Financial Linx' Perspective

On Friday we witnessed a significant event and its real time impact on financial markets. That is Britain voting to leave the European Union.

Despite a final week "Remain" rally that pushed up equities, commodities and the Australian dollar, someone was clearly reading the tea leaves the wrong way.

Financial markets love certainty (Remain) while they dislike uncertainty (Exit) and they certainly dislike this outcome. However, this is just another bump (or dip) in the investing journey that will likely look remarkably benign when we look back on it in the years to come.

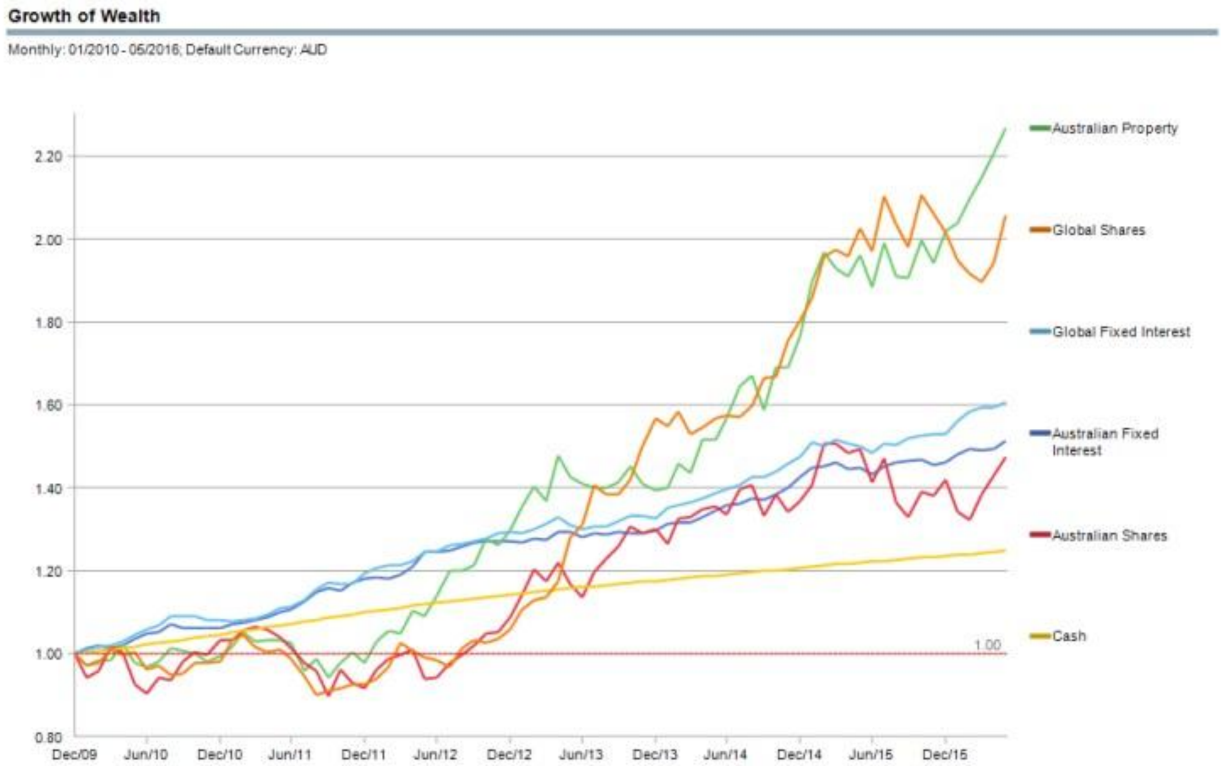
This decade, still living with the lingering after effects of the Global Financial Crisis, has seen several market shaking events. The Japanese Earthquake and Tsunami rocked world markets in 2011, while markets were less than overjoyed when the US had its AAA rating clipped by S&P later that year.

And just when investors have started to feel comfortable this decade, ongoing fears about China and Greece would rear their heads to unleash waves of volatility.

But… where was the worst place to be invested?

The old "safe haven" of cash of course.

Here's $1 invested into the various asset classes from January 2010 until May 2016:



There are some rough moments in there, but Australian listed property leads the way with an annualised 13.60% return, while cash has returned investors an annualised 3.50%. Australian shares have managed an annualised 6.23% and International shares an annualised 11.91%. Anyone ignoring all the market shaking events along the way has inevitably done better than someone who kept themselves safe in cash.

Back to the Brexit.

There's inevitably more uncertainty to come, but there are some things that are certain.

