Here’s an antipodean view of Brexit drawing on the insights of Mercer’s global Dynamic Asset Allocation (DAA) team. In this article, we consider what’s happened, what’s next, and the implications of Brexit on local asset consulting clients and those invested in Mercer-managed portfolios in the Pacific region. The good news is the potential economic and political contagion hasn’t erupted, but investors need to build up their immunity by keeping a relatively neutral overall portfolio exposure to equities, whilst maintaining a level of downside protection.

WHAT’S HAPPENED?

The UK’s referendum on its membership of the European Union (EU) held on 23 June 2016 resulted in a surprise victory for the “leave” campaign. The unexpected outcome generated a wave of economic and political events, with ratings agency Standard & Poor’s downgrading the United Kingdom’s credit rating two notches to “AA” from “AAA”, with a “negative” outlook.

The initial financial market reaction reflected investor concerns over the significantly increased level of political and economic uncertainty. Currency markets bore the brunt of the volatility, with Sterling falling to its lowest level in more than 30 years against the US Dollar. UK and European equity markets suffered large losses in the ensuing days. Safe haven demand led to a fall in European government bond yields to new lows. The 10-year UK government yields declined almost 30 basis points in the largest one-day move since the Global Financial Crisis.

But then most major equity markets went on to at least partly recover in early July. The US market at the end of the first week of July was unchanged since before the vote, while the UK FTSE was up 3%; though mainly because of Sterling’s impact on an “international” stock index. By 7 July, Europe and Japan both remained down by around 5% relative to levels immediately prior to the vote (in Japan’s case impacted by strength in the Yen), and Australia was down just 1% (despite an unclear federal election outcome). In contrast, bond markets continued to rally hard.

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Now that the vote has been cast, the next step is for the UK to formally exit the EU, which requires the UK government to officially notify the European Council of its intention to leave, triggering Article 50 of the Lisbon Treaty. Nobody expects the UK government to be in a hurry to exercise Article 50 and to commit to a two-year deadline to exit. It’s not something that can happen overnight. Yet too much of a delay creates problems also.

IMPLICATIONS FOR INVESTORS

The implications of Brexit are most significant for the UK, although the impact is difficult to quantify given the ongoing political uncertainty. Not least are the terms of the package that the UK is able to negotiate from the EU, bearing in mind the desire by the EU to deter other members from exiting, and the difficulty for member states to agree a common approach to apply to the UK. A tough negotiating stance by the EU (the UK’s largest trading partner) and/or the prospect of a long, drawn out exit process will likely hamper investment activity and fuel further capital outflows out of the UK, hurting the growth prospects for the UK economy in the process. The consensus UK GDP growth forecast has been cut by 0.5% for 2016 and by 1.7% for 2017. Forecast 2017 growth is still positive at 0.4%, but is likely to include some quarters of negative growth, and probably a “mild” recession.

However, great uncertainty surrounds these forecasts. A more pessimistic scenario postulates the uncertain political landscape causing a sharp reduction in company capital expenditure levels, a tightening of bank lending conditions and a plunge in consumer confidence. Such a combination would stifle the UK economy to the point of a painful recession.

The impact on Europe and the rest of the world is clearly smaller, but even harder to forecast as it depends upon the level of economic and political contagion that spreads from the UK decision. Much of the economic contagion will itself depend on financial market reactions. Eurozone consensus growth forecasts have been lowered by 0.1% in 2016, and by 0.6% in 2017. This leaves growth positive, but slowing to just 1.0% in 2017. The impact on the rest of the world is expected to be even smaller, with no change to US growth forecasts as at early July. Nevertheless, expectations of a US interest rate rise in 2016 have been slashed.

Financial market volatility will likely continue especially in the currency markets. Any unfavourable political developments may pose further downside risk for Sterling, and potentially the Euro as well. However, the primary route of financial and economic contagion in the short term would be a stronger USD putting pressure on commodity prices and emerging markets (including China). Over the medium and longer-terms, contagion could also emanate from pushes for similar referenda in members of the European Monetary Union (EMU).
Central bank policy across the world is expected to remain ultra-accommodative in a bid to further stabilize and support the global economy, which has so far seen only a tepid recovery. Rhetoric has focused on reassurances that central banks will act in a coordinated manner to provide liquidity to market participants as required.

**WHAT SHOULD INVESTORS DO?**

In uncertain times, the only certain outcome is elevated risks. The central case global economic outlook has been nudged down, but the downside risks have risen significantly. This is in a world of fragile growth where Mercer already believes risks are high.

The immediate rout in markets has been reversed as investors realised it would be some time before the full consequences become clear and monetary policy makers again signalled further support. However, UK economic data is likely to remain weak, reminding investors of this event’s significance. Contagion to Europe may be the next warning sign to monitor.

Mercer’s DAA team has not altered its previous view, which is that investors now need to keep a relatively neutral overall portfolio exposure to equities, whilst maintaining some level of downside protection (such as a low currency hedge ratio or exposure to “low volatility” equities). We are monitoring developments with our European colleagues, and will update this advice if warranted.

**IMPLICATIONS FOR THOSE INVESTED IN MERCER FUNDS AND SUPER INVESTMENT OPTIONS**

Mercer’s Multi-Manager Fund clients, along with Mercer Super Trust and Kiwisaver members all have varying degrees of exposure to UK and European shares via Mercer’s International Shares portfolios, which target an exposure of around 7.4% to UK shares. Other top 10 European equity exposures (France, Germany, Switzerland, Sweden, Italy and Spain) account for another 13.9%. Those exposures are diluted for those invested in our diversified multi-asset portfolios such as the portfolios of the Mercer Growth or Mercer SmartPath investment options.

Mercer’s portfolio management team has been steadily reducing its equity exposure over the last 18 months. At the beginning of July 2016, we carried a modest underweight to equities, together with other risk mitigation through exposure to low-volatility equities. Our risk management overlay, which utilises options to provide some downside protection, provides another buffer. Together with our global colleagues we continue to monitor economic and market developments and adjust portfolio exposures accordingly.
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