24 June 2016

Heartwood Investment Management

Investment Insight

Weekly Insight

A message from the Investment Team

The UK electorate has voted to leave the European Union in a once in a generation vote. It is a seismic decision that will have meaningful political and economic implications not just for the UK, but also for Europe and the global economy. Over the past week, markets were pricing an increased likelihood of a 'Remain' outcome and this has perhaps exacerbated the sharp market falls seen over the last 24 hours.

Clearly, this is unsettling news. We expect the short-term economic consequences to be painful due to ongoing uncertainty for the UK economy and the future cohesion of the European Union project. That is not to say that UK economic fundamentals have suddenly shifted overnight – consumer spending, for example, remains supported by low inflation and a reasonably strong labour market – but the path ahead is more precarious. The UK government and the Bank of England will use all their tools to support confidence and avoid the economy slipping into recession. A meaningfully weaker sterling may help to counter some of these negative forces longer term, given its potential to boost UK exports and stimulate flows from international investors into areas such as property.

Since the beginning of this year, we have been reducing risk in our portfolios to reflect concerns about a number of issues, including Brexit. In consequence, we have entered this period with higher levels of cash.

Now that we have a confirmed 'Leave' result, we believe the likely implications are:

- Political risk premia will remain high across markets. Other than Greenland, which left the European Union in 1985, there is no precedent for a country withdrawing membership. This raises a constitutional crisis for the entire EU project. The Spanish elections will test the anti-establishment mood this weekend in Europe and, further out, we have an Italian referendum in October 2016 and French and German elections in 2017.

- Economic growth will be vulnerable in the near term for both the UK and eurozone. As evidenced by Mark Carney's speech today, the UK government and the Bank of England will be proactive to support growth. A meaningfully weaker sterling may help to counter some of these negative forces longer term. It should be remembered that eurozone growth has been stable, but it is low at 1.7% year-on-year and there is very little room for error.

- Central banks across the globe will be proactive and will take all necessary coordinated policy actions to stabilise financial markets. However, the risk of more policy dislocation between markets has increased and there will be increasing questions about the effectiveness of these policy responses.

- Overall, in coming months there will be more uncertainty for investors.

Clear Thinking

Contact

To find out more about the Heartwood strategies, visit our website or contact your local representative.

In light of the current environment, some of the actions that we are considering are to:

1. Reduce exposure to European equities. The euro currency has been resilient, which in the short term should help to mitigate potential market losses for sterling investors, but we are very aware of the ongoing political risk in Europe.

2. Explore opportunities in UK property. UK listed property developers have fallen by as much as 30% this week and this plus the sharp fall in sterling could stimulate international investor flows into this market.

3. Potentially invest in Federal Reserve policy-sensitive assets such as US treasuries and emerging market sovereign debt (denominated in US dollar), as we expect the Fed to remain dovish.

4. Consider re-orientating our UK equity exposure into large-caps. These are multinational companies with significant international earnings and should benefit from a weaker sterling.

We recognise that this is the beginning of an unnerving time for investors. As always, we will act in a considered fashion and will keep you informed. Meanwhile, it should be remembered that in this uncertain and difficult environment and when market volatility is high, investment opportunities will arise for fundamental, active investors.

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