Brexit Is a Reality — Now What?

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With the U.K.'s exit from the European Union — the Brexit — now a reality, there is a great level of uncertainty among investors as they try to discern what this means to their financial plans.

After months of speculation, the U.K.'s decision to leave the European Union sent shockwaves through global markets on Friday, with initial reactions to the "Brexit" exhibiting a high degree of uncertainty surrounding the consequences of the U.K.'s controversial decision. While everyone from individual investors to institutional money managers are craving answers as to what this means for the global economy and its impact on stocks and bonds, it is too early to have much certainty on many of the questions that have arisen. One factor clouding our view of the big picture is that actual economic fundamentals take a backseat to consumer behavior and investor expectations as key drivers of developed world economies. While the initial response has been negative, it will take some time to gauge the long-term response.

Below is a list of the things we know and the things we are waiting to find out.

Market Reaction

As indicated above, global equity markets have reacted very negatively to the news of Brexit, resulting in large drops in equity prices across the globe. The move, however, is tied more to uncertainty than to actual fundamental changes in global economies, but the 7.5-percent* plunge of the British pound versus the U.S. dollar is certainly a measurable reality that will hurt some and benefit others. In the U.S., the initial market impact has hurt cyclical areas like consumer discretionary, financials and basic materials and has had less of an impact on defensive sectors like utilities, real estate and healthcare. The good news is that these types of violent moves typically lead to opportunities for investors with long-term views. The bad news is that, in order to harvest these opportunities, some short-term pain must be realized.

Central Bank Reactions

The European Central Bank (ECB) has released a statement that it is closely monitoring financial markets and is in close contact with other central banks as well as the private sector, and it will provide additional liquidity, if needed, for the euro and other foreign currencies. Similar statements have been made by other central banks.

It's expected that the Bank of England will provide a package of policy-easing measures, including credit easing and a rate cut, to reduce the potential negative impact on the U.K. economy.

Consequences for the U.K.

The Brexit vote had a 72-percent voter participation rate, the highest of any major election in the U.K. since 1992. Scotland and Northern Ireland had strong desires to stay (62 percent and 56 percent, respectively, voted to stay), but the U.K. and Wales wanted to leave (53 percent and 52 percent, respectively, voted to leave). In London, however, 60 percent of voters desired to remain in the EU, as concerns about London's ability to maintain its position as one of the world's leading financial centers continues to weigh heavily. It's believed that, in the light of the current migration wave into the EU, the inability for an EU member to control its borders independently of the European Union could have ultimately swung the vote in favor of a Brexit.

As a consequence of the vote, British Prime Minister David Cameron has resigned, and a successor will be in place by October. The next leader is likely to be a euro skeptic, which may complicate the negotiations that are about to take place between the U.K. and its trading partners over the next two years. (Article 50 of the Treaty of Lisbon provides EU member nations a two-year window to exit the union.) The EU is expected to take a relatively hard stance based on the U.K.'s more urgent need for settling agreements and to discourage other member countries from leaving.

We expect a relatively high degree of volatility to remain in place — particularly in European markets — during these negotiations, as the economic consequences of the Brexit will remain uncertain until the negotiations are complete. It is likely, however, that the economic uncertainty will prolong the period of low corporate investment we have seen leading up to the vote, both within the U.K. and in the form of foreign direct investment into the U.K., which will dampen GDP growth in the U.K.

Consequences for the Global Economy

The U.K. makes up 2 percent of global GDP, so the direct impact of the Brexit is limited. The indirect consequence, however, is difficult to measure, but the Brexit is more fuel on the fire of populist movements around Europe, which could lead to further economic uncertainty. Leaders in Scotland have already indicated a desire for a referendum to leave the U.K. in order to stay in the EU. This uncertainty, though, is not expected to have a lasting impact on the global economy, as there is no reason to believe that the U.K. or any current member of the European Union will isolate itself from global trade, whether or not it remains in the EU. It's likely, however, that the uncertainty, as is expected to be the case in the U.K., will restrain corporate investments in the EU and, thereby, provide a headwind for economic growth.

What Now?

1st Global will continue to monitor the situation closely, but we do not expect to make any changes to current portfolio compositions as a result of the Brexit. We do, however, expect to see minor changes in the active mutual funds that make up our portfolios as fund managers readjust portfolio exposure and attempt to take advantage of the dislocations in global equities. Our advice to our clients is to stay on course but to expect higher degrees of volatility for the immediate future.

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About the Author

Jesper Rindboel, CFA, FRM — Portfolio Manager

Jesper joined 1st Global in January 2015 as a senior investment analyst to help support and increase the adoption of Investment Management Solutions (IMS) platform solutions. In his role as a portfolio manager, he continues to support the ongoing adoption and retention of assets of the IMS platform through three broad job functions: due diligence, portfolio management and reporting. In addition, Jesper works with the Investment Committee to provide educational support to advisors and internal staff.

Prior to working at 1st Global, Jesper spent time at First Command working with its Wealth Management Consulting group and Investment Management team. Jesper received his Bachelor of Science in business administration and a Master of Science in finance and accounting from Copenhagen Business School at the University of Copenhagen. He is a Chartered Financial Analyst® charterholder and a Certified FRM.

About the Investment Management Research Group

The The 1st Global Investment Management Research Group (IMRG) is a team of tenured investment professionals that operates under the oversight of the 1st Global Investment Committee and is tasked with finding “best-in-class” investment managers and products for use across the IMS Select Strategies as well as other IMS programs. The team’s primary responsibilities include portfolio construction and investment manager due diligence, monitoring and selection. The team brings years of experience and investment knowledge to help guide clients with asset class allocation and individual fund selection, which are all aimed at providing optimal risk-adjusted returns within each risk category.