Investment Intelligence Online

Highlights of a discussion between Mark Barnett, Head of UK Equities; Jonathan Brown, Equities Smaller Companies Fund Manager; Michael Matthews, Fixed Interest Fund Manager; and Stuart Edwards, Fixed Interest Fund Manager on the Risk and Opportunities of Brexit

Introduction

The referendum on whether the UK should remain part of the European Union is almost upon us. Discussion of the arguments for and against British membership has already created a large amount of uncertainty ahead of the vote on 23rd June. To discuss what impact the referendum has had on the economy and financial markets in the run up to the vote, and what the implications might be, whether it's "Remain" or "Leave", I am joined by a panel of Invesco Perpetual fund managers.

On our panel today: Mark Barnett, Head of UK Equities (MB), Jonathan Brown, UK equities small cap fund manager (JB), and fixed interest fund managers, Michael Matthews (MM) and Stuart Edwards (SE).

A week to go until the referendum; Mark, how likely do you think that there will be a vote to leave?

MB. Well, the polls, if they are anything to go by, have started to indicate in the last few days that it's more likely as an outcome than it was a few months ago. Back then, polls were indicating a vote to stay in was the most likely outcome. So there has been some movement in the polls. So if you believe that the polls are to be judged as a predictor of what's going to happen in the referendum, then actually it is certainly more likely than it has been at any time in the run up to this vote.

Although presumably as a dispassionate observer, investor, you have to work on the basis that either vote is possible.

MB. Well every outcome has to be thought through and considered equally because, with a referendum, the vote – obviously – the outcome is uncertain.

Stuart, turning to you, we've seen a slowdown in the UK economy in recent quarters. How much of that is due to Brexit concerns?

SE. I think it's difficult to say for sure. What we can say is that the UK economy grew strongly in 2014 and it was already slower in 2015. So that trend, I think, was already in place. I think what we probably can say on recent evidence, when we look at purchasing manager surveys, is that they do tend to suggest there's been an acceleration in that slowdown, particularly since the start of the year. Some of that might be to do with more general market volatility – concerns about China, for example. But I think it's fair to say that at least a part of it is to do with uncertainty ahead of the referendum; and it's not a stretch to think that business investment decisions and hiring decisions will at least slow, or it will have some impact on those decisions.

Mark, are you as worried as Mark Carney at the Bank of England is about economic risks if there is a vote to leave?

MB. Well I think we have to try and understand that – or to couch the answer in a short-term, long-term scenario because in the short term I tend to agree with Stuart that there's likely to be an economic pause or some kind of interruption, economically, as a result of a Brexit outcome, simply because it creates a level of uncertainty which we haven't seen for a long time. And certainly we haven't seen this kind of referendum ever before. So in a sense we're in uncharted waters and it would not be a surprise if consumers delay some large purchases, if companies delay hiring, or foreign direct investment slows down.

So in the short term I think that I do agree with Carney when he says this. In the longer term actually I think the UK economy can cope with whatever outcome we're presented with because I think we have a dynamic economy. We have an economy which has adapted to change before and will adapt to whatever change is thrown at us. And I think I would actually be quite optimistic that the UK in the long term could cope with whatever outcome. So it wouldn't necessarily be as negative for the long term.

So we don't necessarily have to anticipate an Armageddon situation, if I can put it like that?

MB. No, I don't think so.

What about the companies in whom you invest in, to whom you've been speaking; what are you hearing from them?

MB. Like us, they're in a position of not knowing the outcome. They have to plan on the basis of: either we remain, in which case the world will carry on broadly as it is; or we leave, in which case they have to think about plan B and depending on where their businesses are located and the kinds of regulation and red tape that they might be subject to as a result of the change. They have to think about adjusting business models accordingly.

But again, the best businesses will be able to cope with this kind of change. I anticipate that these challenges are not insurmountable and we quiz companies that we're invested in on the basis that they can – from what we know today – that they can make an assessment of what the future's going to look like.

Jonathan, can I just turn to you on that? You could argue that smaller companies – smaller cap companies; the kind of companies in which you're investing – are slightly more exposed because of their smaller scale. What are you hearing from them about the possibility of the referendum voting out?

JB. Well I think that's fair. I think they are more exposed than some of the more international large caps. We've been asking companies for the last year what the implications of an exit would be for their business and inevitably we've had a range of responses. So at the more positive end, companies think it would be mildly disruptive to their customer bases – would create an environment of uncertainty, but certainly have some short-term impacts: may increase the level of bureaucracy when it comes to trading with continental Europe.

At the more negative end, some companies believe it would cause significant disruption within their industry. We haven't met a single company – and we've met well in excess of 100 companies in that period – that think an exit would be a positive thing for business. But by the same token, most of them believe that it wouldn't be the end of the world; they could trade through it and after a period of uncertainty the environment would settle down and life would go on.

