



KayneCast

A Podcast Series by Kayne Anderson Rudnick



Episode 37

CIO Commentary on the Brexit Vote

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Markets were clearly surprised by the Brexit vote which occurred late Thursday night. It was clearly an unpleasant surprise for investors. And the question is why did this happen? British voters have become very frustrated with decisions that are being made by unelected officials in Brussels and they simply want more control over their national decisions. Immigration (border control) has become a very serious problem for the average British voter and a lot of their political leaders seem to be somewhat out of touch with this. There also appears to be just a growing anti-establishment sentiment within Britain, particularly towards the banks.

So what does this vote mean? Global growth rates, which have already been relatively slow this year, are definitely going to feel some short-term headwinds from this outcome. Uncertainty about how these new bilateral trade agreements will play out over the next couple of years will certainly hurt the UK business confidence. Most likely, the UK will experience a recession for at least a few quarters. But to put the UK in perspective, the UK accounts for about 3.9 percent of global GDP and less than 1 percent of U.S. exports. Global interest rates are now even less likely to rise (even in the U.S.) as central bankers wait to assess the fallout from this vote. It is also important to remember that the UK has its own currency (the Pound) and its own central bank, unlike many other EU members (which use the Euro) and this should help make this “exit” more manageable.

The real concern for investors going forward is: is this a one-off event or the beginning of the collapse of the EU? Well, nobody knows this answer for sure. It is very likely that we will see similar referendums in France, Holland, and Sweden—to name a few countries—over the next couple of years. And we will continue to monitor these votes and events very closely in the future.

Longer term, the UK and continental Europe are too important to ignore each other in terms of trade. EU exports to the UK represent about 2.7 percent of EU GDP, and the EU needs all the growth it can get these days. So it is much too important for these two not to figure out how to come up with reasonable bilateral trade agreements over the next couple of years. The EU may try to make an example of the UK for leaving the EU by demanding unreasonable terms in these trade negotiations over the next year or two, but in the longer term, these deals will be struck.

Now what are the implications and conclusions for markets? Most economic forecasts for the U.S. have now been reduced by 0.2 to 0.3 percent due to this vote. However, remember that most economic forecasts over a twelve month period are typically off by more than this amount. We continue to forecast slow growth in the 1.5 to 2.5 percent range for the U.S. in 2016. We have already been in a very slow-growth global environment and this uncertainty definitely will not help. Europe and certainly the UK are at greater risk of recession, but they were barely growing even before this vote. European banks (which have been clobbered before and after this vote) have been hurt by lower interest rates from the ECB and this will continue to pressure their net interest margins as we move forward. The dollar will likely show more strength and become a slight headwind for S&P [500] earnings going forward.

At the individual portfolio level, we will continue to examine our holdings on a case-by-case basis and determine whether this surprising outcome will have any material impact on the long-term outlook for our investments.



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Stocks, bonds, currency, and commodity markets have reacted quickly to this vote with stocks going lower, bond yields falling lower, dollar a little stronger, and commodities (except for chaos trades like gold and silver) lower due to slower global growth concerns. We advise clients to stay put and to avoid overreacting to this outcome. This is a very complex situation with very few precedents; therefore knee jerk reactions can end up making very poor investment decisions. We will continue to monitor these events and will inform you if there is any change in our thinking or asset allocation. As always, we will continue invest in quality businesses on behalf of our clients and we appreciate your trust and confidence in us. Thank you.

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