LISI Market Comment

Brexit Effects

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With an historic 72% turnout, the UK populace unexpectedly voted 52% to 48% to leave the European Union. This result sets in motion a two-plus year process toward separation that introduces immediate uncertainties into markets viewed on screens today as a sea of red across almost all but the most safe-haven assets. Observers fall mainly into two distinct camps on Brexit effects: 1) This is a UK issue that will have limited detrimental effects outside the UK after the initial market shock, or 2) The risk of political and economic contagion sets up the potential for wider ranging impacts that could linger for years.

We are in the latter camp. In our view, the vote reflects a growing backlash against political and economic elites led by nationalist demagogues wielding anti-establishment and anti-immigration rhetoric. The pitchforks are on the move. We may be witnessing the early stages of a generational turn toward insularity and domestic focus that could retrace progress in international trade, investment and migration. The "Grexit" scare, intense as it was a year ago, pales in comparison.

The Vote is Done. What Next?

A member country can exit under EU Treaty Article 50: the UK will start initial discussions with Brussels, after which the Prime Minister sends a formal letter activating the provisions of Article 50. That begins a two-year period in which negotiations continue. If at the end of two years an exit deal is agreed the UK exits. If there is no agreement but either party is unwilling to continue the UK exits. Negotiations can be extended, but only with unanimous support of EU members. At any point during this process the UK could decide to run a new referendum, which could occur if a sharp economic downturn ensues.

Potential Economic Effects

Two avenues of disruption are likely to put downward pressure on growth, trade, foreign direct investment, and migration, not only in the UK but also likely across other EU countries.

First, the tangible effects of renegotiating trade and investment rules can muck up the wheels of commerce, and both trade barriers and tighter immigration rules can further limit economic progress. This reversal will cause the UK difficulty, for example, in the financial sector where the "City of London" has unfettered access to continental markets, and in the automotive sector, which exports mainly to the EU (not to mention the potential departure of Japanese auto makers that have set up factories in the UK to serve continental Europe). There are certainly examples of non-EU trading partners that have worked out these issues over time, notably Switzerland and Norway, and it will remain to be seen how the EU-UK negotiations develop.

Second, the intangible effects of uncertainty can depress the "animal spirits" that underlie consumer confidence, business investment, and hiring. Executives cancel or delay new projects that might otherwise proceed. Households decide to wait on new appliance or auto purchases. Vacations get postponed. Because of the multiplier effects of consumption these micro decisions result in macro pressures and these are likely to be felt both by the UK and by its principal trade counterparties.

Brexit represents a problem for the EU as much as for the UK, even though the EU may experience a lesser shock given its greater size. Bear in mind a few statistics. The UK is the second largest net contributor to the EU budget (16%) after Germany. It receives about 13% of Eurozone exports (about 3% of EU GDP). The largest exporters to the UK include Belgium (8%), the Netherlands (7%), Ireland (7%), and Germany (3%), which, if adversely affected, would have lower capacity to import from their other neighboring trade partners. Eastern European countries that supply labor to the UK will likely have higher unemployment and lower remittances. The multi-decade process of globalization has introduced myriad feedback loops such that the UK is not alone. Even China has to worry about its 16% exposure in exports to the EU.

Potential for Political Contagion

The possibility of political contagion is real, and could involve national independence movements such as those simmering in Scotland and Catalonia. Other EU countries have burgeoning anti-trade, anti-immigration political parties whose standing may improve after the UK vote. There is a national election in Spain this Sunday (after an inconclusive vote in December). Italy will vote on constitutional reform in October. The Netherlands will conduct a general election in early 2017, France in the second quarter, and Germany later in the year. Meanwhile, the European refugee crisis continues, which stokes the fires of anti-immigrant movements. The outcomes of these upcoming votes could develop momentum toward an eventual disintegration of the EU, or at least a kind of rollback in globalization.

Market Effects and Portfolio Strategy

The immediate market response today has been flight to safety. Any Fed rate hike in 2016 has become more unlikely after this event, meaning that rates are likely to stay near historic lows. Seesawing US economic data on employment and inflation are likely to become moot as the Fed continues to fret over how to introduce higher rates before some exogenous shock ends the US economic expansion, now over seven years old.

The LISI Investment Committee met yesterday to discuss markets under Brexit/no-Brexit scenarios and concluded that, in either case, the biggest risk now faced by US-focused portfolios (and by extension, those with indirect exposure to US GDP growth) is the end of that long, if shallow, US economic expansion. Broadly, the Committee's view points toward staying invested in equities with a preference for large caps that may be more resilient in a downturn, and asserting a defensive strategy in fixed income favoring improved credit quality over duration. We also favor keeping allocations to alternative assets; in times like these the attractiveness of non-correlated asset classes like alternatives becomes apparent.

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