Turning from equities to currencies, Stuart, sterling has been weak over the past nine months and as we speak with less than a week to go before the vote it's taking a bit of a hit at the moment. How much do you think this is a result of the referendum?

SE. It's a bit like the impact on the economic data: it's quite difficult to really pin down with any kind of certainty. What you can say is the most visible impact on the markets has been on sterling. In a sense it's been the clearest representation of referendum risk in the markets. The Trade Weighted Index has depreciated about 10/11% since last November – much of that has been against the euro. And there have been quite a few

studies, including the study from the Bank of England that think that about half of that move is down to pre referendum uncertainty. I think that's probably a fair estimate.

I suppose the question is whether this is a reflexive response or whether it's going to continue. Some commentators are talking about sterling falling dramatically if we vote to leave. And if it were, would that create – looking at the positive side – a buying opportunity for the currency, long term?

SE. Well I think the people that are the most alarmist about the currency point to the current account deficit in the UK. The current account deficit is about 7%. The UK has one of the worst current account deficits – certainly in developed markets, if not more generally. And that needs to be financed. And as Mark Carney has pointed out, the UK is reliant of the kindness of strangers.

That said, I agree with the comments of the other panellists that it's not going to be a disaster. There will be a reaction in the currency markets. If you think that the polls are currently quite balanced, it's not a stretch to think that sterling could fall further, perhaps by 5% or so in the near term. That's quite reasonable: if you think the 5% fall to date has been to do with the referendum – the build up of the referendum, then if we do get a Brexit vote then a further 5% is quite possible. But I wouldn't call that dramatic. I think the prospects for the currency beyond the referendum will depend on several things, including the political landscape and how that shapes up. We can see it's very divisive at the moment.

But I think all political players will have to coalesce around some kind of view to stabilise sentiment. And if that's the case, I don't think the fall will be that dramatic.

Whether it's a long term buying opportunity – again, we're going to have to see what the post referendum picture or landscape is like. But what I would point out is – going back to the comments you made earlier – the UK was already in a process of slowing down whereas the US is on a slow gradual path towards higher rates.

There might be a buying opportunity if the fall is dramatic, but in terms of a long term buying opportunity, I think we've really got to see how the situation shapes up if there is an exit vote.

Speculating the other way: supposing the vote goes with remain, what will happen to the currency?

SE. Well, of course, that's the flip side. It's an obvious point to make: if the currency has fallen by 5% because of Brexit uncertainty, then it's reasonable to think that sterling will have a pop higher. There is a small risk of further rate cuts currently priced in to the money markets, and it's not unreasonable to think that, if there is a remain vote and sentiment stabilises, then that could be priced out, and because of the relationships, sterling could rise a bit. But that in itself could present a selling opportunity.

Mike, what impact would a weaker sterling have on inflation and monetary policy?

MM. Well, I think the weakness we've already seen, combined with further weakness, will probably raise the pressure on inflation. Will it have an impact on monetary policy? I think not. I think the MPC, like they have done in the past, will just see it as transitory and will just look completely through it. I think it is more likely the MPC will focus on the impact, if forecasters are right, on a weak economy and what they can do to support growth rather than trying to fight inflation. I think there probably is an expectation that the MPC are more likely to be looking at easing policy, given it will be difficult to do too much with fiscal policy, given Osborne's aim to balance the budget is going to be even harder with a weaker economy, and probably politics will be in limbo for a while.

So, I think our expectation is that the MPC will probably give it a bit of time, to see what the data does, to see what markets do, but they seem to be reluctant to go down the route of negative interest rates. So, if more stimulus is required, we might go down the route of a small rate cut and probably then expand QE. When you think back to 2011, we had high levels of inflation then, because of the VAT rise, and high commodity prices. It seems like a long time ago now but, at the time, we had inflation of 3%, 4%, but the MPC expanded QE because the economy was weakening, and that's probably our expectation of a Brexit outcome.

Stuart, how has the referendum impacted non-UK financial markets so far?

SE. Certainly in the last few days, as the polls have started to lean closer toward exit there has been an element of risk-off in the wider financial markets. I think the Standard & Poor's index, until recently, was close to a fresh high, and its fallen 2%, so it's nothing, really, in the context of wider moves. The fact that it rallied 16-17% since February, I really think its noise more than anything.

I'd say, probably in some other markets, the impact on their business around the referendum is perhaps more visible in the peripheral – the eurozone peripheral government-bond markets, for example. Portuguese bonds, Italian bonds and Spanish bonds have weakened versus what we call the core – so, for example, German government bonds – over recent days. Not significantly and certainly not anywhere near the nervousness that surrounded the eurozone crisis, but there is some visible element of nervousness. And in the currency markets as well, obviously we've talked about sterling but the yen has done quite well recently, and that is often seen as the go-to, safe-haven currency of choice. So, there is some element of nervousness over recent days, for sure.

