Three Things Markets Have Shown Us Since the Brexit Vote

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Although the result of the UK European Union referendum came as a surprise to markets, the subsequent response to the outcome has played out largely as many commentators expected. Initial volatility quickly gave way to a more considered approach from markets around the world. Still, the tumultuous events of recent days have given investors plenty of food for thought. Here, three of our investment professionals share the lessons they have learnt since the Brexit vote on June 23.

Markets Are Likely to Take a More Cautious Approach to Political Events in the Future

Traditionally, investors have tended to take the view that in uncertain political situations, such as Brexit, voters would steer clear of the generally perceived worst outcome. What the unexpected Brexit result suggests is that for future political events, markets are likely to take a more cautious approach in the run-up to voting.

We'd expect to see this new approach reflected later this year ahead of both the Italian referendum on reforming its senate, which is scheduled for October and, of course, the US presidential election in November.

In both of those instances, we imagine markets will be less likely to write off the worst-case scenarios occurring, and we thus could see a higher risk premium in markets ahead of both those events.

Still, while the result itself was a surprise, the subsequent reaction of markets to the Brexit vote has been largely by the playbook. Once the indiscriminate selling that characterised the immediate response wore off, there was a period of sobering up, liquidity improved and by the middle of the week, markets had experienced something of a technical rebound.

We think the market's by-the-book response to the Brexit vote may have opened up some opportunities for prudent, long-term investors. First, several global companies based in the United Kingdom—but with largely international operations—were caught up in the initial, indiscriminate selling, despite the fact they might actually benefit from the translation effect of a weaker pound on overseas revenues and hence profits.

The other opportunity, perhaps less obvious, may come from looking at the effect of how equity markets outside the United Kingdom moved after the Brexit vote.

Some investors may be surprised to note that the European stock markets that suffered most in the immediate aftermath of the Brexit vote were not in the United Kingdom, but were in Spain and Italy. This seems to suggest a fear that the United Kingdom's departure could spell the end of the European Union (EU) project, leaving those countries much worse off.

We don't believe in that scenario, nor in the dissolution of the EU, and so the drop in Spanish and Italian equities provide an opportunity for long-term, bottom-up investors, such as ourselves, to invest in good quality companies at compelling valuations.

The World Continues to Spin and Markets Should Get Through This–in Time

I think there's good reason to believe that, given time, markets will get through this period of uncertainty and volatility. It may take some years, but through that, UK companies should still be trading with Europe and it should be, to some extent, business as usual.

That's not to say there won't be upheavals, shocks to the UK economy and possibly economic slowdown. But taking a long-term view, we believe market fundamentals indicate a good buying opportunity in some of the hardest-hit areas, if you're willing to be patient and take that risk on board.

Post-Brexit conditions may give investors the chance to buy shares of some pretty good businesses at prices that are, in some cases, around 30% below where they were only a few days previously. Of course, many of these companies are operating in areas of the market that are out of favour at the moment, like house-building or residential and commercial property. However, we think there already seems to be a lot of bad news priced into some of these companies if you're willing to look through the likely volatility of next three to six months and take a longer term perspective.

The strength of the housing market is an important concern for UK politicians and economists. Between them, the housing market and the retail sector account for around 70% of the UK economy. A decline in confidence in the housing market and the knock-on effect on retailers and manufacturers would be a big negative for the UK market as a whole, and a slowdown would likely dent government revenues.

So it seems possible to us that the UK government or the Bank of England might step up to offer some support if necessary. Over the last five years, we've seen the UK government behaving pragmatically and in ways designed to be supportive of the housing market, with policies including the Help to Buy scheme. If the UK housing market starts to fall more sharply than the government would like, ministers might propose some policy action to provide further support.

Some Sectors Are Ignoring the Brexit Vote and Continuing to Focus on Fundamentals

As investors, my team and I look for asymmetric risk—investments that we believe have more upside than downside potential.

After the initial shock apparent in the days immediately after the vote, global markets showed signs of settling down by the middle of the following week. Within days, market volatility was actually back down to levels seen before the Brexit vote and sterling had recovered somewhat.

In the days since the Brexit vote, opportunities in the energy and health care sectors, which tend to be dominated by large-cap multinational names, have been on our radar. Energy and health care stocks were largely unaffected by the vote as investors stayed focused on investment fundamentals within the two sectors.

Meanwhile, we have also been working through our assumptions on European financials. We feel lower gross domestic product (GDP) growth across the EU region will likely lead to lower lending and a possible uptick in non-performing loans. We are conscious that rising systemic risk and an attendant rise in funding costs could inhibit the progress of some UK financials towards a more normal environment.

Although our base case is for lower near-term GDP growth in the United Kingdom, we believe the United Kingdom's position as Germany's third-largest export market should mean a modus vivendi between the United Kingdom—the world's fifth-largest economy—and the eurozone.

Like most commentators, we believe there will likely be additional monetary assistance from European and UK central banks, but we think the market may be overlooking fiscal levers that governments around the world could pull, particularly outside Europe.

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