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Investment Insight

Focus on Brexit

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"The important thing is not to predict what will happen but understand the consequences of what could unfold."

"Over the past year we have been highlighting a rise in volatility which has started to fracture the uneasy peace in financial markets. That peace was manufactured by central banks and it rests uneasily on the foundation of ultra-accommodative monetary policy. In other words, policy rather than economics has been the main driver of market behaviour."

These were our opening words to our July 2015 'Scenario insights and portfolio positioning' document and they remain equally applicable today. Then we listed a potential Grexit as a vulnerability; today we are seeing the more serious Brexit scenario start to play out. As we said one year ago, these events again remind us of three things:

- ultimately underlying economic fundamentals will drive asset prices
- policy makers are not infallible, and
- policy flexibility faces constraints in the face of a major shock.

Unfortunately we are now facing a negative shock to economic fundamentals; this will reverberate across Europe and impact global confidence and growth. Hopefully this British vote will not be prophetic, that it will not be a catalyst for other risk scenarios. Yet the worry is that this could be.

Key lessons from Brexit

It has been observed that we are now living in a 'post-factual democracy' where facts are unable to counter myths and emotionalism. Michael Gove (leading Tory Brexit campaigner) said, 'The British people are sick of experts' - but anti-intellectualism and populist politicians are a potentially toxic combination.

The rise of anti-establishment politics is seen in the US as much as Europe. The underlying source of discontent is that workers have progressively lost ground (for most workers in the US real wages have been static for decades), while those seen as responsible for the financial crisis have not only escaped punishment, but have prospered. We can hope that what we have seen in the UK will not be repeated in the form of the rise to power of polarising politicians.

A lesson from the UK is not to underestimate the frustration of those left behind economically, particularly when united by a common foe. Fear of losing out further due to uncontrolled immigration galvanised the Brexit campaign. The French have much to answer for the years of chaos at Calais, as does Angela Merkel, the German Chancellor , for her well-intentioned but ill-thought out invitation to the refugees. We must take seriously the unwillingness of voters to defer to logic and their desire to force change (apparently) even if that involves personal cost.

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The repercussions of Brexit

Perhaps the most serious repercussions lie in Europe itself. For the same reasons as in the UK, euro-scepticism is well entrenched in Europe. Around one third of European parliament members represent euro-sceptic parties. The Brexit vote may have set off a chain reaction which could ultimately lead to the unravelling of a united Europe. Legendary investor George Soros commented this weekend: “Now the catastrophic scenario that many feared has materialised, making the disintegration of the European Union (EU) practically irreversible”.

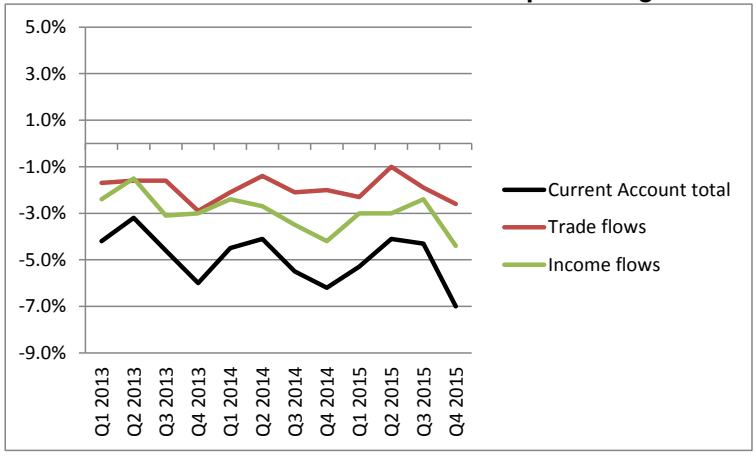
Europe’s failure to adequately deal with the refugee crisis has fostered the rise of extremist anti-immigration, anti-Europe parties. At least five other countries are at risk of leaving the EU including Italy, the Netherlands and Austria. While the euro-sceptic parties are not in a position to force a vote, but as in the UK, incumbent parties may agree to a vote if that shores up their positions in the short term. France faces an election in a year’s time, far right leader Marine Le Pen is already applying pressure for a referendum. Politics in Italy is again in turmoil where the Five Star Movement’s rise is emblematic of the disconnect between people and politics that appears pervasive in the developed world.

