Comments on Brexit vote

Millennium banque privée

Comments on the "Brexit" referendum and market reaction

In last Friday's referendum on UK membership of the European Union (EU) about 52% of UK voters opted to reject the status quo and leave the EU. The final result came as a surprise as the "Remain" camp had recovered some ground after the tragic murder of a Labour MP and according to the latest opinion polls was slightly ahead of the "Leave" camp. However, the number of undecided voters was still relatively large meaning that the referendum was too close to call.

The subsequent market reaction was dramatic with price moves not seen since the Lehman Brothers bankruptcy in September 2008. European equities plummeted more than 7% and the British pound tumbled to 1980s levels. Investors sought refuge in safe havens such as gold, German Bunds and US Treasuries with yields posting significant declines in the day (10-year Bund yield declined 14bps and the yield on 10-year treasuries dropped 19bps). The euro also come under pressure, declining 2.7% against the US dollar.

In our view, this is not another "Lehman moment"

The "Leave" vote changed the central-case scenario where investors were basing their investment decisions by adding a significant dose of uncertainty on the possible economic outcomes. It is impossible to assess the full consequences of this decision to leave the EU, but it is not unreasonable to expect a negative impact on the economy due to the postponement of certain investment and consumption decisions. The UK economy will likely bear the brunt of the direct effects of Brexit, with investment spending in the UK likely to take a major hit due to uncertainty. In our view, a modest recession in the UK seems increasingly likely. As a result, we should expect volatility to remain elevated in the coming weeks, but we do not see this event as a second "Lehman moment".

The economic damage will likely be contained

The UK economy was already going through a period of low corporate investment ahead of the "Brexit" referendum and the complexity of this event will likely prolong that period. Uncertainty will affect investment decisions from domestic players but will also have a negative impact in foreign direct investment. If we take into account the higher costs of trading for the UK economy, it is reasonable to expect a few percentage points negative long-term impact on U.K. potential GDP. Elsewhere, the impact is likely to be felt in Europe given the important trade links with the UK. According to the comments of one Federal Reserve Bank official, "Brexit" will only have moderate direct effects on the U.S. economy in the near term.

What have we done before the referendum

The uncertainty regarding the result of the referendum and the probability of a medium-term damage to the UK economy in case of a "Leave" vote, led us to reduce the allocation to UK equities, initially to an underweight

position, and later to zero that exposure in the two more conservative risk models. More recently, we reduced the allocation to Eurozone equities and added a Gold Mining fund as a hedge as we expected that gold would reacted positively in case of a "Leave vote".

Impact of the market turmoil in Clients' portfolios

Discretionary Management portfolios are highly diversified and some allocations compensated the negative impact from equities. Portfolios benefited from their allocation to European government debt, US Aggregate, long equity volatility strategies and the Gold Mining sector. Euro-denominated portfolios also benefitted from their exposure to the US dollar.

What have we done after the referendum

Given that the UK voters chose a bumpy road, and the likelihood of a UK recession is now above 50%, we decided to zero the exposure to UK equities across all models. We are constantly monitoring the evolution of markets and closely following the evolution of the political situation in the UK and Europe. We cannot exclude a further reduction in the exposure to equities.

From IAS Team

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