

CIO Weekly Perspectives

Britain Votes to Leave the EU

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Market turmoil could create opportunity.

This time the opinion polls got it right. The “Remain” and “Leave” camps were running neck-and-neck coming into yesterday’s U.K. referendum on membership of the European Union and in the event some 52% of U.K. voters opted to reject the status quo and pull out.

Markets have responded dramatically. U.K. equity index futures have slumped and the pound sterling has tumbled to 1980s levels. Safe havens such as gold, German Bunds and U.S. Treasuries are seeing substantial investor demand. The euro has also come under pressure.

Fears of ‘Lehman Moment’ Overblown

No doubt this will be the first of many volatile trading sessions, and the major central banks may intervene if necessary. But we caution against reacting as though this were a second “Lehman moment,” as some commentators have suggested.

The likelihood of at least medium-term damage to the U.K. economy from a “Leave” vote, as well as pronounced market volatility on the back of political uncertainty for the U.K. and the EU as a whole, did lead our Multi-Asset Class (MAC) team to adopt a relatively neutral stance coming into the vote. But this stance was not only designed to try to buffer against volatility, but also to position the MAC team to take advantage, potentially by increasing allocations to riskier assets based on a longer-term view of fundamentals.

Still, the U.K. has chosen the rockier of two paths. It piles up the political distractions that have dogged the administration of U.K. Prime Minister David Cameron and his chancellor, George Osborne. The “Brexit” camp is clearly in the ascendant but the vote revealed a lack of national consensus. And even consensus would not wish away the complexity of this exit, a “monumental,” multi-year task in the words of one legal expert.

Economic Damage Likely to Be Contained

That complexity is likely to prolong the period of low corporate investment we have seen leading up to the vote, both within the U.K. and in the form of foreign direct investment. This, together with the higher costs of trading, is what led mainstream economists to forecast a 3-7 percentage point negative long-term impact on U.K. GDP.

The pain may not be felt evenly. Many of the large companies in the FTSE 100 Index are global rather than U.K. businesses—80% of the index’s revenues come from overseas. This should help insulate them from any domestic downturn and potentially deliver a windfall from the weakened pound. Smaller, more domestically-focused companies are more vulnerable to a fall in consumer demand and higher import costs. That could be a source of opportunity during a sell-off in U.K. assets, particularly if the U.K. makes its new status work over the longer term.

Elsewhere, the economic impact is likely to be felt most keenly in Europe and, in the words of one Federal Reserve Bank president, to have only “moderate direct effects on the U.S. economy in the near term.” Again, we expect an excessive market reaction to be a potential source of opportunity.

Another Blow for Globalization?

A more pessimistic reading of the vote would see it as one more crack in the edifice of international political and economic co-operation built over the past 70 years. Anti-EU parties in countries like France, Germany and Italy may take heart from the result and attempt to further exploit the euro-skepticism increasingly evident in opinion polls across the Continent.

But to us this merely confirms that globalization is under siege, a trend already well-advanced and understood by financial markets. Beyond Europe, a big effect on the outcome of the forthcoming presidential election is unlikely—and besides, as former Treasury Secretary Hank Paulson told Brad in an exclusive interview at our CIO Summit this week, neither the Republican nor the Democratic candidate is promoting a positive view of global trade and investment.

Look Through the Noise to Fundamentals

Most importantly, this vote will probably exert only a marginal effect on global economic fundamentals, which remain stable but weak. We still live in a slow-growth, low-inflation, low-interest rate environment, characterized by sluggish productivity and investment. “Brexit” has been a tail risk stalking markets in the same way that the oil price,

the strong dollar and concerns about China created volatility back in January and February, but we think its implications are overstated. For that reason, we again stress the importance of [looking through the noise to focus on fundamentals](#) and watching for opportunities to add risk to portfolios. The market reaction may provide opportunities to add to some positions in riskier assets once the worst of the initial volatility has passed.

Looking further out, in a lot of places in the world we still need structural reform and a more appropriate fiscal response to the current malaise if we are going to allow our economies to grow on a proper footing, and our companies to generate sustainable earnings growth. Part of that progress will involve addressing the legitimate concerns of those who have failed to benefit from globalization, but populism and political division is not the way to do it. In that respect, today's result is hardly good news. But we believe its effect will be marginal and the market's initial response is likely to create opportunity for patient investors with cool heads.

In Case You Missed It

U.S. Existing Home Sales: +1.8% to SAAR of 5.53 million units in May

U.S. New Home Sales: -6.0% to SAAR of 551,000 units in May

What to Watch For

Tuesday 6/28: U.S. 1Q 2016 GDP (final)

Tuesday 6/28: Case-Shiller Home Prices

Tuesday 6/28: U.S. Consumer Confidence

Wednesday 6/29: U.S. Personal Income & Outlays

Friday 7/01: ISM Manufacturing Index

Friday 7/01: Eurozone Purchasing Manager Index

– **Sonia Mukherji**, Investment Strategy Group

Statistics on the Current State of the Market – as of June 24, 2016

Market Index	WTD	MTD	YTD
Equity			
S&P 500 Index	-1.6%	-2.7%	0.8%
Russell 1000 Index	-1.6%	-2.7%	0.7%
Russell 1000 Growth Index	-1.7%	-3.1%	-1.4%
Russell 1000 Value Index	-1.5%	-2.3%	3.0%
Russell 2000 Index	-1.5%	-2.3%	0.0%
MSCI World Index	-1.6%	-3.8%	-1.7%
MSCI EAFE Index	-1.7%	-5.9%	-6.6%
MSCI Emerging Markets Index	0.1%	0.2%	2.6%
STOXX Europe 600	-2.3%	-7.3%	-8.0%
FTSE 100 Index	2.0%	-1.2%	0.6%
TOPIX	-3.7%	-12.7%	-21.4%
CSI 300 Index	-0.8%	-2.4%	-16.8%
Cash & Fixed Income			
Citigroup 2-Year Treasury Index	0.1%	0.5%	1.2%
Citigroup 10-Year Treasury Index	0.4%	2.4%	7.1%
Barclays Municipal Bond Index	0.3%	1.5%	4.2%
Barclays US Aggregate Index	0.2%	1.2%	4.7%
Barclays Global Aggregate Index	0.1%	2.4%	8.4%
S&P/LSTA U.S. Leveraged Loan 100 Index	-0.3%	-0.5%	5.0%
BofA Merrill Lynch U.S. High Yield Index	0.1%	0.3%	8.5%
BofA Merrill Lynch Global High Yield Index	-0.3%	0.1%	7.8%
JP Morgan EMBI Global Diversified Index	0.6%	1.8%	8.6%
JP Morgan GBI-EM Global Diversified Index	0.5%	2.9%	10.8%
U.S. Dollar per British Pounds	-4.7%	-6.4%	-7.6%

U.S. Dollar per Euro	-1.2%	-0.2%	2.3%
U.S. Dollar per Japanese Yen	2.1%	8.5%	17.7%
Real & Alternative Assets			
Alerian MLP Index	1.5%	3.1%	12.5%
FTSE EPRA/NAREIT North America Index	0.0%	2.3%	8.2%
FTSE EPRA/NAREIT Global Index	-0.7%	-0.1%	4.7%
Bloomberg Commodity Index	-2.0%	1.9%	10.8%
Gold (NYM \$/ozt) Continuous Future	2.1%	8.6%	24.7%
Crude Oil (NYM \$/bbl) Continuous Future	-0.7%	-3.0%	28.6%

Source: Factset, Neuberger Berman LLC.

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