A Vacuum of Optimism

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Yesterday's vote in favor of Great Britain to leave the European Union clearly caught global markets by surprise. Asset pricing over the past several weeks clearly indicated expectations for a "Stay" outcome. While the impact on equity, currency and fixed income pricing was swift and severe, Britain's exit from the EU and the renegotiation of trade agreements will take years. Given all of the unknowns, coupled with the usual items on the worry list (China, presidential election cycle, global growth, etc.), we expect markets to reprice to levels of maximum uncertainty. To quote Peter S. Goodman from the New York Times, "The collective imagination leads to dark places." We expect significant volatility in the coming months as investors position for worst case outcomes. There will be a vacuum of optimism.

This event underscores the importance of asset allocation and periodic rebalancing. While equities traded lower, bonds rallied. We expect hedge fund managers will help buffer volatility. Asset repricing to lower multiples should provide private equity managers the ability to buy good assets at lower levels. Rather than continue with an essay we'll list our key observations and opinions in bullet point format.

- This strengthens our position that the United States is expected to be the risk market of choice for investors around the world. Investors looking to take risk off will look toward US Treasuries. When they decide to put risk back on the first place they will likely wade into will be high quality US equities. It might take weeks or even months for markets to price in a worst case scenario but we will rebalance into domestic equities on a meaningful pullback. One of our core managers in the small and mid-cap space, Select Equity Group, sent us a thoughtful essay today that stated "The turmoil in global markets provides us the opportunity for “thoughtful offense” focused on companies we believe are best equipped to flourish under adverse as well as benign scenarios." This is exactly what we expect from active managers.

- Uncertainty is likely to slow global growth, impacting capital spending and hiring. This is negative for commodity pricing except for precious metals.

- This will cast a shadow of doubt over European capital markets for a longer period. The real question is will the rest of the Eurozone remain intact. The first thing we'll probably see is another vote for Scotland to leave the United Kingdom. There will be lots of speculation about who might be next to leave the EU. Expect to hear the word contagion quite a bit in the near future.

- The world's central banks have very few tools left to stimulate growth. Over $10 trillion of sovereign debt is currently trading at negative interest rates. The United States and Japan have already embarked on aggressive quantitative easing programs. The European Central Bank is posting negative interest rates although they could become more aggressive with QE. The Fed is now thinking globally. They are cognizant that a rate increase in the US may rattle global markets. A rate increase would likely strengthen the dollar, harming earnings prospects for American based multinationals. The British Pound is already trading at the lowest level since 1985. Unilever recently issued 300 million Euros of debt maturing in 2020 with a 0% coupon and a 0.06% yield to maturity. Buyers of that paper are clearly expecting deflation.

- Yield spreads to Treasuries and German Bunds will widen in the sovereign debt of Portugal, Italy, Greece and Spain. Yield spreads for high quality corporate and municipal bonds will remain tight.

- The "Leave" vote is likely to embolden populist parties and isolationism in the western world. This will be viewed by investors as a deflationary force on the global economy.

- Emerging markets are usually a risk off asset class. We're not saying this is the right thing to do in the context of Brexit but it will take EM longer to recover until we see how this impacts global trade. Great companies across the emerging and frontier markets will trade at highly attractive multiples and dividend yields. We strongly advocate active management for this asset class.

- Continued strength in the Dollar may serve as a catalyst for the Chinese to devalue their currency. If this happens expect other export oriented emerging market central banks to do the same, continuing the race to the bottom.

- The Euro and the Pound will likely drift lower after gapping down today. This will hurt international equity managers as lower equity prices and lower currency values represent a double edged sword.

- Assuming interest rates stay lower for longer, high dividend and dividend growth equities will be in favor. Uninformed yield chasing will continue.

- The non-discretionary consumer sectors and utilities will likely perform well on a relative basis. People will not stop buying toothpaste, beer, cornflakes, peanut butter and electricity because of Brexit. Global banks will suffer as margins decrease with lower interest rates and waning loan demand.

To summarize, this is not the time for knee jerk reactions. Let asset allocation and rebalancing work for you. Please feel free to reach out to our partners and client advisors with any questions or concerns you may have.

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