BREXIT: SHORT AND LONG TERM IMPLICATIONS

The people of the United Kingdom have voted to leave the European Union (EU). As the political process unfolds, we anticipate the short term impact to the financial markets will be a period of uncertainty and volatility over the coming weeks and months.

The result of yesterday's Brexit referendum showed 51.9% of voters want the U.K. to leave the EU, compared with 48.1% who preferred to stay. The decision for a "Brexit" would see the country leave a union that it has been a part of since 1973. The polls (and the book makers) had indicated that the voting would be close, with a consensus that the result would be to "Remain". This trend was priced in the stock, bond and currency markets which rallied strongly on Thursday. As such, we at Clearbrook believe that there may well be considerable short-term volatility in light of this unexpected outcome.

We believe, in the near term, markets will be fixated on the following issues:

ARTICLE 50 OF THE TREATY ON THE EUROPEAN UNION

Will 'out be out'? Uncertainty will continue with the possibility of a further referendum. The actual exit process will not start until Article 50 of the Treaty on European Union is triggered. The Prime Minister will need to notify the European Council of the U.K.'s decision to withdraw, as called for under Article 50 of the Lisbon Treaty, the international agreement that underpins the EU. From this point, the U.K. will not be able to take part in EU decision making.

Once that declaration has been made, talks will begin between the British government and the European Commission to define the U.K.'s new relationship with the EU. These talks will likely cover issues such as access to the single market, immigration, and agricultural policy, and there is a two-year time limit for completing them.

CENTRAL BANK REACTION

The ECB's response to Brexit will depend on the extent of its impact on growth and inflation, as well as the extent to which the resulting financial market stress will impact spending and increased sovereign and bank funding costs. Expectations are for the ECB to quickly communicate its commitment to ensure price stability in the EU, which would require a commitment to the integrity of the region. At first, we would expect more easing on rates and an expansion of the ECB's balance sheet. Market forecasts already are expecting further easing in September, in terms of an extension of the current asset purchase program through end-2017 (an increase in asset purchases worth €720bn). There may be additional easing involving a 10bp cut in the deposit rate (to -50bp) and a further extension of asset purchases into 2018.

POTENTIAL IMPACT ON GLOBAL MARKETS:

EQUITIES

Global equities have weakened sharply on the futures market and continued uncertainty will likely depress multiples and valuations. It will be important to differentiate between stocks that could be affected by largely short cyclical factors, and companies, such as banks, which may be affected more structurally particularly in the UK. The market will sell off indiscriminately at first. Afterwards, active investment managers who are stock pickers will see this as a longer-term buying opportunity.

At the sector level, Financials and Discretionary appear to have the biggest near term downside, given their recent rebound. Both underperformed during the early June correction as well. On the other side, low beta sectors such as Consumer Staples, Pharma and Utilities in particular may outperform. The key medium-term strategy remains to be over-weight low beta and defensive sectors, as bond yields will likely move lower. In addition, EM equities are looking cheap in the long term as the likelihood of the Fed staying dovish for longer is a positive.

FIXED INCOME

In the Fixed Income Markets our concern is that the short and medium implications of the UK vote will linger for a while: spreads will remain wider for riskier bonds compared to higher credit quality bonds, but will be biased towards slightly tighter over the medium term. A "Leave" vote is a necessary but not sufficient condition to change our view that global interest rates are at historical lows, and eventually rates will rise and bond prices decline albeit at a slower pace. The realization of other political risks such as the U.S. Presidential election, along with the potential for a significant slowdown in the Euro area economy will likely favor lower rates particularly for development market sovereign debt. Over time, any sell-off in riskier parts of the credit market, such as high yield debt, may present an opportunity to add yield as well as upside potential.

SUMMARY: NO CHANGE TO CURRENT PORTFOLIO ALLOCATIONS

We believe that the majority of investors have been cautiously positioned, given global growth concerns and geo-political risks. The Brexit vote ends the referendum's related uncertainty, though there will be issues regarding UK and EU assets in particular over the next several months. The prevailing global risks will put financial markets in a less comfortable position in light of the recent macroeconomic stability and dovish rate stance from the US Federal Reserve. Short term, defensive assets such as sovereign bonds will rally strongly, while risk assets will be negatively impacted. However, as we have seen over many market cycles over many decades, markets tend to adjust rapidly and often over-react. We believe investors will be better served by not reacting to the outcome of the referendum, as markets are currently being driven by psychology and sentiment, and we are not advising any changes to client portfolio allocations as a result of Brexit. Should the down-turn continue we may see buying opportunities, particularly in EM and High Yield. Over the longer term, we believe economic and corporate fundamentals will present long term value opportunities, and drive market and asset valuations.