MARKET COMMENTARY

June 2016

EU Referendum Result

After weeks of mounting speculation, and with investment markets being steered by sentiment driven polls, the UK electorate has voted to leave the European Union. To many this was unthinkable - city investors in particular have been shocked, with markets overreacting in the immediate aftermath.

The referendum result provides far more questions than it answers and the long term outlook is far from clear. For now, the UK is still a member of the EU and will likely remain so for at least two more years, and thus existing laws and regulations will apply.

However, this is the first time that a major member state has elected to leave the EU since the European economic bloc was established. More importantly, it opens up the prospect of contentious, multi-year negotiations. The UK must agree upon the terms of separation with its biggest trading partner, and it must form a new trading relationship with the EU and the world. The complexity and political difficulty of this task should not be underestimated.

The shorter term outlook

The consensus appears to be that uncertainty will mean lower GDP growth over the next 18 months. Some commentators have suggested than the UK may suffer a “DIY” (i.e. self inflicted) recession as a result of the referendum outcome.

Certainly businesses are likely to delay foreign investment decisions and of course some of the large banks that use London as a base for European operations are already considering moving some staff to other jurisdictions.

Last year there was much speculation as to when the Bank of England might bring to an end the period of abnormally low interest rates. It now seems likely that the Bank of England will instead look to cut interest rates. Furthermore a number of investment commentators have suggested that the uncertainty created by the referendum outcome effectively rules out any future rate rise by the Federal Reserve during 2016.

The devaluation of Sterling relative to the Eurozone would of course make UK exports relatively more attractive to Eurozone consumers. The counter side is that the fall in sterling will make imports more expensive, which will put upwards pressure on inflation.

How quickly the Bank of England would look to act to mitigate inflation is debatable in a time of economic uncertainty. What is relevant here is that after a period of low and stable inflation, it is likely that inflation will become a more significant investment issue.

The UK appears set to lose its triple A sovereign credit rating in the immediate future. (We had previously lost our AAA rating with Moody’s a few years ago, but the S&P rating remained). Whilst credit rating is theoretically important in terms of public borrowing (and the cost thereof), it is less of an issue for a country like the UK which prints its own currency. It is also worth noting that the US has already lost its triple A rating – with little apparent effect.

Finally we also have elections coming up in Spain, followed by the US in November.

The longer term outlook

In our most recent investment commentary, we said that the longer term impact of "Brexit" was far from certain. This remains the case today with many variables to be considered:

Trade:

- The UK is one of the largest economies in the world and so it seems unlikely that the remaining EU countries would no longer wish to trade with us.
- However, trade treaties will need to be renegotiated – and not just with EU countries but with other countries with whom the EU *(rather than the UK)* has the treaty in place.
- In addition, EU leaders are taking a strong line against the UK – *“Out means out.”* To an extent EU leaders have little choice if they are to avoid other countries trying to renegotiate their terms of engagement with Europe.

The European Project:

- Some commentators suggest that the referendum result may serve to act as a rallying call to disenfranchised Euro sceptics in other EU countries. Although other commentators have highlighted that few other member countries have had as fractured a relationship with Europe as the UK.

The United Kingdom:

- Whilst the scale of the wins for the “leave” campaign across the UK have been surprising, it is important to note that Northern Ireland, Scotland and London all voted clearly to "remain."

- It now seems difficult to imagine that we will not see a second Scottish Independence referendum following the narrow defeat last year. As we discussed last year, this would have implications for the UK economy.

Bank of England

In the run up to the referendum the Bank of England were clear in their view that "Brexit" represented a significant near term risk to UK financial stability. Speaking early this morning, Governor Carney explained that HM Treasury and the Bank of England have engaged in extensive contingency planning.

- The capital requirements of our largest banks are now ten times higher than before the crisis.
- Banks have raised over £130bn of capital and now have over £600bn of high quality assets
- £250billion of "Additional Liquidity" is available through normal Bank of England facilities
- The Bank of England is able to provide substantial liquidity in foreign currency if required.

Governor Carney concluded by stating, *"We will not hesitate to take any additional measures required to meet our responsibilities as the United Kingdom."*

What happens from here?

The UK remains part of the EU and subject to all existing rules, requirements, relationships & obligations. This is particularly relevant to Financial Services where much of our regulation is derived from Europe and continues to apply in full, something our regulator (FCA) has wasted no time in reminding us publically today.

However, we are entering unchartered waters and David Cameron's resignation as Prime Minister earlier can only serve to delay the point at which the UK actually sits down to formally negotiate our exit. Indeed the leaders of the leave campaign seem to be in little rush to invoke the much vaunted "article 50." All this adds to the uncertainty.

With the leader of the Labour Party, Jeremy Corbyn, coming under increasing pressure this afternoon, it may not only be the Conservative Party who are seeking a new leader. Added to the complication is Northern Ireland and in particular Scotland, both of which voted clearly for "remain," so there can be little doubt that any negotiations will need to operate on multiple levels.

Summary

We need to step back from the headlines, of which there are many and instead attempt to understand the fundamental implications of the referendum result. There is much uncertainty and considerable legal work to be undertaken but the world will continue to trade with the UK, irrespective of the referendum result.

The result certainly creates a short to medium term headwind. However, as with any change and uncertainty, there will be good opportunities for longer term investors. We continue to recommend broadly diversified investment portfolios – invested for the long term. At a strategy level this means holding equities that can exhibit defensive growth characteristics, while holding a broad range of fixed income, property and alternatives to benefit and protect from a lower growth environment and political uncertainty that will continue to dominate.

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