

HEALTH WEALTH CAREER

MERCER VIEW ON BRITISH EXIT FROM EUROPE

JUNE 27, 2016

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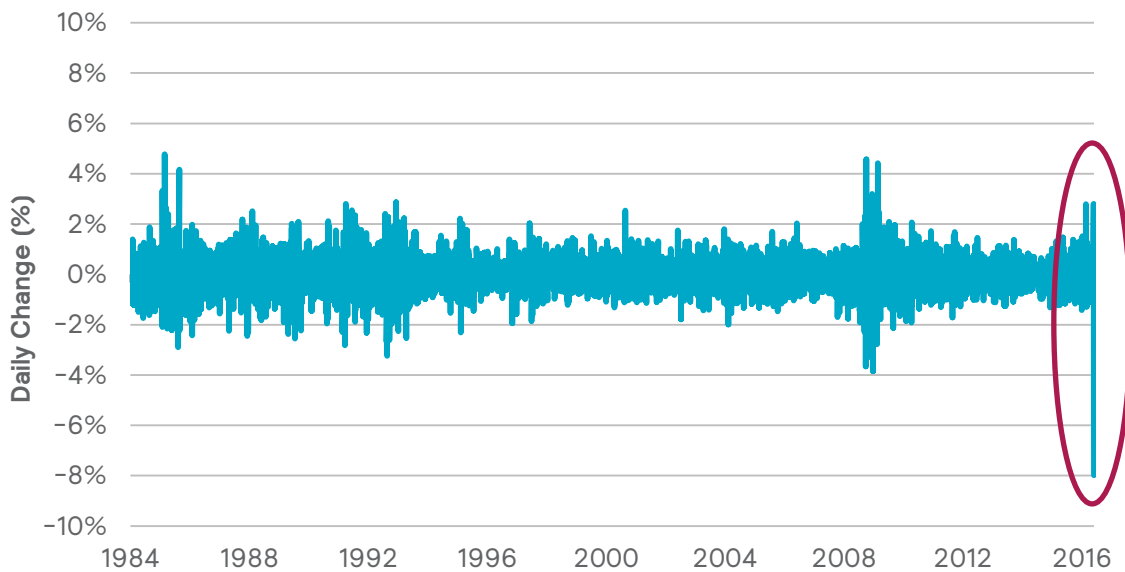
WHAT HAS HAPPENED?

The UK's referendum on its membership of the European Union was held on 23 June 2016 with the result yielding a surprise victory for the "leave" campaign, with 52% in favour of exiting the EU compared to 48% who voted to remain. Analysis of voting showed marked differences of opinions across regions, with England (excluding London) and Wales voting for Brexit whilst London, Northern Ireland and Scotland opted to remain. The shock result of the referendum has since set off a wave of important economic and political events, including the resignation of David Cameron as prime minister (with his successor expected to take office in October 2016), increasing speculation over a second Scottish referendum over independence, suggestions from credit rating agencies of a likely downgrade of the UK's AAA credit rating and a deepening political crisis in the UK marred by significant turnover within both the ruling and opposition parties. Somewhat ironically, the UK is also due to hold the Presidency of the Council of the European Union (a six-monthly rotating position) from July 2017, which will be complicated by the "out" vote.

The initial reaction in financial markets reflected investor concerns over the significantly increased level of political and economic uncertainty, with currency markets bearing the brunt of the volatility. On the day of the results being made known, Sterling fell by 8% to 1.36 against the US Dollar, the lowest level in more than 30 years, and fell by 6% to 1.23 against the Euro, the lowest level in over two years. The fall in Sterling against the Dollar was the largest one day move, by far, on record as seen on the below chart.

Daily Change in USD*GBP

(31 Jan 1984 - 24 June 2016)

