FIRST EAGLE
INVESTMENT MANAGEMENT

# First Eagle Insights | After Brexit

**Commentary**
As of June 24, 2016

The investment markets have seen a lot of turbulence in the last 24 hours. If there ever was an event that established the futility of crystal ball prognostication, it was Brexit. The polls, the betting markets, the leading financial pundits and the world markets themselves all suggested that the UK would vote to remain in the EU, yet it did not. We've been speaking for some time about the sluggish nominal growth and the highly levered global environment that have led to less predictable geopolitical forces and more political populism. And these forces really asserted themselves in the past 24 hours.

We would describe what we saw today as more of a surprised environment than a truly distressed one. Market risk perception is certainly up, but it is not extreme. The VIX index of implied volatility has risen to slightly over 20%. This is a little above average but well below the 40%+ implied volatility that we see in real market crises. The S&P 500 Index was down 3.6% today, but it is still within 5% of its all-time high. The Barclays High Yield Index was soft, but it edged down less than 2%. And while gold was strong, it's still well below its highs of a few years ago.

It will take some time for us to get a clear read on the long-term impact of Brexit. David Cameron, the UK prime minister, has resigned, but we won't know his successor for some time. In fact, it's likely to be a few months before his successor is appointed. Candidates for his position are quite different in character, and the choice the Conservative Party makes will no doubt have a bearing on the UK's negotiating posture as it withdraws from the EU. This process is likely to take a couple of years. The key area of focus here will be the UK's access to the single EU market, as this represents nearly half of UK exports. The EU heads of state are not meeting until next Tuesday, so we won't have a preliminary read on their intent until then.

We simply don't know if the UK will negotiate a position close to what it already has, along the lines of Norway, for example, which maintains full access to the single market in exchange for labor mobility, fiscal transfers, and willingness to accept most EU legislative directives. It's also uncertain whether Germany and France will want to make the divorce painful enough to dissuade other EU members from considering this path forward. In the short-term, this uncertainty is likely to weigh heavily on the UK's economic performance. Longer-term, the combination of a weak currency and perhaps a more flexible legal and regulatory regime could be a positive for the supply-side of the UK economy, but we'll simply have to wait to see how policies unfold.

The UK itself is small in a global context, so the question of contagion is actually more important. On this score, we will be closely monitoring developments in the European banking sector, credit spreads for high yield issuers in Europe, and spreads for the peripheral sovereign issuers. There are also political developments that we'll have to keep an eye on. There are elections this weekend in Spain, an Italian constitutional referendum in October, and then we'll be looking at what the polling trends are for euro-skeptic politicians like Le Pen in France. Then there are French and German elections scheduled for next year. There's also the potential for renewed talk of a Scottish referendum on independence.

There are many paths that both markets and the political economy can go down, given the propensity of central banks to rush to the rescue whenever a danger seems to lurk. Central banks have already stated their willingness to provide liquidity if required. Futures markets now predict that a rate hike in the US is all but off the table this year. Having said that, the ammunition that central banks of the world have is somewhat more limited today, unless they choose to engage in increasingly unconventional policy, which could actually add to expectational uncertainty at some point.

## Impact on Our Portfolios

Not surprisingly, our portfolios did not emerge unscathed today, but overall they proved to be resilient in the face of the downdraft. Property and construction companies in Europe weakened, and export-oriented Japanese companies were hurt by the dramatic appreciation of the yen. Some of the most pronounced weakness in markets was in sectors we've avoided, like the European banks. We've seen no reason to rush in there, despite the statistical cheapness of such securities. In the US, stocks that are economically sensitive declined, but we saw these as temporary rather than permanent impairments of capital. A number of the more defensive names in the portfolio held up relatively well in the market turmoil. Our potential hedge in gold has also served us well. Gold has rallied sharply in the last 24 hours, and, generally, gold-mining shares have, as well. We made no dramatic shifts in our asset allocation but selectively took advantage of the market dislocation to add modestly to some positions.

Our foreign exchange hedges were largely unchanged. The euro and pound weakened, but we believed the undervaluation was modest enough to warrant no changes. In the UK, we maintained our hedges on companies that operate in the domestic market, but we have not hedged our positions in UK-based multinationals, which have generally weathered the storm relatively well.

The crystal ball remains foggy at best, not just for us, but for all market pundits. The complex global backdrop makes specificity in forecasting even more difficult than usual. We believe our portfolio construction has positioned us well for potential resilience in this environment and has also positioned us to take advantage selectively of market dislocation, which we intend to do. So we're sailing a steady course, with no need to change direction.