Mark, so far as equity markets are concerned, what's been the impact of the referendum outside of the UK?

MB. Limited, I would say. Obviously, markets are correlated but the UK has probably, in recent days, been weaker as a result of some of the recent polls that we've seen and an increased nervousness about a Brexit outcome. Perhaps a little bit in the eurozone more than anywhere else. Echoing Stuart's comments, the European Central Bank and the EU authorities will be nervous about some kind of domino effect as a result of a Brexit outcome, and they will be worried about some of the other peripheral countries, concerns about knock-on effects there. That may have already started to be reflected, to a certain extent, in equity prices, but the key impact has been within the UK.

Aside from the referendum, there are other things which have been happening in the world, so, presumably, they are influencing markets as much or more?

MB. Yes, absolutely, there's been a huge impact from discussions around US interest-rate policy, around the direction of the dollar; commodity prices and, obviously, a rise in the oil price may have started to have an impact in certain areas as well, so back up to $50 on the oil price. So, there's quite a lot of other areas of concerns that might be drifting into share prices outside the Brexit issues.

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SE. We have the US election as well, of course. And we also have the Spanish election, two days after the EU referendum.

Mike, Gilt and sterling credit markets: how have they been performing in the run-up to the referendum?

MM. Well, it's probably not going to surprise anyone that Gilt markets and government-bond markets generally have been doing very well. Every day we're seeing record lows in yields in the Gilt market and in most government-bond markets. In many cases, we've got negative yields. I think it's hard – a bit like currency markets, and a bit like Mark said, I think it's hard to pin too much of that down to Brexit. I think the fact that you have central banks that are operating a QE policy and buying government bonds, and the fact you've got negative interest rates in many parts of the world. I think these have been bigger drivers in forcing down Gilt yields and US Treasury yields, more than Brexit fears have been.

Credit markets have underperformed government markets to a certain extent. Obviously, we had weakness in February, when we had the whole risk-off equity credit market. We've got back some of those losses. I think, in terms of performance, I think the Gilt market's up about 8% year to date – not bad for something that yields you slightly more than 1%, so it's been all capital gains. Credit markets are up about 2-6%.

Supposing there is a vote to leave, how do you think that will impact sterling credit markets, and are you doing anything in the portfolios to reflect that possibility?

MM. Well, I think what we've learnt from this week, if we didn't know it before, is it's not going to be just a UK phenomenon. We've seen contagion very quickly spread to all risk assets, as we've seen big falls in equity markets, flight to quality in government bonds. I think maybe when we come in on Friday the 24th, the first discussion is going to be about what it means for UK domestically focused companies – Jonathan's companies; what it means for more economically sensitive companies, like the banks. Probably they'll be the first ones to get hit but I think, given the significance of what a Brexit vote will mean, and the high degree of uncertainty, I think there'll pretty quickly be contagion to the rest of the risk markets.

In terms of what it means for the credit markets, I think if there's a flight to quality, a rally in government-bond markets will probably offset some of the negative impacts on credit markets. I don't think you can take that for a certainty, given how low yields already are, but you may get some benefit from that. Personally, I think, if there is a Brexit outcome, I think the moves could be significant. I think it's highly uncertain what a Brexit vote means. I think markets are very illiquid, even on very good days, and economies, as already discussed, are already pretty fragile. I think, if you just add the three together, I think there's a chance that we end up with a significant negative outcome for risk markets.

In terms of the portfolio, we haven't made any significant changes, really, to position for a Brexit outcome. Firstly, I think our base case is still that remain will win the vote. Clearly, as Mark mentioned, the polls are challenging that view in the last few days. I think, secondly, to position to a more defensive portfolio would involve us selling assets that are yielding 3%, 4%, 5%, 6%, that we like, and buying a government-bond market that we think has next to no value, yielding nothing.

And, thirdly, and something we should have all learnt, is there probably will be a policy response if markets and economies weaken on the back of a Brexit. We've already got the ECB operating a corporate-bond purchase programme, which should mitigate some of the weakness. And who knows what other central banks will do if markets and economies weaken?

Mark, what do you think Brexit would mean to UK equity markets? We'll come also to the question of what would a remain vote mean by contrast?

MB. I think the initial reaction will be a negative one in the equity market. I think the key instrument to watch, as we've already mentioned, will be the currency. And that will determine quite a lot of the other moves as a result. I think, though, the initial sentiment will be negative – and that will take the market down. The question is how much, because we have seen quite a lot of weakness in the last few days already. I suspect some of that is priced in, but there will, I think, be a knee-jerk reaction.

