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POINT

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Post-Brexit Vote BRITAIN LEANS TOWARD A CLEAN BREAK FROM THE EU

KEY POINTS

- New UK Prime Minister Theresa May has announced that Britain will begin the process of leaving the European Union by the end of March 2017.
- This removes some of the uncertainty about how the country will extricate itself from the EU but has also heightened concerns about the potential ramifications of a so-called hard Brexit.
- In our view, May's announcement and the tone she used to make it signals less market-friendly government policies, potentially harming the UK's growth prospects and weakening the sterling.
- The continuing market uncertainty, however, will provide opportunities for patient investors with a long-term investment horizon.

May's statement on October 2 at her first Conservative Party conference as Prime Minister was by far the strongest indication that she prefers the "hard" option of disentangling Britain from the EU, meaning a full withdrawal from the customs union and single European market.

"There will be no unnecessary delays in invoking Article 50. We will invoke it when we are ready. And we will be ready soon. We will invoke Article 50 no later than the end of March next year," May said.

Quentin Fitzsimmons, a portfolio manager in T. Rowe Price's fixed income team, says, "The Brexit vote was won by people who haven't been doing well with the status quo. May is out to win their support and confidence in order to win the next general election. A more hardline approach to Brexit now seems more likely as May's government regards the referendum result as a clear signal that border and migration controls are nonnegotiable in the coming Brexit negotiations."

The best way to ride out any instability is to continue investing in high-quality businesses that trade at attractive valuations.

“May’s stance is about politics, social cohesion, and law—it seems that economics is subordinated to all of these,” Fitzsimmons adds. “It is often said that former Prime Minister Margaret Thatcher knew the price of everything but the value of nothing. May knows the value of many things, but is less concerned with the price. Economics considerations seem to be less important to her than her vision of the UK as an autonomous society.”

Fitzsimmons believes that the sterling—the UK’s most liquid financial asset—will weaken further, but not to the point where it is at parity with the U.S. dollar. He says, “May believes that the current monetary and fiscal policy framework has not supported the welfare of a large swath of society—those reliant on savings and those lacking asset wealth—and that it is the government’s job to rectify this. This raises a flag for investors in sterling markets—both the pound and gilts will continue to be vulnerable despite the weakness already seen.”

“As the sterling weakens, net income from abroad will be worth more and net income flowing out of the UK will be less valuable to foreigners, which could narrow the current account through the capital flows channel,” he says. “However, as the pound weakens, the trade deficit could increase. Overall, the mix will change—and it could be a bumpy road along the way. We have become more defensive in gilts and maintain our underweight in sterling.”

The risk of a “hard Brexit” means that “the likelihood for extended support from the Bank of England via lower interest rates and an extension of the current quantitative easing program has increased,” Fitzsimmons says. “Ironically, a weaker pound adds to disinflationary pressure globally even if it raises a potential red flag for stickier domestic inflation.”

Our portfolio manager for European equities, Dean Tenerelli, believes that the possibility of a hard Brexit has soured the outlook for the UK and European economies, which have shown resilience since the UK referendum in June. He adds that the divorce process will be “lengthy and complex.”

Tenerelli says that his portfolio has been shaped “in a way that is balanced, a blend of both growth and value companies, which should benefit if the economy continues on its road of steady recovery or stutters as a result of the threats that Brexit has thrown up.”

“We are not positioning the portfolio to benefit from a specific route as we do not feel we have an advantage over others in knowing which way the exit will play out,” Tenerelli adds.

The best way to ride out any instability is to continue investing in high-quality businesses that trade at attractive valuations,” Tenerelli points out. “We expect these attributes to be rewarded in times of uncertainty.”

Ben Griffiths, portfolio manager for European small-cap equities, says he has been inclined to reduce his UK exposure. “Specifically, certain cyclical names are exposed to any potential slowdown in demand. We will look to rotate the proceeds into new opportunities. The European financials sector is one area of interest. In the interim, we are happy to maintain a higher-than-usual weighting in cash,” Griffiths adds.

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