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Brexit
THE UK'S VOTE TO LEAVE THE EU: WHAT HAPPENS NOW?

KEY POINTS

- Markets worldwide are bracing themselves for a sustained period of volatility after the UK voted to leave the EU in yesterday's referendum.
- British assets will be hardest hit in the coming days, but the impact of this historic vote will be felt all over the world as the EU and UK begin what could be messy and fractious proceedings.
- The UK now faces a huge challenge in not only completing the complicated process of separating from the EU, but also in negotiating new trading agreements—with both the EU itself and the UK's other partners across the world.
- However, the turbulence of the period ahead could also create significant opportunities for bottom-up, fundamental investors.

Markets worldwide are bracing themselves for a sustained period of volatility after the UK voted to leave the EU in yesterday's referendum. British assets will be hardest hit in the coming days, but the impact of this historic vote will be felt all over the world as the EU and UK begin what could be messy and fractious proceedings. However, the turbulence could also create significant opportunities for bottom-up, fundamental investors.

MARKET TURBULENCE TO BE WIDELY FELT

Britain voted 51.9% to 48.1% in favor of leaving the EU, of which it has been a member since 1973. As the outcome of the vote became increasingly clear overnight, the pound fell to its lowest point against the dollar since 1985. Markets were only beginning to get to grips with the result early on Friday morning, but rating agency S&P has already confirmed that the UK is likely to lose its final AAA credit rating. In early trading, the 10-year US Treasury yield fell to below 1.5%, the lowest level since 2012.[1] Quentin Fitzsimmons, a portfolio manager in T. Rowe Price's fixed income team, believes that sterling—the UK's most liquid financial asset—is likely to be the biggest victim in the short term. "Sterling is highly vulnerable as UK business confidence is

[1]Sources: FactSet and Thomson Reuters.

likely to fall and the country already has a large current account deficit," he says. "We added some modest hedging positions on sterling ahead of the vote but did not take a major bet on the outcome. However, we may look to add to these now."

But fears that the pound could move toward parity with the U.S. dollar are unfounded, according to Fitzsimmons. "Sterling is a reserve currency, is widely traded, and is a store of value," he says. "When it falls to a certain point, there will be buyers, and that will prompt a correction. It will certainly weaken, but fears that it will tumble endlessly down are unfounded. However, the prospects of a cut to UK interest rates have risen as a result of the vote to leave."

Dean Tenerelli, portfolio manager for European equities, warns: "There will be a protracted period of uncertainty—not only in UK and European financial markets, but also globally. Markets do not like uncertainty. The UK is the first member to leave the EU, so there is no template to follow. There are so many variables that it is hard to predict the economic impact with any level of conviction, but I anticipate a deterioration of the UK growth outlook."

UK financial services firms are likely to be hardest hit by the vote because the decline in the pound will likely prompt investors to hedge their risks by taking money out of the country. David Stanley, portfolio manager for European investment-grade bonds, says: "Spreads on UK banks were widening before the vote—and they're going to widen even further now. But anything that is perceived as risky will also be hit—most UK and European assets will be marked down. Sterling-denominated corporates, as well as those issued by UK companies denominated in other currencies, will weaken."

Mike Della Vedova, portfolio manager for European high yield bonds, adds: "Capital markets will become more inward-looking. Overseas investors will be less likely to invest in UK corporates, making it harder for those companies to raise debt. UK companies' access to global capital is likely to be reduced, meaning they'll have to raise more from the UK market."

OPPORTUNITIES AND CHALLENGES FOR FUNDAMENTAL INVESTORS

The key to successfully navigating the difficult period ahead will be the ability to identify the sectors and individual companies that will be hit hardest by Britain leaving the EU—and those who may ultimately benefit from it. Ben Griffiths, portfolio manager for European small-cap equities, says: "We were overweight the UK in the lead-up to the referendum, but now that we're entering uncharted territory, we will consider reducing our UK exposure, particularly in more domestically focused areas like housing and consumer stocks. We're already underweight financials and will be reviewing our remaining holdings on a case-by-case basis to determine how much of their business comes from Europe, whether these channels will remain open to them, and the potential cost of any regulatory changes.

"In truth, given the lack of clarity on what the post-Brexit environment will look like, market volatility is likely to be broad-based in the short term," Griffiths says. However, even in this environment, there will still be quality companies to be found that are relatively immune to a downturn—those with innovative technologies, leading players in niche markets, or those with dominant products or brands.

In the near term, investors will likely benefit from holding companies that operate across different regions, says Tenerelli. "Despite the uncertainty of the period ahead, multinational companies with significant international earnings will benefit from the decline in sterling as the value of their earnings will increase," he says.

He adds: "Throughout the campaign period, our message has been 'business as usual,' and this message remains unchanged now. We see little merit in trying to predict uncertain outcomes and have not sought to adjust the portfolio composition in any way that is not aligned with our investment philosophy and process."

In fixed income, the ECB's corporate bond-buying program should provide some strong technical support for European investment-grade issuers. Spreads will widen, but less so than if the program did not exist, and the European investment-grade market should outperform the UK market, and possibly even the U.S. market.

Stanley believes that spread-widening within the UK corporate debt market will also present an opportunity. "One of the key areas of differentiation is between companies that have more or less UK exposure," he says. "UK-domiciled companies that derive the majority of their earnings from mainland Europe may initially weaken along with everything else, but in reality, they are less at risk and could therefore be a good buying opportunity.

"In addition, U.S. and European companies that issue in sterling will be hit hard. This will present a very good opportunity to buy high-quality corporates in sterling rather than euros or dollars, then hedge them back to their base currencies."

It may take a while before investors feel confident enough to invest in European high yield, according to Della Vedova. "Global investors may look toward the U.S., even though it is further through the credit cycle and potentially faces more defaults than the European market," he says. "This will negatively impact European high yield, but it will also create a buying opportunity. Our aim is to look beyond the broad sell-off and identify those names where we believe there has been a negative overreaction. For example, UK companies that do not need to import from overseas will be less affected by the decline in sterling and will be more insulated against the downturn."

TOUGH NEGOTIATIONS POINT TO LONG-TERM UNCERTAINTY

The UK must now brace itself for lengthy and difficult negotiations with the EU, which faces a challenge in keeping the rest of the bloc together. Griffiths says: "There are a number of EU member countries that will be monitoring developments closely in the coming months now that the UK has set the precedent to leave. Greece, Spain, Portugal, and Italy have all seen their competitiveness impacted by being in the EU. Should one of these common currency members decide to follow the UK's example, it would undermine the bloc."

To reduce the threat of "exit contagion," the EU is likely to adopt a tough negotiating stance with the UK. Della Vedova explains: "The EU will want the contrast between membership and non-membership to be as stark as possible. In practice, this will mean propping up the European market using any means at its disposal in order to make life rosy for the remaining members—it will also mean making life hard for the UK."

However, the degree to which the EU will "punish" the UK post-Brexit will depend on complex—and potentially fractious—negotiations *between* the remaining EU member states. Although the EU must be dealt with as a single entity, individual members have their own trading relationships with the UK, with some countries more dependent on British consumers than others. How these competing interests play out will ultimately determine the EU's post-Brexit posture toward the UK.

"The power of economic self-interest should not be underestimated," says Fitzsimmons. "France will probably want to make it very difficult for UK financial services firms to operate on the Continent. However, Germany might be inclined to be more flexible because its car industry is heavily reliant on exports to the UK, and it would not want to lose that trade. Different countries in Europe have varying levels of trade dependency with the UK, which could make negotiations within the EU very complicated. It could be divisive."

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