Meanwhile, at the epicentre of change, a victorious Boris Johnson left home on Friday to be greeted with shouts of ‘scum’. The UK is divided along regional and demographic as well as socio-economic lines. For young people, who were strongly in favour of remaining, the outcome has led to an increased feeling of disenfranchisement, fearing they have lost the right to live and work in 27 countries. They also now face bleaker job prospects. On-going protests seem inevitable. In Scotland, which voted strongly to remain, there are calls for it to vote again on its independence. However Scotland would want some certainty of gaining EU membership which may not be straightforward. Northern Ireland also voted to remain, and there are now calls for union with Ireland. This possible disintegration of the UK does not bode well for near term stability.

Already the UK’s AAA rating has proved to be untenable with two rating house downgrades. None of this is reassuring for the UK, particularly given a current account deficit (CAD) of 5.2% of GDP in 2015 or 7% in the December quarter (see Chart 1). Whilst the UK has had a continuous annual CAD since 1983, it is currently at the highest level seen since records began. While exchange rate depreciation boosts competiveness, which should help boost exports and lower the CAD, more than half the UK’s exports go to the EU. Of these, financial services comprise the largest component and will be particularly adversely impacted. Already a number of firms are talking about moving operations out of London, which has flow on consequences too for the housing market. The risk-aversionary impact on the price of oil, if it persists, will also not be supportive.

The UK’s deficit with the rest of the world has to be balanced via foreign direct or portfolio investment, or in the absence of these in sufficient quantity, via deployment of the Bank of England’s foreign reserves. It seems self-evident that both companies and investors will now be more cautious with respect to investment in the UK. The Bank of England was quick to make its readiness to intervene clear, an intent backed by £250 billion in liquidity if required. However, while this may have helped stabilise the situation on Friday, in reality central banks can only smooth the path, they cannot stand against the tide. A rapid re-imposition of austerity may be required to shrink the deficit, if that is insufficient or too slow there is clear risk of further sharp currency depreciation. Such a situation may also see a general rise in risk aversion, triggering further share market losses.

Chart 1: UK current account balances as percentage of GDP



Source: UK Office for National Statistics

Where to from here?

Post the referendum we now face an environment of greater complexity, uncertainty and hence risk. While, other things being equal a significant drop in asset prices would see us respond with higher risk asset allocations, this time other things are not equal. We are in a changed scenario, the consequences of which are still uncertain. The challenge that we face is to understand and respond to the consequences of these changes. Forecasting the future is like picking the roll of a fifty-sided dice. The important thing is not to predict what will happen but understand the consequences of what could unfold. If we do that thoroughly we are then in a position to understand how to best build in protection against the key risks while exploiting return potential to the extent this makes sense.

The worst case scenario is already being outlined by a number of commentators. Soros has commented that "financial markets worldwide are likely to remain in turmoil as the long, complicated process of political and economic divorce from the EU is negotiated". He goes on to add that the "consequences for the real economy will be comparable only to the financial crisis of 2007-2008". This is a credible but not inevitable scenario – though we note less likely given the action taken to strengthen the banking system (as illustrated by the recent announcement that all US banks have passed the latest stress tests). We can also paint a more optimistic picture if a way can be found back from the 23 June Brexit vote.

Following the Brexit referendum outcome supporters have been strangely quiet, apparently unsure about what to do next. Far more vocal have been the protestors, with a call for a second referendum reaching over four million signatures at the time of writing. A general election could also provide a second opportunity. While this is anecdotal, a number of Brexit voters may have been shocked into changing their minds. Any re-run which includes specification of a coherent exit plan would allow for a more informed vote. Both the leading major parties would require new leaders – UK Prime Minister David Cameron has already announced his intention to resign, and the hapless Labour leader Jeremy Corben is facing a confidence vote in the wake of mass resignations from the shadow ministry.

