What does the UK's vote to leave the EU mean for investors?

24 June 2016

UK votes to leave – what next?

The situation is **unprecedented**:

There is no verified or tested procedure for EU exit

This means it is **uncertain** what happens next, but it is **plausible** that:

- **Article 50** of the EU constitution – the law governing the process of the UK's divorce from the EU – will be triggered
- This will kick-start the formal **two-year process** determining the terms of the UK's EU exit, including the shape of its future access to the Single Market
- There will be significant **pressure on Prime Minister** David Cameron to resign

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Economic impact - UK

Like the Bank of England,* we think that the leave vote will probably have a **negative short term impact** on UK economic growth, because of:

1. Increased uncertainty and reduced confidence depressing private consumption and fixed investment
2. Increased risk premia in UK bond markets and potentially higher borrowing costs
3. Increased uncertainty, risk aversion, and possibly higher funding costs in the UK financial sector

Note: a weaker pound is likely to support exports and the Bank of England may cut interest rates, mitigating the overall adverse impact

* http://www.bankofengland.co.uk/publications/minutes/Documents/mpc/pdf/2016/jun.pdf

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Market impact - UK

In the short run, investors can expect:

- Shock to investor confidence and increased UK asset price **volatility**
- **Further declines in the pound,** adding to the 5% depreciation versus the euro YTD
- **Downward pressure on UK equities**, especially financial sector stocks and those most reliant on EU migrants (e.g. construction, hospitality sectors). Less pressure on UK companies with large FX earnings
- **Modest upward pressure on Gilt yields** is possible owing to increased uncertainty, higher risk premia and the prospect of higher inflation due to the weaker pound (although initially yields could fall due to a flight to safety)
- **Upward pressure on UK corporate bond yields** owing to increased uncertainty and the worsening short term growth outlook – as with equities, the financial sector is most exposed
- **Modest declines in UK house prices** are possible, owing to reduced buyer confidence and a possible uptick in unemployment

Impact on Europe

Modest direct economic impact:

- European companies with significant UK exposure and assets may cut back on investment until uncertainty about the UK's future EU engagement eases
- Uncertainty may also have some negative impact on EU trade with the UK
- If the adverse economic impact looked significant, the ECB would likely expand its asset purchases, reducing the risk of a worse-than-expected economic outturn

But some impact on European markets:

- Short term pressure on equities, especially for European companies with significant UK revenue, trade and investment exposure, and particularly so if the euro rises
- In bond markets, perceived safe-haven yields may compress while corporate bond yields and spreads may increase; as with equities, the financial sector is most exposed
- In the longer run, the UK leave vote could bolster other euro-sceptic movements, raising concerns about the wider EU project; this would be most negative for peripheral country assets

Managing volatility

From time to time, equity markets experience heightened, event-related volatility

In such times, it can be helpful to keep in mind:

- Volatility is a normal part of long-term investing
- Avoid being swayed by sweeping sentiment
- Long-term investors are usually rewarded for taking equity risk
- Market corrections can create attractive opportunities
- Active investment can help navigation in periods of increased volatility

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Investment team comments

"We believe the impact of the UK's leave vote will primarily be seen on UK assets, with sterling and UK equities selling off, and UK gilts likely to rally (at least initially) as investors seek out safe havens. Globally diversified portfolios that invest across different asset classes, regions and sectors, should be well positioned to take advantage of resulting volatility."

Eugene Philalithis, Portfolio Manager, Fidelity Solutions

"I have been paring down risk in the last few months, especially in sectors/names we deemed to be most sensitive to Brexit, but still as a high-beta asset class, we can expect some headwinds to persist in the short run."

Andrei Gorodilov, Portfolio Manager, European Fixed Income

"We have been doing extensive analysis of the potential impact of the UK's EU referendum in the months leading up to the vote. It is our view that the leave vote may not move markets to the extent that some have been expecting. Despite the fact that the probabilities of remain were consistently higher, the market, perhaps wisely in retrospect, always appeared to be more driven by the potential impact of a vote to leave. The result of this was weakness in sterling on a trade weighted basis and underperformance of domestic companies in the UK relative to international companies. This means that a certain amount of concern and anxiety about the vote to leave has already been priced in.

So in brief, while the leave vote entails further downside potential, we certainly do not expect a Doomsday scenario and sharp declines should increase investment opportunities."

Paras Anand, Head of European Equities

Investment team comments

"The leave vote will create short term headwinds as markets deal with increased uncertainty. Inevitably however, the increased volatility should open up potential opportunities to benefit tactically through buying of those credits deemed sufficiently well capitalised and managed and which should be able to best withstand the uncertainty created by the exit vote."

David Simner, Portfolio Manager, European Fixed Income

"The leave vote makes it likely the pound will fall further. UK commercial real estate values could weaken on a relative basis, but it is important to remember that property is a real asset and any fallout should be modest compared to higher frequency financial asset markets."

Matt Richardson, Director of Research, European Real Estate

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