June 2016

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BREXIT: WHERE TO NOW FOR MARKETS?

Financial markets can act irrationally at times, but generally they do think rationally and expect rational outcomes. As events of the past few years have made clear, this makes them vulnerable to events such as elections, which don't always follow the expected, rational path. The UK referendum on the EU, which was highly emotionally charged and decided as much by the heart as by the head, is the most recent example. As a result, markets largely misread the situation and did not price in Brexit as a realistic outcome. So what now? Although it is still too early to determine the full implications of Brexit over the longer term, there are medium-term risks for investors to consider. In the short term, we can expect significant market volatility as uncertainty prevails, but this does not mean that investors should panic.

One of the greatest risks is contagion within the EU

In the short term, Brexit will most likely be negative for the UK. Financial markets don't like uncertainty and this will create considerable volatility over the coming weeks and months. However, a lower currency should assist competitiveness and may help to offset a potential decline in domestic demand.

With both of the major UK parties in disarray, the vote has reignited old political tensions, as highlighted by the revolt of senior members of the Labour party against their leader Jeremy Corbyn. Most EU politicians are calling for a swift Brexit, but given that the Conservative party has yet to elect a new leader to trigger Article 50 of the Lisbon Treaty, it is unlikely that the British will oblige. In addition, the UK will not want to be put in a similar position to Greece and have terms dictated to it.

Although it is widely expected that the EU may impose harsh terms on the UK to make an example of it for leaving and so discourage others, this may just inflame tensions and potentially negative sentiment towards the EU from other member countries. As German Chancellor Angela Merkel has said, the EU may be well advised not to draw "quick and simple conclusions" that could create further and deeper divisions.

It is easy to understand why the EU would favour a swift exit. The UK vote points a spotlight on a lot of pre-existing issues in the EU, where the past couple of years have seen a rise in the success of right-wing, anti-European populist parties throughout the region. They started to gain traction with the Euro crisis in 2011-2012, but the migrant crisis of the past couple of years has added further impetus. Hungary is due to vote later this year over whether the EU has the right to resettle refugees in the country without its own Parliament's consent. Even in France, support for the EU is starting to wane, with a pan-European survey by the Pew Research Center finding that 61% of French voters have an "unfavourable" view of the EU vs. 48% in the UK ("Euroskepticism Beyond Brexit", 7 June).

The Polish Ministry of Foreign Affairs summed up the situation in a media release on 24 June: "…the voice of the British people should send a warning signal and mobilize us to take further action. The disillusionment with European integration and declining trust in the EU can be observed in some member states and is something we must counteract by bringing the Union closer to the citizens."

What is required to support the common currency and the Euro project is greater integration around fiscal payments and the banking system. In our view, lack of integration in these areas weakens the fabric of the Euro. One positive outcome of Brexit would be if it were to lead to a desire for greater fiscal integration within Europe. However, we believe that is unlikely since it is still not viewed positively by many nations, apart from the fact that it is a significantly less attractive proposition for Europe's richer nations, such as Germany. Currently, the European Central Bank (ECB) is keeping the system together, but questions around the viability of the Euro project, which were common during the Greek crisis, could re-emerge.

Brexit likely to continue to have 'flight to safety' impact on US dollar and Yen

The UK is the fifth-largest economy in the world and so we must expect that while uncertainty continues, markets will continue to be volatile, with a 'flight to safety' tendency. With a weaker British pound, we expect a stronger US dollar, which may lead again to weaker commodity prices and negative implications for many Emerging Markets. In addition, we expect a more dovish US Federal Reserve (Fed), with the first rate rise now unlikely to be before December. The US stock market has been buoyed by a weaker US dollar since the Fed reversed some of its hawkish rhetoric, so a stronger US dollar could potentially be harmful for US stocks and the wider economy. A stronger US dollar could also put the focus back on the Yuan and China, which markets have largely ignored since the US dollar started depreciating.

Following Brexit, the Yen has fallen to around 100 against the US dollar, which reduces the effectiveness of one of the three arrows of Abenomics. The Yen has been drifting higher over the past few months, following the US dollar's depreciation and the Bank of Japan (BoJ) initiating its negative interest rate policy. This trend has been reinforced by the risk-off situation

triggered by Brexit. Although the BoJ did not lower interest rates any further in June prior to the UK referendum, we expect that it will act at its next meeting in an attempt to combat Yen appreciation.

Conclusion: As always, one of the cardinal rules of investing is not to panic

Risk markets don't like uncertainty and the Brexit vote has unleashed a wave of uncertainty on markets, including raising questions which haven't been asked since the Euro crisis of 2011-12. The longer the uncertainty persists, the worse it could become. Although a quick resolution may be desirable, it is unlikely. Despite current volatility, we should remember that investing in currency and bond markets is a long-term game. We cannot predict when the volatility will end, but panic-selling usually leads to investors missing out on any subsequent relief rallies.

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