Harbour Navigator

Brexit

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Brexit has shocked capital markets - markets had not been positioned for a British vote to leave the European Union (EU). While risk assets have been sold off we expect volatility to continue in the near term.

The potential Brexit process:

A full technical separation of Britain from the EU may actually take some time (years rather than months). There is potential for a Brexit 'lite' setting to emerge with Britain remaining a member of the common market, with signs that EU policy makers are seeking a quick, clean 'lite' separation. Britain leaving the EU will cause significant disruption for the UK economy and test London as a financial centre.

Geopolitical implications:

Over the weekend Spanish election results delivered a slim majority to the left parties. Both the Brexit and Spanish results can be seen as a progression towards more populist politics, which has been developing ever since the GFC fallout affected the broader community, while at the same time financial wealth grew. The theme of wealth distribution is working hand-in-hand with resentment towards immigration and as yet a political solution has not been found.

In Europe, there are many different contagion scenarios. At this stage the risk of other countries leaving the EU looks still looks slim, but clearly the risks are not static. We see the most likely developments being increased concern around trade policy changes from populist governments under pressure to do something.

Investment Implications:

The largest reaction to the Brexit vote has been in the foreign exchange markets, where the British Pound (GBP) has fallen to its lowest level since 1985. This reflects that Brexit is first and foremost a British political crisis, and a sharp depreciation in the GBP is the best way to help the UK economy through the economic adjustment.

For broader global capital markets, increased uncertainty means global trade and economic growth forecasts will need to be trimmed. Similar to the post 'Grexit' market uncertainty the cost of capital for some asset classes will increase, particularly some more marginal credit issuers. And market liquidity may dry up for some asset classes, meaning price volatility may increase. As there is very little scope to provide policy support via monetary policy, pressure will build for other forms of stimulus. This will be a challenge for those countries that are already in a difficult fiscal position.

In the lead up to the EU referendum we needed to ask some key questions. Has the market priced in the potential range of outcomes? Has it over/under stated the risk? Our analysis suggested that while capital markets had allowed for some degree of Brexit, with bond yields falling to recent low levels and equity markets softening, a full Brexit and potential EU contagion event had not been priced in. While we remained relatively fully invested through the Brexit period we kept liquidity available to take advantage of investor overreaction.

Markets may have over-reacted in the near term, and some asset classes may be oversold. But there is a significant amount of uncertainty to work through, and a recovery may be hesitant.

We have and will make selective investments after careful analysis.

Markets face a number of known events currently, for example, changes to US federal monetary policy and US federal elections, which may have a range of impacts on asset class returns. Arguably markets always face known events, but the current crop of events seem to be influencing investor confidence more than usual**.** Referendums, elections, geopolitics and central bank policies all increase investor uncertainty. They often contribute to investors 'doing nothing' but they can lead to investors making short term investment decisions that are inconsistent with long term objectives. As Citibank highlighted in a recent report 'it is challenging to consider a period when doubt did not loom and clarity was evident – think Grexit fears, financial crises in the US, periphery Europe and Asia over the years, the Cold War, Japan's lost decades, etc'. Uncertainty and limited visibility have been a factor in all of these events. New technology which allows information to be shared everywhere, all the time, with everybody may not be reducing uncertainty.

At Harbour Asset Management we consider potential event scenarios in advance and make changes where appropriate. But we mostly focus on longer term structural trends, and recognise that while events may increase near term volatility, they may not change underlying trends. We find fundamental data regularly beats near term uncertainty.

Near term we continue to expect a subdued capital markets backdrop of low economic growth, low inflation rates and low interest rates. We also expect capital flows from ultra-low monetary policy economies will continue to support local market returns. Our focus remains on companies that have internally generated growth, and investments that generate sustainable (and growing) income.

Harbour Asset Management
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