Commentary

Brexit: Britain Votes Leave

June 2016

- In a tight 51.9% to 48.1% vote, the U.K. has voted to leave the European Union.
- As expected, the reaction in equity markets was negative.
- We believe our diversified approach should serve investors well, and we remain diligent in evaluating future investment opportunities as financial markets react to the news.

On 23 June, Britain took to the polls and voted to leave the European Union (EU) in a referendum that was too close to call ahead of the vote. In fact, the final tally was relatively close with 51.9% of the roughly 31.9 million votes cast preferring the "Leave" option. Despite concerns that poor weather in the south and London could dampen voter turnout a record (for a referendum poll) 72% of registered voters participated. With polls in flux ahead of the vote, we believe our consistent and diversified investment approach was more rational than betting on either "Remain" or "Leave."

Markets React

Leading up to the vote there was a fair amount of volatility as investors vacillated between risk taking and risk aversion depending on the results of the latest polls. In the five trading days prior to the polls closing, the FTSE 100 Index rose about 6.5%. This seemed to indicate at least a portion of investors were betting on a "Remain" vote and were caught offside by the result.

As generally expected, equities reacted negatively with U.K. equities falling about 8.4% in early trading before quickly recovering some; at midday, FTSE 100 Index losses stood at about 4.5%. Global equities declined as well, and in many instances by even more than U.K. equities. In Europe this may be related to the potential risk of the Brexit vote providing support to "Leave" movements in other EU countries. Bond markets, many of which already had yields hovering at historically low levels, saw yields fall even further as investors sought out the relative safety of government bonds. Sterling fell to its lowest level in 30 years versus the U.S. dollar, trading as low as 1.32 (U.S. dollars per pound) before recovering modestly. The euro has also declined in this environment, while the Japanese yen has strengthened. In strategies that allow for active currency positioning, SEI held an overweight U.S. dollar versus underweight euro position, which has performed well following the vote and served to partially hedge some of the Brexit risks.

Negative sentiment and associated volatility could linger across financial markets, which might actually provide attractive investment opportunities. Markets should eventually settle down after the initial "Leave" shock has worn off and investors begin to focus on the U.K.'s transition out of the EU.

The Transition

In evaluating the repercussions of Brexit, investors must understand the time frame needed for such a transition to take place is measured in years and that there are still uncertainties. While no country has left the EU in its nearly 25-year history, Greenland's 1985 exit from the European Economic Community (a precursor to the EU) took three years to negotiate. In our view, the U.K. government must act promptly to negotiate new trade agreements with the EU, its single largest trading partner. According to the Treaty of European Union (Article 50), parties involved are granted a two-year deliberation period, which would be triggered by a formal notification, in which agreements must be made unless both parties agree to extend the time frame. These negotiations, should they fail to progress in a promising fashion, could impose a second shock on the U.K. economy around 2017-2018.

Political Uncertainty

With complex negotiations ahead, one important question that remains is who will lead them on behalf of Britain. As the effective leader of the "Remain" campaign, British Prime Minister David Cameron swiftly made his intention to resign clear. This power vacuum and added uncertainty may cause further unrest in the markets, at least over the short term. Other nations may reconsider their EU membership. We also believe that the issue of Scottish independence could continue to percolate. Although the 2014 referendum on this issue was settled with a 55% vote to stay in the U.K., a significant portion of the Scottish population desires close ties to the EU. Another referendum on this issue seems possible now.

Our View

We could see continued weakness in sterling and the euro versus the U.S. dollar, which could have mixed results for the U.K. economy. It might help some companies increase exports to the rest of the world, but this could be offset by increased uncertainty and reduced levels of investment. The previous year's weakening of sterling likely implies rising import costs, while a broad-based depreciation of the currency would likely boost inflation. The impact on gross domestic product growth is difficult to predict with precision, but we firmly believe it will result in slower growth over time. The remaining members of the EU could face similar challenges but to a lesser degree. Overall, while the U.K. is one of the largest economies in the world, it still represents just under 4% of global gross domestic product. Given that, the impact on a global basis may be somewhat muted in the long term.

Our Positioning

We build diversified client portfolios that are designed to meet investor goals and withstand market gyrations while taking appropriate risks for an investor's time horizon. To that end, positioning is largely strategic in nature with tactical positions (where applicable) intended to generate alpha over shorter time periods. As noted earlier, where possible, we have implemented an underweight position in the euro versus the U.S. dollar and we expect this position to benefit from potential weakening of the euro in the aftermath of the Brexit vote. With the short-term dislocations created by the decision to leave, we expect there may be opportunities for more active positioning and are diligently monitoring the prospects.

Index Definitions

FTSE 100 Index: The FTSE 100 Index measures the performance of shares from the 100 largest companies listed on the London Stock Exchange.