Straight talk

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From the UBS Asset Management Investment Committee

Dawn Fitzpatrick, Head of Equities, Multi Asset and O'Connor, highlights the key themes of discussion at the June Asset Management Investment Committee (AMIC).

The AMIC comprises the most senior investors from each investment area, providing a key forum for the sharing of cross asset expertise and debate on the major factors impacting client outcomes.

Brexit. What now?

The UK has spoken. By a margin of 52% to 48% the UK public has voted to revoke its membership of the European Union. Prime Minister David Cameron has resigned. However, the invoking of Article 50 of the Lisbon Treaty is on hold while the leading lights of the Conservative party position themselves for the leadership battle. The main UK opposition party, Labour, is similarly riven with in-fighting post the Referendum. In short, next steps for the UK are unclear and UK political dysfunction may be higher than most investors will have accounted for.

With all this as a backdrop the reaction of markets on Friday was, in our view, surprisingly benign. Moves were at the very low end of scenario stress tests. There was certainly little evidence of any Lehmans-style panic, distressed and indiscriminate selling or liquidity crunch. Overall, capital markets appeared to be functioning fairly well.

So why has the reaction to-date been so muted to an outcome so few predicted? We believe that despite a high level of conviction that the UK would remain in the EU, hedge funds and long only investors were running low risk levels overall coming into the event – and particularly low risk to Brexit-sensitive assets.

But in truth we believe that many investors are simply still digesting the ramifications – in terms of politics, in terms of economics and in terms of markets. At the best of times the impact of politics on markets is often difficult to quantify. Right now even the political implications are unclear.

We expect the EU to take a hard line with the UK in trade discussions in order to reduce the prospect of further country exits. Based on our analysis, we see the impact on the UK economy over the next year or two as materially negative.

According to a recent Bank of England survey, corporate investment and hiring in the UK had already slowed markedly in the run up to the Referendum. Those corporate decisions are likely to be further delayed or cancelled following the Leave vote. Amidst employment uncertainty we expect UK house prices to weaken and consumption growth to follow suit (around two-thirds of the UK economy is driven by the consumer sector) and see a very high probability of a UK recession.

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While there remain so many uncertainties we see the backdrop for risk assets as likely to get worse before it gets better. Higher volatility looks inevitable in the short-term. We believe that with the balance of risks favouring the downside neither institutional long only investors nor hedge funds are likely to rush back into risk assets at current levels. Indeed, without a co-ordinated response from central banks globally or a clear rationale for new buyers we expect equities to drift lower in the short-term. With on-going uncertainty it is going to require compelling valuations or major dislocation to spur meaningful buying interest.

So while we believe that investors are still digesting the impact from a fundamental perspective, from a technical perspective we expect a significant pick-up in flows from all investor types in the coming weeks.

In particular, we expect significant trade activity in targeted volatility, exchange traded volatility products and risk parity funds in this environment. We estimate as much as USD100bn of sell orders will hit equity markets in the coming days from these funds. Most readers will need little reminder of the impact these funds had on markets in the sell-off earlier in the year.

When we look closer at Friday's sell off both credit and a number of major equity indices globally are only back to levels seen in mid-June. In the fixed income world spreads on Italian and Spanish benchmark 10yr government bonds widened just 16bp on Friday. When one considers that the yield on equivalent German bonds fell 14bp the net result is that yields on some peripheral European sovereign bonds are unchanged.

This all seems incongruous to us. We do not expect the absolute risk of investing in peripheral European debt to remain unchanged post-Brexit. We view the UK's Leave vote as a structural regime change in geopolitical risks – a structural change that we believe will be reflected on a long-term basis in a higher risk premium. Brexit may also further empower and embolden voters to back populist parties in a number of key European elections over the coming months. In the US, there are significant concerns about the outcome of the upcoming US elections in November.

In FX markets, we also see further downside to both the pound and the euro. Right now, buyers cannot know exactly what it is that they are buying. This lends additional support to hard currencies away from Europe such as the USD, JPY and CHF. The role of the euro as a reserve currency globally also seems open to question.

In summary, there are likely to be compelling long-term opportunities among the growing dislocation we envisage – but we believe that there is clear merit in investors staying patient as the political backdrop develops along with its economic and market implications. It may be some time before fundamentals take priority over geopolitical risks again. We favor active management in this backdrop.

As the AMIC meets more regularly during this volatile period for markets, we will keep you updated with our views on the likely impact on client outcomes.

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