



EU referendum: Our thoughts as the UK decides to leave

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Following the UK's historic decision to leave the European Union (EU), we share the views from across our economic and investment teams as to how this result might shape their thinking and the investment landscape going forward.



Nick Mustoe, Chief Investment Officer, Invesco Perpetual

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"The EU Referendum has increased volatility and depressed risk taking by investors. We think an exit vote will likely increase the search for defensive assets."

After months of anticipation, UK voters have decided - in an historic move - to leave the European Union (EU), some 43 years after joining its predecessor, the European Economic Community, in 1973. The UK government, institutions and wider business community now have the task of addressing a multitude of financial, economic, fiscal and political implications and consequences.

In our view, the decision to leave will likely increase existing market volatility in the immediate aftermath, driven by investor uncertainty over the potential consequences of the outcome, and may see investors moving further into defensive assets. This type of market volatility often leads to price adjustments that are indiscriminate, and can therefore present attractive buying opportunities for fundamental, long-term investors, such as ourselves.

Market consensus appears to be clear that, over the short term, the decision to forego EU membership will likely lead to weakening of Sterling and impact UK economic growth. The extent of such an impact and how long it will last can only be speculated at this time. The more immediate impact on the UK economy and growth will likely be determined by several domestic and global factors, from trade, productivity and capital investments (domestic and direct foreign) to the direction of central bank monetary policy.

Longer term, we believe the UK economy will not only be able to handle the decision to leave the EU well, but continue to thrive as we remain optimistic about the UK's growth outlook. Having experienced some of the strongest growth among the G7 nations over the past four years, we believe the economy is well-positioned to handle what lies ahead.

For our part, we have been investing across global equity markets for more than 30 years. And whilst markets have changed, we have always remained true to our investment principles. This event is no different. In doing so, we remain focused on what is in the best long-term interests of our clients. It is our commitment to taking a long-term view that has been the key to the investment performance that we have generated over time.

Jeff Taylor, Head of European Equities

"On the political front, we think it is wrong to see Brexit as a trigger for the complete break-up of the EU."

The UK voters have decided to leave the European Union. The focus will now shift on the intended transition period and the negotiations between the two parties (UK and EU), which will take some considerable time.

The real extent of the impact on the broader European economy and political environment is uncertain. Markets do not like uncertainty and so we expect market volatility in the UK and in the rest of Europe. In economic terms, we see less risk of lasting damage to the rest of Europe given that the Eurozone recovery, driven by domestic demand, has shown itself well positioned to withstand external risks as demonstrated in the last couple of years. Some damage to broader European growth cannot be excluded but we would not anticipate that Continental Europe will automatically slip into recession because of Brexit. The ECB and the key politicians in Europe (e.g. Chancellor Merkel and President Hollande) know the risks and will more than likely use policy to counteract near-term stress. What form that takes remains to be seen, but it is highly unlikely they stand on the side-lines and watch the market panic.

On the political front, we think it is wrong to see Brexit as a trigger for the complete break-up of the EU. Near-term, we expect political noise as both France and Germany have general elections in 2017, and neither country can therefore afford to give the UK an easy ride. In Continental Europe, that



Jeff Taylor, Head of European Equities, Invesco Perpetual



John Greenwood, Chief Economist, Invesco Ltd.



Arnab Das, Invesco Fixed Income



Mark Barnett, Head of UK Equities

some populist politicians express anti-EU views does not mean that a series of follow-on referenda is a given. It has been wrong historically to underestimate the commitment of European politicians/institutions to the EU project (e.g. during the sovereign debt crisis in 2012, Greece in 2015); all the periphery countries are still in the EU and playing by the rules, despite the rest of the world predicting they would have exited by now. Populist risk exists globally (not least in the US) and is not a factor unique to Europe.

It is worth remembering that the Brexit vote has been well flagged for some time, and whilst the end result is a negative surprise, flow data in the European markets pointed to significant nervousness already, ahead of the result.

Most of our portfolios are generally pro-cyclical in their positioning, so a slow down to the broader economy does not obviously help our case short-term. This positioning reflects where we see the most interesting valuations at the current time. We will under all circumstances stick to our long-held investment philosophy based on bottom-up fundamental analysis and driven by valuation, the single most important long-term driver of investor returns in our view.

John Greenwood, Chief Economist Invesco Ltd.

