

SURPRISE! WE HAVE A BREXIT

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June 24, 2016

In the near term, the biggest winner from Britain's vote to exit ("Brexit") the European Union is uncertainty — not only as it relates to what this actually means for trade agreements and a host of other variables in the U.K. but also as to the consequences for the eurozone overall. Of course, as demonstrated by the reaction immediately after the announced results, uncertainty is not good for equity markets. Over the next few days, it is likely that investors will examine possible contagion with a microscope and sell anything that appears to have the potential for catching the "Brexit flu." Some will move towards quality or protection by buying the U.S. dollar, U.S. Treasuries and, perhaps, gold or similar tangible assets.

Three Scenarios

It is important to note that the disengagement process for Britain is expected to take up to two years to legally execute. In the end, required actions such as the reformation of agreements constitute another unknown that may produce results that are more favorable than anticipated. From an investment perspective, we envision three scenarios over the next 12 to 18 months:

- **Base Case** Short-term volatility recedes as investors realize that, while the Brexit creates complexity, life and trade will go on. The impacts are limited to Britain and there is little contagion. As the supporters of "remain" have said throughout this debate, the U.K. will suffer more harm than good from a Brexit after all. The world continues on its previous slow-growth track and we return to worrying about China's hard or soft landing.
- **Pessimistic Case** Brexit is indicative of a structural pushback and growing populist nationalism. New referendums occur across the E.U. The E.U. tumbles towards breaking apart. The fear factor puts additional pressure on sovereign bond yields, with rates rising substantially in the "have-not" countries, such as Spain and Italy. Uncertainty continues, markets decline further, and growth slows even more with the E.U. and the U.S. moving into recessionary territory.
- **Optimistic Case** The E.U. and others reexamine frameworks for global trade and the regulatory environment with much-needed reform, improved cooperation, and more-balanced trade. Issues of wealth inequality and stagnation of wages are in the early stages of being addressed as part of these discussions in the E.U. and the U.S. Governments and businesses recognize that monetary policy alone is insufficient to sustain economic prosperity. The global economy begins to grow more rapidly driven by improvements in food production, medicine and energy.

How Investors Can Respond

Needless to say, each of these scenarios would suggest a very different response for investors, ranging from:

- Base case – buy the declines now – to,
- Pessimistic case – seek mechanisms to increase hedges against market declines and move to quality – to,
- Optimistic case – review portfolios in the context of greater global growth and tilt towards sectors that benefit.

The challenge, however, is not to know what to do if a scenario plays out, but rather to correctly predict which scenario will actually occur. This, in our view, is not possible without a degree of foresight that we believe few, if any, possess. Many will tell us with great certainty what they believe will occur and, in 12 to 18 months, the correct predictors (many of whom will simply be lucky) will be proclaimed prescient, those who are wrong will explain that they were early, but will be correct eventually, and most predictions will simply be forgotten as we move onto the next crisis to be forecast.

In our view, times of crisis are opportunities for investors to reengage in three important tasks:

- First, review your long-term goals and objectives and, most importantly, your appetite for downside risk. Stock markets go up and down, often with great rapidity. Is your target asset allocation consistent with your ability to withstand that volatility?
- Second, most investors employ some form of rebalancing technique but often are lax in implementation, particularly during periods of general market increases such as what we have experienced since the market declines of 2008 and 2009. If your asset allocation is sound relative to your risk tolerance, rebalancing regimens should be enforced rigorously.
- Third, during so-called “risk-on” periods (when investors are stretching for returns due to a general sense that losses are unlikely), investors often migrate towards portfolios with less obvious market-based exposures. Low-quality high yield assets, for example, may react much more like stocks than fixed income in times of stress. This is a good time to consider and assess the degree of diversification across your investments to assure that your program has not taken on unintended risks. It is possible that you should reemphasize asset classes that provide protection from equity declines, including some of the real assets. While diversification works variably over time and seems to work less well in times of stress, there is still long-term value to thinking globally and to recognizing that putting all of the eggs in a single equity basket does create volatility in the short term.

To Conclude

There will always be surprises in the macroeconomic environment that impact capital markets. We believe that there are mechanisms that can serve to limit how these affect investors. Planning and preparation are the two most important. Patience is also often a virtue.