What strategy should we adopt on Brexit?

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The UK's vote to exit the European Union has sent the financial markets spiraling into uncertainty, prompting hefty sell-off on the equity and corporate bond markets at the end of last week. Investors have numerous questions, which we will endeavor to answer, while also providing some insight into the issues to watch over the weeks ahead.

Main fall-out from Brexit for the financial markets

In view of the element of surprise, investors' knee-jerk reaction was to cut back risk in their portfolios by:

- Selling off the currencies most affected by Brexit (sterling and euro) and buying into the dollar and yen;
- Massively selling off equities across the board, particularly on the markets most affected by the overwhelming increase in economic and political uncertainty: equity markets in the Eurozone and Japan (also hampered by the rise in its currency);
- Adopting a relatively wary stance on the most risky bond markets.

Consequences for the UK economy

Beyond ratings agencies' moves to downgrade the UK's credit rating, the main consequences for the real economy in the UK will be the uncertainty created, as well as the effect on sterling.

The pound plummeted against the dollar, reflecting investors' concerns on UK growth.

We can reasonably expect sluggish investment and consumer spending, dragged down by more expensive imports, but it is still too early to assess with any precision the drag caused by Brexit on economic growth over the medium term.

Investors should also closely monitor the potential damage to UK banks' profitability as a result of the possible loss of the "single passport" system, which allows financial services operators legally established in one Member State to establish/provide their services in the other Member States without further authorization requirement, and also due to the slowdown in credit demand, the contraction in net interest margins as well as the deterioration in asset quality.

Impact on the Eurozone and the world economy

Exports towards the UK account for only around 3% of Eurozone GDP, so the direct impact on the Eurozone economy should be a relatively limited 0.3% of GDP approximately, although there will obviously be some indirect consequences.

In contrast to the situation in the USA, which is clearly moving towards the end of its economic cycle, the Eurozone is still in the early stages of its cycle. It is worth noting that growth in credit demand only moved into positive territory last year, and still remains weak, while credit demand has been growing for five years in the USA. Similarly, investment has been buoyant over the past few years in the USA, while it has only just turned around in the Eurozone, which leaves considerable leeway for the zone to make up the lag. Overall then, economic momentum looks much more buoyant in the Eurozone than in the USA, and this is set to underpin production capacity utilization rates and corporate margins.

In the shorter term, the world economy should be buoyed by moves from the central banks, which will seek to inject a maximum amount of liquidity into the financial markets and the European banking system in order to cushion the shock.

Investment strategy

We recommend an ongoing cautious stance on investment portfolios over the days and even weeks ahead, as uncertainties on world growth and European integration are set to dent investor sentiment in the short term. The best way to safeguard against this is to maintain a highly diversified position and wait patiently for opportunities, while focusing on more defensive assets or those with solid yields, as follows:

- On the equity markets, US corporates look best able to weather the storm in the current context, along with companies offering regular steady performances and clear visibility (healthcare, consumer staples). If the impact of Brexit on European growth remains limited, as we think it will, Eurozone equities could provide an attractive opportunity to take positions at a later date.
- On the bond markets, it is important to note that the Fed is likely to take on board this new situation and defer its monetary tightening moves. Investing in US bonds (perhaps by taking on some dollar risk, in the event of euro weakness) could be a good measure to safeguard performances.
- Lastly, gold could become a safe haven again in the event of further disruption on the markets.

Zoom on European equities

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At the start of trading on June 24, the European equity markets were hit by an increase in risk aversion and saw a massive sell-off. Let's look into the day in detail.

All the European stockmarkets were affected

- **Southern Europe suffered most**: the announcement of Brexit triggered severe underperformances on the Southern European stockmarkets (Spain, Portugal, Italy where the FTSE MIB plummeted 12.4%).
- **"More limited" declines for Northern Europe** with the EuroStoxx50 down 8.6% and the CAC40 shedding 8%, while Swiss index SMI lost "only" 3.4%, **as the Swiss market played its usual safe haven role in Europe.**
- **The UK stockmarket suffered more than the index performance would suggest:** the UK stockmarket index seems to have suffered limited losses (-3.15%), but this is only because it is expressed in sterling: the pound actually shed more than 6% against the euro in that one day alone.

Some sectors more affected than others

- **The market instantly punished the most exposed sectors to the UK market,** such as banking stocks, cyclical, and stocks solely exposed to the UK domestic market.
- Meanwhile, other sectors benefited from the **investor quest for safe havens**: "profitable" sectors as well as corporates offering regular steady performances and clear visibility such as **healthcare – pharma, food/beverages and staples** (usually resilient even during slowdowns or crises) as well as **telcos and real estate** in continental Europe, which are also shored up by low interest rates.

Disorder and severe volatility on the European stockmarkets are poised to continue over the weeks ahead**, so high-quality sectors outlined above are the ones to focus on in investment portfolios.** Pending a clearer view of the next political moves in Europe, and despite a fragile market context, a lot of major European listed groups still offer high-quality fundamentals.

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