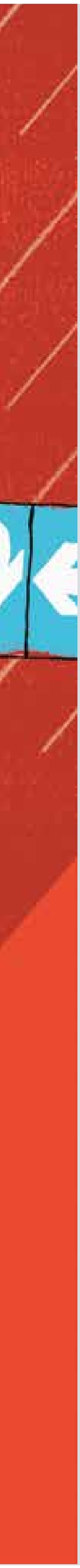
Talking point



## "The only certainty is uncertainty"

# THE AFTERMATH OF THE VOTE

The EU referendum result will be remembered as one of those defining moments in the history of the United Kingdom. In the immediate aftermath of the vote, the UK was beset by a feeling of uncertainty: over its future relationship with the EU, the economic consequences of withdrawal, the domestic political consequences, the implications for the EU itself, and, of course, the outlook for financial markets.

### AN OVERVIEW

## Janet Mui, Global Economist, Cazenove Capital

A vote for Brexit was, we were warned, akin to a vote for recession. However, this is not what the stock market indices are telling us: both the FTSE 100 and the FTSE 250 are well above pre-Brexit levels at the time of writing. Meanwhile, activity on the high street did not collapse and remained resilient, seemingly discrediting the dire assessments of the implications of a post-referendum slump in consumer confidence. Although the (early) post-Brexit signs are positive so far, we are cognisant that the impact will take time to show and we will closely monitor how hard data evolves over the remainder of year.

Despite the strong rebound in risk assets and resilient economic data so far, we should not be complacent as financial markets can quickly reverse. The only certainty is that there will remain a lot of uncertainty on the financial, economic and political fronts, until there is clarity on the UK's eventual relationship with the EU. Financial markets dislike uncertainty and as such risk premias and volatility may persist. On the positive side, this may lead to opportunities for longer-term investors.

Looking ahead, we are pleased to have experienced experts across Cazenove Capital and Schroders to share their views on the market outlook.

### EQUITIES AND PORTFOLIO STRATEGY

## Kieron Launder, Head of Investment Strategy, Cazenove Capital

The 'before, during and after' periods of the Brexit vote reminded investors of some key investment tenets in terms of market behaviour. The 'no' vote had been forecasted by polls and resulted in currencies (sterling in particular), appreciating in the immediate run up to the referendum. Given the binomial outcome of the referendum, markets were always likely to see some post-result movement, however given the conviction, and more importantly positioning of the market towards a 'no' vote, the unexpected result led to some sizeable moves. This is a clear reminder that initial investor sentiment and positioning can have a significant bearing on the ultimate performance of investments. ▶

During the following days after the Brexit decision, we saw some considerable movement in sterling, equities and fixed income, some of which was logical and predictable, and others that did not appear to be at first. With the only short-term certainty being uncertainty it is not surprising that sterling depreciated, losing almost 12% in the first two days (after which it oscillated but stayed around the same level).

This immediate correction was also exhibited in UK equities with the FTSE 100 falling almost 6% over the same two days, until more rational investors interpreted the double-digit fall in sterling as being very positive for companies' overseas earnings, which account for about 70% of the total. As such the FTSE 100 rallied strongly, rising above the pre-Brexit level within the subsequent two days before rising further still. For investors, understanding the true return drivers of investments is critical, as is building more multi-dimensional diversification into portfolios (for example not just the top-down allocation to fixed income, equity and alternatives). Many UK investors have been very pleasantly surprised by the benefit of having international exposure, (both direct and indirect) in their portfolios.


## "Markets were always likely to see some post-result movement"

In the subsequent days after Brexit, there was a huge increase of volatility in equity markets, and significant dispersion of sectors and styles leading to potential opportunities that normally accompany volatility. However, due to the surprise outcome and existing investor positioning, the explosive reaction led not only to over-reaction, but also illogical sell-offs where broad indiscriminate selling punished companies that should have been less affected.

Defensive stock became even more expensive and cyclical stocks and financial companies were immediately punished, although most of this has subsequently unwound. The more domestically-oriented medium and small company indices suffered significantly and whilst they have lagged compared to the large-cap companies, year-to-date they are still positive for the year and more recently have been catching up. We should remember that volatility, for longer-term investors, provides potential opportunity as not everything is treated equally or logically.