Now, the countervailing forces, if there's a knee-jerk fall in currency of 5-10%, actually, UK equities and particularly large-cap UK equities, which have predominantly overseas earnings, may not actually be negatively impacted, because you have a tailwind of currency translation coming through at that point. We've spoken to a number of companies already. If you're in the pharmaceutical sector, the oil sector or tobacco, which is obviously important for our portfolio, as these are, many of these companies have got large earnings outside the UK. So you get tailwind benefits as a result of the weakness of sterling, and that would apply to the large caps.

Now, the question is, if we do see a fall initially, will that then, over the following few days, be followed up by a rally in the markets as people watch the dust settle and try and think through the implications of a weaker sterling?

Jonathan, you say the small-cap companies with whom you deal appear in the main – most or all of them – to be more anxious about the possibility of Brexit, but if there is a remain vote, do you think there will be, contrary-wise, a very positive response?

JB. Yes, I think there's no doubt that we would have a significant market rally in the event of a remain vote. In truth, we haven't seen that much of a market reaction so far. If you look at the UK market generally versus the other major international markets, it's performed reasonably well. Again, if you look at small and mid cap so far, year to date, it's outperformed the FTSE All-Share. I don't think there's an awful lot priced in to small and mid caps in the event of a Brexit vote, but the removal of the uncertainty would certainly be a positive.

In the event that we have a vote to leave – day one will be bad. There's no doubt about that. There will be significant market falls. And it will centre on the companies you'd expect, the domestic UK cyclical businesses: sectors such as real estate, retail, travel, leisure, house-builders and related industries I think could suffer significantly in the short term. Now, that may throw up some buying opportunities, I think particularly if you look at something like the house-building sector. I think, in the event of a Brexit vote, the chances of interest rates going up any time soon is very remote, so the cost of mortgages for individuals will remain attractive. The government stimulus programmes, the help-to-buy programme, will be still in place. You may, in reality,

on a six-month to one-year view, see a reasonable outcome for some of these businesses.

So, it's not all bad: there will be opportunities. But an awful lot hinges on the outcome of the vote in the short term for small- and mid-cap markets.

And presumably there's no way you can protect yourself against either possibility, because if you vote for one you're voting against the other?

JB. Yes, it would be a binary bet on the market, and that's not the way I look to invest. I don't think that's what my investors expect me to do with their money. We have, very much, a view on the long term. We look at things that could be substantially bigger in five years rather than worrying about what's going to happen immediately.

MB. I think Jonathan's right. We don't manage money on a three-month view or a six-month view. We try to act for the long term. Similarly, in terms of the investment decisions we're making, we don't want to be reacting to the events as they emerge or the day after they emerge. We don't want to be making snap investment judgements.

There's quite a lot of uncertainty around. That may create opportunities, as Jonathan said, but I think we'll have to wait to see some of the dust settle before we move portfolios one way or the other, because it's not going to be clear, if we do vote for Brexit, it's not going to be clear how long that negotiation is going to take, what the form is going to be, how some of the moving parts will look like and, ultimately, what the outcome for our exit will look like.

So I would urge investors to recognise that we're trying to make considered judgments on the basis of the facts as they emerge and how that might impact our investment opportunities.

In effect, you've made no adjustment of any sort at this stage to your portfolio?

MB. No

Are there any areas of the equity market which have been impacted in the run-up to the referendum and do you have a sense of which sectors generally might be more vulnerable?

MB. Well, there have certainly been some opportunities cropping up in some domestic sectors that Jon referred to. Real estate is one that I'm exposed to. I've had a little bit in some of the positions and some falling share prices. Similarly, there are one or two domestic areas that I have been following a bit more closely as a result of share-price falls. And, to be fair, some of the weakness is probably attributable to the fact the economy has stated to perform a bit more slowly than we've seen in recent years. Is it Brexit-related or is it underlying economic weakness related? It's difficult to distinguish the two.

But some of those areas have started to pop up which look potentially a bit more interesting for investment: one or two retailers, one or two leisure companies.

As a final question, Mark, what is the overriding message that you would like listeners, your clients, to take away from this discussion?

MB. Well, I think that we are trying to think through eventualities on both outcomes. We're certainly not panicking over or making any rash judgments over one outcome versus the other. And I go back to the point about trying to skew the portfolios to reflect a binary vote, which is certainly not in our clients' interests. And we won't change in terms of the methodology that we've put in place for many, many years in terms of how we put portfolios together, what we're doing to analyse businesses and to understand and respond to opportunities. We will consider the outcome in light of the facts as they emerge and we'll make adjustments accordingly – and we'll try to act in the best long-term interests of our clients.

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