One thing not mentioned – the referendum isn't legally binding in any way. The next step will be parliamentary politics. We'll take up that part of the story from *The Financial Times*

The UK government could seek to ignore such a vote; to explain it away and characterise it in terms that it has no credibility or binding effect (low turnout may be such an excuse). Or they could say it is now a matter for parliament, and then endeavour to win the parliamentary vote. Or ministers could try to re-negotiate another deal and put that to another referendum. There is, after all, a tradition of EU member states repeating referendums on EU-related matters until voters eventually vote the "right" way.

Despite the celebrations and glum faces we'll see in the media, Britain can't just leave the EU tomorrow. The Lisbon Treaty demands a negotiating period with the European Council of up to two years.

Fortunately for markets and unfortunately for the exit voters that's plenty of time for all manner of goodies and interventions to possibly convince the UK to stay… let's wait and see.

The economist – Shane Oliver's – Perspective

Below are extracts from a Shane Oliver article that was written prior to the referendum result being finalised. However we believe the core themes within this article offer a unique perspective on the historical events that occurred within the UK.

Brexit or Bremain - or does it really matter?

21 June 2016

- Uncertainty around the outcome of Britain's referendum on whether to Remain in or Leave the European Union has reached fever pitch.
- While a victory for the Leave campaign will likely see more volatility, the global economic consequences have likely been exaggerated.
- A Leave victory is unlikely to have a major direct impact on Australia but could have an indirect bearing via financial market volatility.
- The key for investors is to look for opportunities that such volatility throws up.

Introduction

Y2K, Bird Flu, Peak Oil, Swine Flu, the end of the Mayan Calendar, Grexit, the fiscal cliff, US debt default, ghost cities, Ebola, Grexit again, imminent property crashes, etc…the world seems full of key events and phenomena upon which its whole existence - well at least the financial realm - supposedly hinges. Brexit seems to be the latest. In the last few weeks interest in Brexit has skyrocketed as indicated by searches on Google for the term. With this has come a surge in financial market volatility in the last two weeks.

What is the Brexit referendum?

Well if you don't know you must be off the planet…or then again just someone who is wisely focussed on the long term and not short term noise!

It's basically a referendum this Thursday on whether the UK should Leave or Remain in the European Union. While not binding it would be dangerous for UK parliamentarians not to pass a law to Leave the EU if Leave wins the referendum.

A problem is that voting is not compulsory so a close vote to Leave (say 50.1% v 49.9%) with only 50% turnout would mean only 25% of the voting population voted to Leave. A close vote could lead to a degree of political instability in the UK, particularly in the Conservative Party which has been divided on the issue.

How would exiting the EU work?

Under the Lisbon Treaty which governs the European Union on this type of issue, after notifying the European Council of intent to leave a withdrawal agreement would be negotiated. This could take up to two years after which membership lapses. At stake would be what sort of trade relationship the UK will have with the EU. Here there are various models, eg, if Britain becomes a member of the European Economic Area like Norway and Iceland it would continue to enjoy free trade access to the rest of Europe but would have to accept the free movement of people, contribute to the EU budget and accept virtually all EU rules and regulations without having a say in determining them. All of which would of course beg the question as to why Leave in the first place!

What would be the impact on the UK of a vote to Leave?

Leaving the EU is generally seen as negative for the UK economy given the impact on trade, the UK financial sector (which may over time lose its status as the pre-eminent European financial centre) and on labour mobility. The precise impact depends on the sort of exit deal negotiated in terms of trade access to the EU, but has been estimated by the UK Treasury and the OECD at around a cumulative 5% of GDP over 15 years. In other words GDP would be around 5% lower 15 years after exiting. Of course these numbers are very rubbery but expectations of something like this would be negative for British assets, particularly the British pound (as the UK share market is dominated by a bunch of multinationals anyway).

However, given the two year negotiation period it may take some time for the economic impact to become apparent. There is no reason why a Leave vote per se on Friday will plunge the UK into recession (unless the British talk themselves into it). As an aside, both sides of the Brexit debate have been grossly exaggerating their case.

Longer term though a decision to Leave could see Scottish independence pressures resurrected with Scots known to favour EU membership more than the rest of the UK. So Leaving could mean a weaker and smaller economy long term, further diminishing Britian's global influence.

What about the impact on Europe?

The British economy isn't what it used to be. In fact I spend most my time focussing on Europe, the US, China and to a lesser degree Japan these days. The UK does not get much of a look in (except right now!). In fact it only takes 2.7% of Australian exports. So a 5% hit to the UK economy spread over 15 years would not be a global disaster (as it would be less than 0.03% of global GDP per annum).