### FIXED INCOME

## Alex Smitten, Head of Fixed Income, Cazenove Capital

Large market movements occurred in the immediate aftermath of the vote. Firstly, as Kieron mentioned, sterling depreciated by around 12% against the US dollar, as investors discounted potential capital outflows and a likely easing in monetary policy to support an expected weaker growth outlook. Secondly, gilt yields fell sharply to reflect the likely lower path of interest rates. Finally, corporate bond risk premia rose as investors shied away from more risky assets. So far, so sensible.

The interesting thing about the corporate bond market (and other risk markets) was just how short lived the sell-off was. It essentially lasted a week, and within three weeks it was back to where it was. Not for the first time, markets were reacting to changing expectations of central bank policy. The European Central Bank (ECB) had just started buying euro denominated corporate bonds, and the Bank of England (BoE) had injected liquidity into the banking system and hinted strongly at easier monetary policy to come. It delivered in August with a cut in bank rate and another round of gilt and corporate bond purchases. Furthermore, the Federal Reserve (the Fed) had appeared to be shying away from tightening monetary policy and this prompted another wide scale hunt for yield. This has been a powerful driver of asset markets for the last few years as central banks have pushed official interest rates and government bond yields ever lower.

We now find ourselves in a position where the absolute yields of most developed world bonds are exceptionally low and offer increasingly less buffer against rising yields or risk premia. Indeed 38% of developed world government bond markets yield below zero. Even companies have been able to issue bonds with a negative yield in some currencies. Legendary bond investor Bill Gross goes as far as saying that "negative yielding bonds should be viewed as liabilities not assets"!

To illustrate why this situation is potentially so dangerous for investors, consider that since starting to writing this article 24 hours ago, the yield on 50 year gilts has risen from 1.18% to 1.37%. If that does ▶

not sound like much of a move, consider that the bond's price fell nearly 6% or equivalent to five years of income! In other words, with such low levels of yield, the balance of risk and return has shifted dramatically against the buyer. As investors have tried to mitigate this they have been tempted into longer maturities and more risky bonds (for example, emerging markets) than perhaps they would normally consider appropriate. We should be prepared for some more volatile times ahead particularly if central banks signal that they have reached the end of the quantitative easing road.

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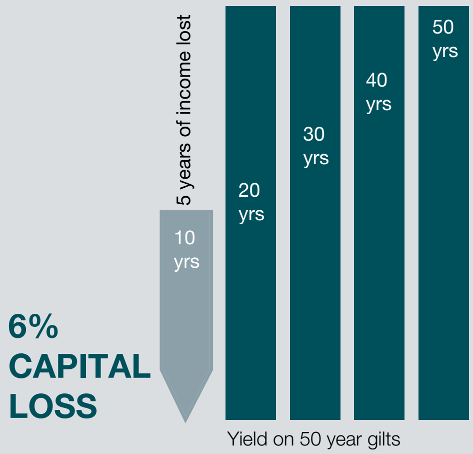


SOURCE: BLOOMBERG.

**REAL ESTATE**

## Tom Dorey, Head of Real Estate Product, UK, Schroders

The knee-jerk reaction of investors in daily dealing commercial property funds was to rush to the exit in the days following the referendum. The subsequent fund suspensions, coupled with sharp pricing changes have called into question the suitability of these vehicles for property investment.

The actions of retail investors have contrasted sharply with institutional investors who have remained unmoved. Why is this and what are the options? ▶

Commercial property should be considered as a strategic investment whose returns are driven primarily by income and income growth. Institutions with a medium-to-long-term time horizon (a group that includes families), understand that the cost of buying and selling real estate is high and that the benefits of owning it are best obtained through buying and holding. While the outlook for the UK economy is uncertain, with gilt and cash yields at record low levels, the average rental yield of UK commercial real estate of 5% looks a compelling entry point, rather than a reason to exit. Anecdotally we have continued to see good interest from retail, office and industrial occupiers over the summer, including the giant office letting we completed on behalf of Schroder UK Real Estate Fund to HM Revenue & Customs in Croydon. Long-term investors know that sustainable rental income is the key to good long-term returns – and on the evidence to date it is business as usual.

So for real estate investors with a need for genuine liquidity, there are two main options. The first is listed property investment trusts. These are structured as companies that invest directly into UK or European real estate. Due to investment trusts being listed on the London Stock Exchange, their shares are tradable daily and are not subject to fund suspensions. The second is an extension of this: investment into a portfolio of listed real estate investment trusts and other real estate securities, typically globally. Mutual funds with this objective provide both diversification and liquidity. d

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