which has provided some offset to foreign earnings.
- Defensive sectors including Consumer Staples, Real Estate Investment Trusts (REITs) and, somewhat surprisingly, Commodities have held up somewhat better over the week to 24 June.
- The impact to US shares has been more muted, although a sharp and broad based strengthening of the US dollar (USD) would be a headwind to US earnings, commodities (apart from gold) and emerging markets. US bank stocks are down around 3% over the week.
- There has been a spike in the 'safe haven' assets that usually strengthen when markets are more uncertain like the Japanese yen, Swiss franc and USD and high quality bonds such as US Treasury and German bunds.

- There could be large market swings, however, the Bank of England (BoE) and a range of other central banks have drawn up contingency plans to inject liquidity. This could work to sooth markets and prevent a prolonged correction.
- While we may see large swings in the markets we expect these may eventually moderate given that central banks will step in and overall there is only likely to be a moderate impact to global growth.

Summary

Longer-term implications very much depend upon any further EU member states moving to leave. This, along with the actual exit process of the UK from the EU, may take years, not months, to play out.

The fallout from the vote to leave will keep monetary policy easy for longer across the develop economies. This will likely provide some support for share markets.

While headlines can be unsettling, it is important to remain focussed on your overall investment strategy. To discuss your own circumstances please contact your financial adviser.