BREXIT: THE AFTERSHOCK.
Thoughts from London

GUARDIAN CAPITAL

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Guardcap Asset Management Limited ("Guardcap") is the U.K. affiliate of Guardian Capital LP and acts as a sub-advisor to several Emerging Markets and Fundamental Global Equity strategies offered by Guardian. Steve Bates, Chief Investment Officer for GuardCap, has pondered the unfolding developments and offers his observations on this volatile and rapidly changing situation.

Disclosure

I voted to remain and was very surprised by the result. What follows is a personal view of developments and reflects the current political vacuum and resulting uncertainty. Capitalism is a resilient and flexible organism and companies adapt quickly to new circumstances. This is why economies usually muddle through crises even in the absence of good leadership. I hope that that is what happens here.

The Context

The vote on Thursday has triggered the political equivalent of the financial crisis of 2008 in that the implications of the vote reach well beyond the UK. Britain itself is in the grip of a constitutional crisis.

The victory for the Leave campaign seems to have come as a surprise to its leadership and to many who voted for them. This is visible in the complete absence of a plan or vision for what the country might be outside the EU, and by the anecdotal evidence that many Leave voters didn't actually want to leave but instead to stick two fingers up to the establishment. Nevertheless, the vote has revealed a divided country. The less well educated, poorer and older you were (at least outside the big metropolitan areas), the more likely you were to have voted to leave. This seems to represent a number of contradictory constituencies. The leadership of the Leave campaign is made up of buccaneering libertarians who would like the UK to look like a cross between Singapore and the US, and in order to achieve this, they needed to have sovereignty. There are plenty of Brexiters who share these views, but many more see themselves as victims of globalisation and innovation (and resent the related concentration of wealth in very few hands, and resulting wage stagnation) and view immigration as the lightning rod which has brought the ill effects of the world to their doorsteps. The views of the voters and of the leadership look irreconcilable.

The vote delivered a narrow victory, and in so doing, offers a weak mandate to an inadequate leadership. There are many uncomfortable issues which must be considered: the rage of young people, who feel that their parents and grandparents have saddled them with the after effects of the financial crisis and mountains of debt have now narrowed their freedoms as well; the likelihood of the secession of Scotland, which voted heavily for Remain; the risks of fissures reopening in Northern Ireland; and not least the conflict between globalisation and fear of its consequences – a factor which helps to explain the populism we see across the developed world, but which has found here its loudest expression so far.

The Economy

The general consensus is that economic growth in the UK will take a short term hit (until end 2017) of about 1% of GDP annualised. A larger drop may be mitigated by the weakness of sterling, which fell by the largest amount in a single day in its history. Sterling has been significantly overvalued (witness the huge current account deficit), and may now be more rationally valued. The medium term potential growth is also expected to be about 1% per annum lower than previously forecast. There is also expected to be a rise in inflation compared with pre-existing forecasts, albeit more modest. While it may be comforting to have some numbers, the reality is that nobody has a clue. Nothing like this has ever happened before. Anecdotal evidence is that transactions are either being pulled or renegotiated, and the uncertainty seems certain to lead to greater volatility, not just in markets, but in the economy too, as all actors wait to see what happens.

Given the general backdrop of low economic growth around the world, it is possible that the consensus is too optimistic and that BREXIT delivers a deflationary shock to the UK, through falling demand and rising unemployment, with the impact of currency dissipating as demand crumbles across the EU. The Bank of England has stood ready to provide emergency funding to the banks in the immediate aftermath, but the banking system is much less vulnerable than it was in 2008, and this is likely to be a short term measure. Looking a little further out, interest rates will fall further and more QE is almost inevitable. The weak economy will mean that fiscal targets will be missed and taxes will probably need to rise.

Foreign direct investment in the UK will suffer, even if the effect is temporary. For example, most Asian countries see the UK as the access point to the EU. It is not hard to defer a decision until things get a bit clearer.

Despite all this, the capacity of the system to adapt suggests that the effects of BREXIT, which remain uncertain for now, could be relatively minor in the long run, by which I mean very long run.

