BREXIT...WHAT NOW?

NEPC Research
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The outcome of the United Kingdom's referendum to leave the European Union has stunned forecasters and market participants. Markets responded in dramatic fashion today with Local European and UK equities down 7% and 3% respectively. Currencies fell against the US Dollar from 2% (Euro) to 8.5% (British Pound). Notably, these losses mostly reset the recent momentum of the "Remain" campaign over the last week. Meanwhile, safe haven bond markets rallied up to 25 basis points.

As your inbox overflows with reactions and commentary we think it is important to identify the known and unknown and assess potential actions. As heightened risk premiums filter into global markets, we advise investors to focus on a long-term perspective of how events may play out and how markets and portfolios may respond.

What We Know...

At this point, David Cameron announced his resignation and the UK must trigger Article 50 of the Lisbon treaty to start the multi-year process of leaving the EU. We also know markets are repricing equities and credit, favoring safe haven assets.

What We Don't Know...

A Long Process and Range of Outcomes for New Deal: The EU and UK need to negotiate new trade agreements with options ranging from an arrangement similar to current structure to bitter and protracted negotiations leading to significant disruption. Further, the UK must determine new policies for immigration and job mobility. A timeframe is similarly cloudy since trade agreements can often take many years to finalize.

Momentum for Further Referendums: The UK vote may serve as validation for independence parties across Europe, establishing a template for political campaigns in other countries. While the process and timing for referendums will differ across countries, this outcome forces investors to now consider a new set of political risks in Europe.

The Fed's Global Perspective May Further Delay Rate Hikes: Depending on the nature, length and impact across markets, the Fed has a new variable to consider in its calculus on when to raise rates.

What Should We Do...

Recognize the Benefits of Currency Hedging and Diversification: Investors managing foreign currency exposure can take comfort in protecting some of the downside in currency markets. For those who do not hedge the opportunity to protect against this event has passed, but unknowns described above highlight the need to be vigilant in currency risk management.

Be Disciplined and Look for Rebalancing Opportunities: Market moves have been severe but not as extreme as during recent bouts of volatility. Should markets stabilize and recover quickly, there may not be a strong tactical opportunity. However, further weakness may emerge. Losses beyond 10% in equities, particularly in regions like the US and EM that are caught up in the contagion but only indirectly impacted, may represent an opportunity to "buy on the dip". Diversifying allocations to long Treasuries have provided protection and may be a funding source.

Looking forward, we will continue to monitor markets closely and interact with investment managers to understand their positioning and views. As markets evolve and events play out, we look forward to communicating our views both broadly (*look for a webinar next week*) and on a customized basis, working closely with you to capture potential investment opportunities and position your portfolios for long-term success.

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