Now that the UK voters have decided and have opposed the establishment consensus to remain in the EU, the action will switch to the markets in the short term and the government, parliament, and the negotiations with the EU over the terms of exit in the longer term. I expect sterling to experience an immediate fall, but the euro could also be adversely affected as investors assess the possible knock-on effects on the EU and the Eurozone. Most likely, the US dollar, Japanese yen and Swiss franc would be regarded by investors as preferred "safe havens".

In the near term, the current Cameron administration is likely to undergo a significant shake-up to reflect the views of the victorious Brexit rebels. These changes could even include the departure of Prime Minister Cameron, resulting in a Conservative party leadership contest. Even so, simply changing the prime minister and members of the cabinet could prove inadequate, and the UK may demand a general election. The Conservative party may end up divided, giving rise to the possibility that Labour is re-elected but opposes the result of the referendum.

Next, there is the very real problem that although the UK electorate has now voted for Brexit, up until the referendum Parliament was solidly in favour of remaining in the EU. Since under the British constitution it is Parliament that is sovereign, Parliament cannot be counted on to pass the necessary legislation to implement the break from the EU.

Finally there will be extended negotiations with the EU to establish the new *modus vivendi* between the UK and EU member countries. These talks will need to cover trade, investment, regulation of products and services, migration, security, and a host of legal matters from human rights to the healthcare

treatment of Britons in the EU and EU citizens in the UK. Each agreement will in turn require new legislation. The new UK administration will have its hands full!

Arnab Das, Head of EM Sovereign and Macro Research

Now that Britain has decided to leave, we believe it is impossible to be precise about the economic consequences of this decision, although a number of official studies have come to relatively specific conclusions about the economic and financial costs. High uncertainty is a result of the intangibles, which are many: Bilateral UK-EU exit negotiations will likely take at least two years, under EU and UK law, but the timing of that decision could vary and the negotiating stances of the UK and EU could range from friendly to contentious. Negotiations with other trading partners will also likely need to take place, otherwise, the UK could face higher import tariffs or other barriers to exporting to the rest of the world - even if it goes for the unilateral trade liberalization that some 'leave' campaigners have suggested. Such negotiations are likely to be complex and could take many years, based on previous experience.

The underlying question for UK, regional and indeed, global economic and financial performance is whether the ultimate destination will be for little change, more opening, or higher barriers in the trade and investment environment in the UK, Europe and by extension the world economy.

Mark Barnett, Head of UK Equities

In simple terms, the UK's vote in favour of Brexit has cast us into uncharted waters with a level of uncertainty we have not experienced for a long time. In the coming weeks and months, there may be delays to consumer spending, companies' recruitment and foreign direct investment as the UK and wider global economy digests the decision. In combination, these factors present substantial short-term headwinds to the UK economy.

Over the longer term, however, we believe the UK economy can cope with life after Brexit and we remain optimistic about the future outlook. We have a dynamic economy which has adapted to change before - and is now primed to adapt again to whatever change is thrown at us.

Sterling will be a key instrument to watch over the near term, as movements in currency will likely determine the extent of the wider market response. We expect the initial sentiment to be negative and expect a fall in markets, but the question is - how much? We have seen quite a lot of weakness building already, so some of the negative sentiment will already be priced in. There will likely be a knee-jerk response, potentially followed by a rally in the market as people start to think more carefully about the wider implications of weakening sterling.

If there is a sharp fall in Sterling, many UK companies - particularly international large caps with predominantly overseas earnings which we are heavily invested in - could reap some tailwind benefits as currency translation feeds through into earnings.

More broadly, we believe the best businesses will be well equipped to deal with the challenges wrought by Brexit. UK companies have withstood the numerous and variant headwinds of the recent period - where discussion around US interest-rate policy, the direction of the US dollar and commodity prices have contributed to hostile market conditions.

Ultimately, we don't manage money on a three month view or a six month view but in the best long-term interests of our clients. We will be waiting to see some of the dust settle before we move portfolios one way or the other because at this

stage it is difficult to accurately assess what some of the moving parts will look like as international trade and regulatory negotiations take shape.

We would urge investors to recognise that we will endeavour to make considered judgments on the basis of the facts as they emerge. We will not be making changes to the methodology we have used for many, many years to build our portfolios, nor departing from the processes we deploy to analyse, understand and respond to investment opportunities across UK equity markets.

Important information

Data as of 24 June 2016, unless otherwise stated.

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