

ARTICLE

For professional investors

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Mid-term outlook depends on any Brexit domino effect

- Brexit vote could lead to referendum calls in other EU nations
- Negative fallout likely to be seen in data due in the Autumn
- Mid-term depends on politics; hedging risk is now a priority

The mid-term outlook for investors depends on whether the Brexit either unifies or further breaks up the European Union in a domino effect, says Lukas Daalder.

Britons stunned the world on 23 June by narrowly voting to quit the EU, causing a large fall in the British pound against the US dollar and euro, and sending equity markets plunging before they began to rally again five days later. Banks with UK exposure along with currency-sensitive stocks were particularly badly affected.

"Markets seem to be in a no-man's-land at the moment, as it looks like there's not going to be a major development in the short term. We are waiting for the UK to invoke Article 50, which is not going to happen until there is a new Prime Minister," says Daalder, Chief Investment Officer of Robeco Investment Solutions. "The shock and awe has gone now, so we need to wait and see what the eventual outcomes will be."

In the meantime, investors will focus on the underlying economic statistics, though the initial aftermath of the historic UK referendum result won't be seen until the Autumn, he says. Deciding what kinds of asset to buy remains a day-to-day decision, particularly as currency and equity markets remain volatile, and hedging currency risk is a priority."



Lukas Daalder, Chief Investment Officer, Robeco Investment Solutions

'Markets seem to be in a no-man's-land'

We will see a recurrence of interest in the underlying statistics again, and we expect a negative fallout in the economic data, though this will take about two months to feed through. The August data is going to be indicative of what the real fallout is going to be longer term, and we won't get that until September or October, so everyone is in 'wait-and-see' mode."

Possible domino effect

Daalder says the mid-term effect – typically viewed as three years for pension funds – depends on the effect that a Brexit has on the rest of the EU. "Is this the first domino, and will it drag the whole of the euro down, with Greece, Sweden or the Netherlands leaving next?" he asks. "The nationalist movements in other countries are already calling for referendums. Any such domino effect would be pretty bad for the European economy and for equity markets."

"But that's not necessarily the outcome – conversely, it could also be the wake-up call that leads to a more unified EU in which the politicians and people come to their senses, rejecting populist movements. Instead they may decide to run Europe on the merits of good arguments and what would happen following an exit – none of the pro-Leave parties in the UK have any idea what to do now. So this could lead to a stronger, more unified Europe. This is not the end of the road yet."

"The real question for investors is whether it is going to be a happy divorce between the UK and the EU, or years of fighting. So far, indications seem to be that it won't be a happy one, with political bickering taking place on both sides of the fence, so if the markets think that it is now business as usual, then this is a wrong assessment in our view."

Hedging against uncertainty

Daalder says the future value of the euro is crucial to mid or long-term decision making. This means that hedging – the practice of buying derivatives that act as insurance policies against sudden moves in currencies – will become more important as the whole Brexit saga plays out. "For pension funds it's a question of whether there actually is an unraveling of the Eurozone, and adjusting hedges accordingly," he says.

"Pension funds have a well-diversified portfolio, and normally it would hedge against currency risk regarding the euro. If you really believed in this unraveling scenario, then this is the moment to reduce your currency hedge because the euro will weaken structurally and the dollar will strengthen, so you will gain from your US dollar holdings."

Selling into rallies

Daalder says in the short term, market movements in either direction present buying or selling opportunities. Equity markets remain volatile, while the initial Brexit shock caused a

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stampede into AAA-rated government bonds as a traditional safe haven. High yielding corporate bonds sold off due to the higher risk environment, but then recovered slightly. "If equity markets now start to properly rally, then that's a good opportunity for us to sell into any rally and take some risk off the table," he says. "We don't believe that everything is priced in at the moment, and there will be future dips."

"For government bonds, we do not buy into quick rallies from a tactical perspective. Why would we want to buy a 10-year government bond that earns minus 11 basis points? Bonds serve a purpose in that they are risk-free, but reward-wise there is no upside."

"We're still overweight in high yield credits, and we will probably stick to this, as high yield still offers better trade-off in terms of risk and reward than equities. We had a short position against the pound as a hedge which worked fine when the pound plummeted. So in the short term it's more tactical, with a hands-on approach to the prevailing market conditions."

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