Heartwood
Investment Management

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Investment Insight

Weekly Insight

The UK referendum: Pragmatism over emotion

In February, when we first wrote about the UK referendum ("Brexit: The Investment Impact"), we highlighted the fact that the UK electorate would vote as much on emotion as opposed to complex economic arguments. Emotions have certainly run high in this campaign and probably more intensely than many of us had expected. Campaigning has temporarily ceased and there is now a time of quiet reflection, following the tragic and shocking murder of the British MP, Jo Cox, on the streets of West Yorkshire.

It is hard to know what direction this campaign will now take as voters make their decision next Thursday. Various opinion polls suggest that the result hangs in the balance and this has led to higher levels of market volatility, risk aversion and significant falls in government bond yields globally. Concerns are high that a UK exit from the European Union (EU) may well be realised. Non-UK authorities have responded by stepping up their vocal support for the UK staying in the EU; the Fed, the Bank of Japan and the Swiss central bank have all expressed their concerns about 'Brexit', while Finland's outgoing Finance Minister, has warned of a 'Lehman Brother's moment' if the UK votes to leave.

Economic fundamentals are unchanged

We can expect further jitters in markets over the next few weeks, as investor behaviour is driven more by emotion and sentiment. However, it is worth reminding ourselves that amid the political rhetoric and uncertainty, the fundamental global economic backdrop remains unchanged. In fact, economic data has been improving globally:

- The consumer appears to be coming back in the **US**, after several quarters of disappointments. Retail sales have rebounded in the second quarter and there are more signs that May's disappointing employment report in the US could be an aberration. Other labour market indicators show underlying conditions remaining firm. Importantly, wage pressures are building as the US economy reaches 'full employment'. The Federal Reserve Bank of Atlanta's wage growth tracker, a measure we find more representative of underlying wage trends, shows that median wage growth increased 3.5% year-on-year in May 2016 and follows a steady upward trajectory since October 2015. Meanwhile, the latest manufacturing reports also signal that the worst may have passed in this sector.

- Notwithstanding concerns about the current EU referendum weighing on **UK** growth, recent data reports have delivered positive surprises. Retail sales saw healthy rises in April and May (6.0% year-on-year), supported by ongoing labour market improvements. There are also preliminary signs that the UK's industrial sector's malaise is easing.

- European Central Bank stimulus measures are supporting the **eurozone's** credit recovery, as household consumption measures have remained firm, owing to improving labour market conditions, low inflation and lower oil prices.

- The economic effects of the recent earthquakes in **Japan** appear to have been short-lived, given better industrial production data. In addition, strong labour market conditions seem to be finally filtering through to the consumer, as spending has improved at the start of the second quarter.

Clear Thinking

Contact

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If the UK votes to leave the EU, the short-term economic consequences will undoubtedly be painful for financial markets, as well as the UK and continental European economies. There are so many variables – In or Out, the durability of Prime Minister Cameron's premiership, the stability and cohesion of the European Union itself - that it would be futile to position for any one definitive outcome. Even if the UK votes to stay in the EU, a close result may well provide more political uncertainty.

Portfolios positioned pragmatically

From an investment perspective, we have consistently taken the view that our portfolios need to be positioned pragmatically: able to defend in periods of capital loss and take advantage of valuation opportunities where there is fundamental justification. And it is at times like these when a multi-asset class investment strategy enables investors the flexibility to make those choices.

Over recent months, we have:

- Raised cash and moved into more liquid instruments, such as large-cap equities.
- Reduced overall levels of equity risk.
- Reduced property risk, trimming our exposure to those instruments with a higher correlation to equities.
- Maintained a short duration position in bonds.
- Reduced currency risk.

We are comfortable with current risk levels in our portfolios and we are prepared, as much as we can be, to meet any potential liquidity and tail risks. Importantly, though, our active decision to gradually raise cash in recent months places our portfolios in a strong position to capture potential investment opportunities should we see a significant sell-off in markets.

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Important Information

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