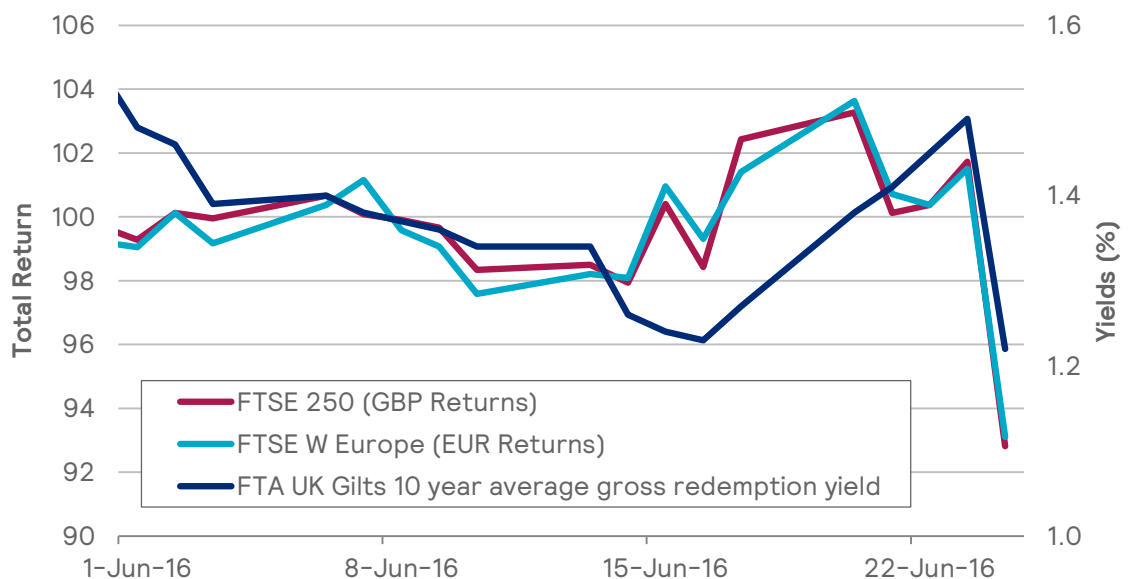


Source: Bloomberg; Thomson Reuters Datastream

Domestic UK and European equity markets also suffered large losses with the FTSE 250 and FTSE World Europe Index both posting negative returns of 7% in Sterling and Euro terms respectively over the first day of trading post-result. In the “risk-off” trading environment, safe haven demand led to a fall in the region’s government bond yields to new lows, with 10 year UK government bond yields decreasing by c.28 basis points, the largest one day move since the financial crisis, to 1.02% and 10 year German bund yields going deeper into negative territory to reach -0.17%. Gold, often seen as a store of value amidst market turbulence, outperformed risk asset classes, increasing by 4% in US Dollar terms¹. Meanwhile the ratings agency Standard & Poor’s downgraded the United Kingdom’s credit rating to “AA” from “AAA”, with a “negative” outlook.

Market Movements

(01 June 2016 - 24 June 2016)



Source: Bloomberg; Thomson Reuters Datastream

The key questions have since turned to when and how the UK will exit the EU. The formal procedure begins when the UK government officially notifies the European Council of its intention to leave the EU. This triggers Article 50 of the Lisbon Treaty, which provides for the exiting country and the European Council to negotiate the terms on which exit will take place. The UK will then have two years to negotiate an exit package before its membership will cease (unless the negotiating parties agree unanimously to extend the process).

In practice, it is expected that the UK government will be in no rush to exercise Article 50 (and to commit to the two year deadline) given the complications of unwinding more than 40 years of collective arrangements and deciding terms of separation; though noting that too much of a delay would lead to a build-up of external pressure from other EU governments and domestic voters. In addition, separate trading relationships inside (and outside) the EU bloc would need to be agreed, which may prove problematic as broad trade deals will need unanimity and ratification by national parliaments within the EU.

¹ All figures sourced from Bloomberg and Thomson Reuters Datastream.

IMPLICATIONS FOR INVESTORS

A number of uncertainties remain, not least the terms of the package that the UK is able to negotiate from the EU, bearing in mind the desire by the EU to deter other members from exiting and the difficulty for member states to agree a common approach to apply to the UK. While it is difficult to forecast with any certainty how these political events will develop and what the implications may be, we foresee the following on a one to three year outlook:

- A tough negotiating stance by the EU (the UK's largest trading partner) and / or the prospect of a long, drawn out exit process will likely hamper investment activity and fuel further capital outflows out of the UK, hurting the growth prospects for the UK economy in the process.
- In a more pessimistic scenario, the uncertain political landscape may mean a sharp reduction in company capital expenditure levels, a tightening of bank lending conditions and a plunge in consumer confidence; the combination of which will act to stifle the UK economy to the extent that there is a painful recession.
- The risk would then be that both the political and economic negativity seen in the UK could extend to other European countries, and irretrievably dent the European project. This could be a trigger of a global recession.
- Financial market volatility is likely to continue especially in the currency markets. Any unfavourable political developments may pose further downside risk for Sterling, and potentially the Euro as well.
- Central bank policy across the world is expected to remain ultra-accommodative in a bid to further stabilize and support the global economy which has thus far seen only a tepid recovery. Rhetoric thus far has focused on reassurances that central banks will act in a coordinated manner to provide liquidity to market participants as required.

WHAT SHOULD INVESTORS DO?

While many uncertainties remain, we believe there are a number of areas that investors could consider to better position their investment portfolios in light of an expected increase in market volatility, as follows:

- **Review currency hedging arrangements.** Thus far, the market effect of Britain's decision has been most marked in currency markets. The depreciation of Sterling has been significant and the risk of further devaluation remains. Investors should consider reviewing current hedging arrangements to ensure that they remain appropriate within the context of the overall investment strategy and in line with an investor's specific risk tolerances and preferences;
- **Review investment governance arrangements.** A period of heightened volatility within financial markets creates possible opportunities for dynamic asset allocation decisions to add value. However, success in dynamic asset allocation is more likely within a structured framework and a robust decision making framework needs to be in place for an investor to be able to appropriately capitalise on market volatility. This framework should cover all key aspects of the investment decision making process, including delegation of responsibility and implementation; and should be well documented;
- **Review transition plans and rebalancing arrangements.** Clients who are planning transitions of assets might wish to consider whether current market volatility may be cause for them to delay their transitions. We recommend that clients in this position discuss this with their appointed consultant. We also note that our central house view is that regular rebalancing of assets can enhance returns, and we recommend timely rebalancing back to strategic weights, as determined by investment policy, when market conditions permit;

Looking to the longer term, the vote to leave the EU and the political and economic ramifications of this are likely to be significant. At this juncture, we are not recommending any significant changes to our asset allocation advice as a result of the recent market turmoil. However, we will continue to monitor any related developments closely and will review our recommendations to our clients as part of our regular dynamic asset allocation process over the next few weeks.

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