CUMBERLAND

Brexit Impact on Global Equities

The world's most complicated divorce has been just put in motion.

Going into the referendum, the vote was too close to call, although the momentum swung to the Remain camp post the killing of Labor MP Jo Cox. MP Cox was an advocate of immigration and campaigned for the Remain side. The markets in the few days prior to June 23 also signaled that the UK would remain as part of the EU.

The democratic process will be honored, where 51.9% of the electorate have voiced their view that the UK should no longer be part of the EU. In Prime Minister Cameron's concession speech earlier this morning, he congratulated the Leave camp in their victory. But has this group really won? In the words of Sir Mike Rake, chairman of BT, he believes "emotion has trumped facts and untruths have been believed" and as a result, it has weakened not only the UK but the EU as well.

It was unthinkable and shocking that the British people would believe statements from the Leave Party that were twisted and untruthful. The Leave vote has not resolved anything but it has only created more uncertainty, mainly because we are entering the unknown. The key issues we are not certain about include; (1) what kind of policies will be put in place by the EU to deal with the UK, (2) who the new UK Prime Minister will be and how this person will lead the negotiations with the EU, (3) the length of time the negotiations will take place. When there is such an elevated level of uncertainty, we can expect corporations to hold off on any major capital investments in the UK, leading to a sustained period of weakness. We have seen a dramatic decline in the sterling pound to a thirty year low.

The concern we have is the possible contagion to other markets globally. There are a number of politicians across Europe that are calling their own referendums in the wake of Britain's exit from the EU. For example, Italy's anti-establishment Five Star Movement has called for a referendum on whether to keep the Euro. This is a different referendum from the one that is taking place in October where voters will be asked whether they approve of amending the Italian constitution including reforms such as changes to civil bankruptcy laws and rules on employment and ownership of Italy's mutual banks, aimed at boosting foreign direct investment. Other countries calling for referendums include Denmark, France, and The Netherlands. Spain is holding an election on Sunday, June 26 where there is uncertainty of the outcome on the markets.

Now that UK has voted for Brexit, then the possibility of the US voting for Donald Trump this fall has become elevated. This may have negative implications for global trade given the rhetoric from Trump during his campaign. As a result, the possibility of a global recession has just become more elevated. The scope of alternatives available to Central Banks globally to fight off a global recession is now limited given the already low rates.

Post Brexit, the UK can choose from five main models.

1. UK can be like Norway where it enjoys full access to the single market while being outside the customs union and this would cost 90% of the current contribution;
2. Another option would be to emulate Switzerland where it has 20 major and 100 minor bilateral agreements with the EU and this would cost 40% of the UK's current contribution;
3. Or they can establish a customs union with the EU the way Turkey has done;
4. Or rely on a normal World Trade Organization rules for access to the EU market;
5. Finally, they can negotiate a special deal for Britain alone that retains free trade with the EU but avoids the disadvantages of other models and this is preferred by those supporting Brexit. The leaders of the Leave camp has repeatedly said they will not negotiate for a single market because they do not want a freedom of movement. Thus, we would not expect the UK to negotiate the Norway or Switzerland alternatives.

The first swing has been taken by the markets, reflecting their fear of this uncertainty. In light of this environment, here is what we can say about the impact on our portfolio. The banking sector, both UK and global banks have been the hardest hit, including our holdings in Lloyds Banking Group and BNP Paribas. In the case of Lloyds, it is predicated on the fear the economic growth in the UK will be hit, causing a rise the bad loans and the decline in the market value of the homes while in the case of BNP, there is fear of the dismantling the EU as noted above (referendums in various countries). The initial reaction today is likely overdone, but these are two positions we shall have to monitor very closely. They are trading at multiples similar to the financial crisis but at this time, there is no liquidity crisis and the balance sheets of both banks are very sound.

Our global and international portfolios were conservatively constructed going into the Brexit vote with a high level of cash and limited exposure to the UK economy. This leaves us well positioned to take advantage of the weaknesses in the markets in the days ahead. Our concern lies with foreign exchange headwinds and the prospect of a global slowdown. However, we observe that defensives outperform during these times of uncertainty and would submit that high quality companies will generally be able to outperform in this environment.

The British people have spoken up against the establishment and a globalized world. The post-mortem of this event will take place in the years and perhaps generations to come. Our view is that this is not positive for the UK nor for the rest of the world. However, the vote has taken place and the world today is a different place compared to the one of yesterday. While we are still of the view that being invested in best of breed global equities is the most appropriate place to be invested, our view of a slower global growth has become elevated. We shall re-examine the thesis for each of our positions where we can be confident they will be able to withstand any future shocks.

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