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Investment Insight

Brexit aftermath shock…what next?

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We are now witnessing the threat of Britain's exit from the European Union (known as "Brexit") starting to fracture the (so-called) peace in financial markets. Regrettably this is a negative shock to economic fundamentals which currently looks like it will reverberate across Europe and impact global confidence and growth. Hopefully this British vote will not be prophetic, that it will not be a catalyst for other risk scenarios. Yet the worry is that this could be.

We've been highlighting the rising volatility of investment markets over the past year. Up until mid-2015 fragile peace and stability in financial markets was being maintained by central banks with extraordinarily low interest rates and Quantitative Easing. Essentially policy rather than economics has been the main driver of market returns. Even in this artificial environment, we maintained our core investment views that:

- ultimately underlying economic fundamentals will drive asset prices
- policymakers are not infallible, and
- policy flexibility faces constraints in the face of a major shock.

The repercussions of Brexit for Britain…

Given a mood of resentment and frustration, voters' facts have been unable to counter fears and myths. Elites are no longer trusted, there is a rise in "protest politics" in Europe as in the US. The underlying source of discontent is that workers have or feel they have progressively lost ground, and there is fear that rising numbers of immigrants threaten their position further. Politicians with extremist views are gaining prominence. Britain's exit provides an important lesson that the frustration of those left behind economically cannot be ignored. Politicians must take seriously the concerns and fears of voters that change is at their personal cost rather than for the national interest.

Britain is now divided along demographic, regional and socio-economic lines. For young people who were strongly in favour of remaining, the outcome has led to an increased feeling of disenfranchisement. They have lost the right to live and work in 27 countries and now face bleaker job prospects in Britain itself.

Scotland voted strongly to remain with Europe and is now likely to vote again on independence and this time secede from the UK. Northern Ireland also voted to remain and there are now calls for union with Ireland. This potential disintegration of Britain does not bode well for stability. Already S&P have downgraded Britain's previous AAA rating to AA.

Given that Britain already has a current account deficit of -7% of Nominal GDP, then the pressure on UK asset prices is dramatic. Britain's deficit with the rest of the world has to be balanced via foreign direct or portfolio investment, or via deployment of the Bank of England's foreign reserves. While the Bank of England has rapidly pledged £250 billion in liquidity if required, in reality central banks can only smooth the path rather than hold the tide. Government Budget tightening or "austerity" may be required to shrink Britain's current account deficit or the currency will continue to be at risk of further sharp falls. Given these financial and political risks, both British companies and investors will now be more cautious.

…and in Europe

Perhaps the most serious repercussions are in Europe itself. "Euro-scepticism" is becoming more deeply entrenched in Europe. Around one third of European parliament members represent Euro-sceptic parties. The Brexit vote may have set off a chain reaction which could ultimately lead to the unravelling of a united Europe. At least five other countries are at risk of leaving the union including Italy, the Netherlands and Austria. Politics in Italy is again in turmoil with the Five Star Movement's rise emblematic of the disconnect between people and politics that appears pervasive in the developed world.

How does MLC deal with this uncertainty?

In an increasingly unpredictable and changeable world, we use our Investment Futures Framework to reflect and assess the very wide range of potential market scenarios – both good and bad – that could occur. This helps provide us with insight into the potential risks in our portfolios.

The scenario played out across the world on Friday is aligned with our **Extended Risk Aversion** scenario. While this is a negative scenario, our portfolios had a defensive position well before the Brexit vote. While we may not be able to avoid negative returns, particularly over short periods of time, the following positions should be helping reduce the impact of market weakness:

- Higher allocations to cash than normal, from both our asset allocation decisions and some of our managers not being fully invested because they have been unable to find attractive assets.
- MLC Inflation Plus portfolios have relatively low allocations to shares, while MLC Horizon portfolios have reduced allocations over the past year. And we include managers in our portfolios that require companies they invest in to have downside protection.
- Key elements of the MLC Inflation Plus portfolios, notably the low correlation and multi-asset real return strategies have fared particularly well; our defensive global shares allocation has also increased portfolio robustness. MLC Horizon portfolios' higher allocations to the real return strategies (ie Inflation Plus strategies) in turn provided them greater robustness.
- Increased exposure to the Australian dollar (AUD) since the beginning of 2016. However our remaining foreign currency exposures, which are defensive in many risky scenarios, are not so in the current scenario. Notably the AUD is exhibiting some renewed safe haven characteristics.

Assuming it goes ahead, there will be winners and losers from the Brexit and the market will take time to understand the true impact. We, and our investment managers, are closely monitoring the evolving situation, assessing evolving risks and building understanding of the potential scenarios (good and bad) which may play out. While we are comfortable with the performance of our portfolios over longer periods, we are not complacent about the future challenges. After this British referendum there is greater complexity, uncertainty and risk. The important thing is not to predict what will happen but to understand the consequences of what could unfold. If we do that thoroughly we are then in a position to understand how to best build protection into our portfolios against the key risks.

We will maintain our risk discipline even if this requires some patience before return expectations are met.