The real issue is the potential impact on the Eurozone. Brexit would not be the same as a Grexit (Greek exit from the Eurozone) because Britain is not in the Eurozone unlike Greece.

Global financial markets have been jittery over the last two weeks. With “risk off” – basically financial market lingo for investors selling assets that are seen to be risky in favour of safe havens (global and Australian shares down led by European shares, the euro down, commodities down and government bonds, the $US and Yen benefitting) whenever opinion poll support for the Leave campaign has gone up. Conversely, we have seen “risk on” (basically the reverse of all of these moves) whenever poll support for the Remain campaign has improved. An 8% top to bottom fall in Eurozone shares was at the centre of recent financial market jitters.

However, fears about the break-up of the Eurozone are likely to yet again prove to be premature. The hurdle for a Spain, an Italy or a France to leave the Eurozone is much higher than for the UK to leave the EU as they would end up with a depreciated currency and higher debt costs. Just think of Greece which despite all its woes over the last six years consistently wants and decides to stay in the Eurozone. In fact, support generally remains high for the Euro within Eurozone countries. So fears that a Brexit will lead to a domino effect threatening the Euro may be premature. Of course investor’s won’t know that initially.

What would happen if Leave wins?

If Leave wins there would likely be more “risk off” turmoil, eg; shares down, commodities down, bond yields down, British pound and Euro down and $US, Yen and gold up. The $A would probably fall against the $US but rise against the British pound and Euro. Eurozone and British shares could easily fall 10% or so and Australian shares maybe 5%.
But this will likely prove to be a buying opportunity as Europe is likely to hang together as it did through its sovereign debt crisis for the reasons noted above and central banks led by the Bank of England and European Central Bank would run easier monetary policies than otherwise fearing an adverse financial and economic outcome. In which case, Brexit would ultimately be a storm in a teacup with financial markets yet again over-reacting.

What will be the impact on Australia?

Given that a Leave victory is unlikely to plunge the UK or Europe into an immediate recession the main impact on Australia will be on financial markets as indicated above. This could affect short term confidence and may add to the case for the RBA to cut interest rates again particularly if banks increase their mortgage rates out of cycle due to higher funding costs flowing from an increase in lender caution. That said we expect the RBA to cut rates again anyway.

Concluding comment

Ultimately many of the fears around a Brexit are likely exaggerated, but global investors and hence markets are not to know this. The key for investors is to look for opportunities that Brexit related volatility may throw up, particularly in the event of a win for the Leave campaign.

About the Author
Dr Shane Oliver, Head of Investment Strategy and Economics and Chief Economist at AMP Capital is responsible for AMP Capital's diversified investment funds. He also provides economic forecasts and analysis of key variables and issues affecting, or likely to affect, all asset markets.

The Fund Manager – Dimensional's – Perspective

UK's EU Referendum Result

On June 23, citizens of the United Kingdom voted to leave the European Union. While there has been much speculation leading up to and since the vote, many of the longer-term implications of the referendum remain unclear, as the process for negotiating what a UK exit may look like are just beginning.

Dimensional has nearly 35 years of experience managing portfolios, including during periods of uncertainty and heightened volatility. We monitor market events—including their impact on trading and trade settlement—very closely and consider the implications of new information as it comes to light. We are paying close attention to market mechanisms and they appear to be functioning well. Our investment philosophy and process have withstood many trying times and we remain committed.

We urge caution in allowing market movements to impact long-term asset allocation. Long-term investors recognize that risks and uncertainty are ever present in markets. A drop in prices is generally due to lower expectations of cash flows, higher discount rates, or both. In some cases, a drop is also due to investors demanding liquidity. In the current situation, some investors and economists may expect lower cash flows due to possible trade barriers that may not be implemented. Higher discount rates may be occurring due to uncertainty about changes in the economic landscape and regulations. We have seen markets increase discount rates in times of uncertainty before, resulting in lower prices and increased expected returns.

However, it is difficult to know when good outcomes will materialize in the future. By attempting to time the right moment to invest or redeem, one risks not enjoying the potential benefits of such materializations. Many of those who exit the markets miss the recoveries. What we have often seen in the past is that investors who remained in well-diversified portfolios were rewarded over time.

The UK will have up to two years to negotiate a withdrawal, during which time it remains subject to EU treaties and laws. Any potential operational changes depend on what path the UK and EU decide to take. Leading up to and since the vote, we have worked with our counterparties, including custodians, brokers, and dealers, regarding potential operational implications resulting from the UK's leaving the EU.

Dimensional remains committed to helping our clients in the UK, other parts of Europe, and around the world have a good investment experience.