

GREYCOURT

Friday June 24, 2016

Outlined below is a brief note from Greycourt's Chief Investment Officer, Jim Foster, addressing the recent actions that took place in the European Union.

The momentous decision by British voters to leave the European Union (EU) was unexpected by the markets, which, like the British and EU elite, seriously underestimated public discontent. Investor reaction might be pointing to a broader concern that the Brexit vote reflects intense dissatisfaction with the status quo for the working class and that the rise of populist politicians, including Donald Trump, could lead to even more sweeping changes in the months to come. Nonetheless, the response in markets to the vote has been an immediate and significant flight to quality. Sentiment is negative, confused, and therefore fearful.

Over the medium term, the actual economic and political consequences of the vote will depend on how the United Kingdom (UK) and the EU negotiate the exit path, especially with respect to trade, banking, and immigration issues. Article 50 of the Treaty of Lisbon provides for a two-year period for negotiations leading to an exit, but this article has never been activated so how the mechanism will work is uncertain. The political choices of Scotland and other countries and regions could prove very disruptive to the general political economy, growth, and markets. Japan is a particular victim, as the yen has risen to its highest point since Abenomics began and Japanese policymakers have few options at their disposal. Investors are also paying attention to the strengthening US dollar and its implications for trade and the risk of a yuan devaluation.

Despite all the negatives, in our view the long-run global economic impact should be fairly minimal and manageable. Of course there will be growth impacts but there will also be countervailing stimulus responses (e.g., direct stimulus and delayed rate hikes in the US). Even in the UK, larger global companies could benefit from a lower pound. Even significant decreases in asset prices (as in the period of December 31st to Feb 11th) did not, and do not, necessarily result in recessions or lead to bear markets. Again, the bigger issues are political as pressures on the EU will mount regarding membership and the ability to enact positive pro-growth economic reforms.

We are closely watching market measures of liquidity such as the TED spread to determine if the impact of the Brexit vote leads to global liquidity concerns. So far, these metrics are a bit elevated but not alarmingly so. Implied volatility has risen, but not remotely as high as during the Financial Crisis or even 9/11 or during the Long Term Capital Management debacle. In addition, we are in discussions with all of our managers to assess their exposures to the GBP/Euro and the likely impacts on their portfolios. Given generally heightened stock market valuations, we are not broadly recommending that clients add to equity exposures at this time. As many of you know, we have been watching for an attractive entry point for high yield credit and should spreads widen materially, we will likely suggest initiating or adding exposure here. In addition, as the turmoil subsides, we may be recommending selected opportunistic equity purchases.

Please do not hesitate to contact us if you have questions or comments about the implications of Brexit in general or on your individual portfolio.

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