While the situation is convoluted and complex, a decision reversal cannot be ruled out. Perhaps more likely is a scenario in which the UK joins Norway and Switzerland in having other arrangements (such as the European Economic Area and European Free Trade Association) which allows for free movement of goods. Whether this will satisfy staunch Brexiters however will depend on the issues of free movement of people and the budget contribution. The extent to which such a scenario would restore confidence in the UK and the EU depends on how it plays out and, in particular, whether the risk of other countries exiting is reduced. In the most positive scenario there is meaningful reform, or even reconstruction, of the EU. The EU was founded to strengthen economic and political bonds and to move towards the concept of European citizenship with the intent of reducing the risk of another major war. This objective is consistent with the inclusion of an increasing number of less developed economies being included in the union, but it has become clear that this is not entirely aligned with the wishes and expectations of the voters in the core member states. At the very least there will be some delay before Article 50 (which states that a member country may decide to withdraw from the union) is invoked. Ideally this would provide an opportunity to look at re-architecting the EU. However this is merely conjecture at present.

Presuming the exit of the UK goes ahead, the EU rhetoric suggests it is less likely to soften the pain of an exit than it is to take a hard line as a deterrent to others. And in this scenario there is a greater chance of Scottish and perhaps Northern Irish independence being sought. This leaves the UK in a challenged position. The main questions for us revolve around the flow on consequences. Can further EU exits be averted; if not, are we facing a disintegration scenario? If so, can it be managed in an orderly fashion with new structures and arrangements replacing the old? It is too early either to discard this scenario or to pin down the way in which it would emerge and evolve.

Turning to the economic and policy consequences, in an exit scenario the UK faces a currency devaluation and a potential demand shock. This combination could result in a stagflationary scenario. In the event of EU disintegration, the same risks also apply. Such a scenario would risk an escalation of protectionist measures which lower growth more generally.

We see potential inflationary consequences elsewhere too. In the US interest rate rises may be delayed, which supports wage inflation gaining greater traction. And Japan is adversely impacted via a stronger yen, requiring policy easing. Recent monetary policy changes in Japan which introduced negative interest rates failed to weaken the yen, which has been a key underpinning to their policy. In response there has been increasing discussion of fiscal stimulus – potentially a money-financed fiscal program (former Federal Reserve Chairman Ben Bernanke's term) which involves cash handouts to consumers in one form or another or for public works. Such a move, if made, could reinforce the impact of labour shortages which now appear to be pushing up wages. Companies are starting to have to pay more for part-time workers in order to keep them, which would be a welcome shift in the balance of power. We regard this as key for sustainable growth in Japan. A rise in inflation is not unambiguously positive or negative - it depends on the context. The key point here is that recent developments may reinforce emergent inflationary trends, and may trigger an adverse inflationary scenario in the UK and Europe.

How does MLC deal with this uncertainty?

Well before the Brexit vote our portfolios had a defensive bias, particularly the MLC Inflation Plus portfolios. This positioning is a function of multiple significant risks (notably the on-going excessive level of debt in a number of countries), complacent market pricing, lacklustre economic performance despite extreme monetary policy settings, and limited room for policy manoeuvre in response to shocks. Part of this defensive stance has involved a tilt away from longer duration bonds, which are risky in a number of scenarios, but in this particular instance are protective. However, these assets become increasingly risky as yields ratchet even lower.

Foreign currency exposures which have been defensive in many risk scenarios are also not in the current scenario, with the Australian dollar (AUD) potentially exhibiting some renewed safe haven characteristics (given limited direct impact on Asia and perceptions of a slowing in the path of US rate rises). The relatively low share exposures of the MLC Inflation Plus portfolios together with the bias to total return rather than market relative stock selection (which means stocks are held because they offer an adequate potential reward for risk taken, and not because they are a significant portion of the market index) provide significant protection in all risk scenarios. Key elements of the portfolios, notably the low correlation and multi-asset real return strategies, have fared particularly well; our defensive global shares allocation has also increased portfolio robustness.

Importantly the MLC Horizon portfolios have a significantly higher level of inflation robustness than peers, and the MLC Inflation Plus portfolios are always focused on generating returns above inflation and reducing the risk of large losses. Recently we have been working on building in increased inflation protection - this has for example included a small allocation to gold in the MLC Inflation Plus Assertive portfolios.

While we have made some small adjustments to our already defensively positioned portfolios it's important not to act irrationally when events such as Brexit shock markets. We continue to carefully consider the future scenarios that could unfold and the impacts on our portfolios' ability to achieve their objectives and deliver to our clients' expectations.

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