The Wider Implications

Within the EU, it seems likely that the Eurosceptic parties will take heart from what happened here. Some of these groups are openly xenophobic and the echo from history is very upsetting. There will be pressure in other countries for referenda, and the two largest EU countries face general elections within the next year. The markets have already marked down peripheral country banks and bonds and seem to be starting to price in another round of Eurozone wobbles. How the EU responds to the crisis will be affected by these considerations. The choice is between pulling up the drawbridge and heading for 'ever closer union' or addressing some of the implicit criticisms of the BREXIT campaign (that the EU is corrupt, inefficient, bureaucratic and undemocratic). It is too soon to say how this cookie will crumble.

The broader question of the effects of globalization and innovation could well lead to a more protectionist tone both in Europe and in the US. From here, it is hard to comprehend how these genies might be put back in the bottle, but that was the same story at the end of the 19th Century, when the world was very open and free trade was the dominant economic philosophy. This would be very bad for economic growth at a time when growth is scarce enough already.

The Politics

The UK faces a period of prolonged uncertainty: both major political parties are currently in meltdown and have no idea of what to do. Nobody even has a clear idea of what 'Leave' means. We are already being treated to sophistry about the differences between 'freedom of labour to move' and 'freedom of movement' as well as the difference between 'being part of the single market' and 'having access to the single market'. These subtleties are certain to be lost on those voters who just want less immigration and herald real division within the Leave camp.

The process of leaving involves two stages. The first is negotiating the terms of departure; the second concerns the future relationship. The EU has said it will not start on the second until the first element is agreed. The UK cannot agree to this as it would remove all its rather limited bargaining power – the UK represents 6% of EU exports, even though the EU does run a trade surplus with the country. The future trading relationship with the EU will be critical in determining how the UK can recover. Many countries will want to send a strong signal that leaving has damaging consequences and as a result, one should expect hardball, at least in public. The reality is that some sort of compromise is likely to emerge. Already, there are signs that the wiser heads in Government are starting to think about how access to the single market can be maintained. Examples from Norway and Switzerland suggest that it will be possible but might be unpalatable to the xenophobic end of the Leave movement, as it will probably involve continuing migration and payments into the EU to ensure access to the single market. Nevertheless, a sensible trading arrangement between the EU and UK is the most likely outcome when everybody calms down.

The role of the City is another complication. Other trade agreements with the EU do not involve financial services. For example, Switzerland has no access to the single market for financial services, which is why most of its financial institutions base their EU activities in London. Both France and Germany are unhappy that the UK is the hub for Euro based transactions, and it is very likely that there will be enormous pressure on organizations based in London either to move to locations in the EU or open branches somewhere inside the Eurozone. This is likely to be disruptive to financial markets and add cost to all financial services. In asset management, most firms already have UCITS structures regulated inside the EU, and it is unlikely that much will change on this front – many UCITS are managed by asset managers located outside the EU.

In the meantime, we are just going to have to wait until somebody comes up with a vision of what the UK might look like outside the EU. We might expect an attempt to build a low friction economy with low taxes for companies, support for entrepreneurs and limited red tape, with a very outward facing trading structure. If Scotland secedes, England will shift permanently to the right and those who suffer most from this are likely to be precisely those who voted for BREXIT.

The Markets

There has been a flight to safety which may have further to go. More capital will flow into government bond markets, further exacerbating the overvaluation which has been evident there in recent months. The strength of the Yen, Dollar and Swiss Franc are unsurprising. This will put pressure on Emerging Markets, but less than in previous similar episodes as valuations are already depressed. The Eurozone, as mentioned, will share the uncertainty which plagues the UK. Inside the UK, the large international companies as embodied in the FTSE 100 are somewhat insulated, while medium sized and smaller companies with export activities are probably in reasonable shape. Smaller businesses with predominantly domestic activities and specific sectors like housebuilders might find life quite difficult.

With interest rates staying lower for longer, equities remain the asset class which can offer a positive return and we would expect markets to recover when the road becomes a little clearer. For now, the best option is to maintain geographically diversified portfolios with as much exposure to growth and yield as possible.

Markets are discounting mechanisms and were shocked by what happened last week. There remains the potential for political mistakes, but based on an expectation of moderate competence, a muddle through scenario looks the most likely outcome.