SRS
Strategic Retirement Solutions

Market View

Since the UK first joined the EEC, Conservative Prime Ministers have known that the European question is one to be avoided at all costs. David Cameron, perhaps overly confident following the Scottish and General Elections successes, did what no other Prime Minister dared do and asked the British Public what they thought of the EU, the problem was that they told him and in no uncertain terms. We now have a political crisis and possibly an economic one, not just in the UK but more importantly in Europe as well. Only time will tell if UK voters have either shot themselves in the foot or have shrewdly grabbed the first lifeboat off the European Titanic?

What happens next?

Initially nothing, the Conservatives were shocked by the result (including allegedly Boris Johnson) and have sensibly started off by playing for time. Cameron resigning and triggering a leadership election has given the UK and EU a cooling off period. Despite popular opinion, our status within the EU is unchanged; the referendum it appears is not actually legally binding. For now, we "remain" in Europe and in all probability will do so for some considerable time yet, certainly a minimum of two years, probably a lot longer, we have seen dates as far out as 2025 from some research. This is critical as the new Conservative leader may go for a snap General Election well before the 2020 official date, and no doubt Europe will be a manifesto item. Furthermore, there are elections across Europe in 2017 and we may end up negotiating our exit in partnership with some other countries. So the electorate has had their say, but for now and possibly for a long time into the future, not much will change. Prevarication will suit the UK for now.

Implications for the UK Economy

The political uncertainty has global economic implications and it is the global economy that drives FTSE earnings. The Fed will now not raise rates as this uncertainty in the UK and Europe will cause corporates to defer investment decisions which will impact on growth rates. So it is likely that the global economy moves from normalisation back to anaemic low growth. That will be the same for the UK. But this will not be forever, policy decisions in the UK and Europe could easily turn the outlook from mildly pessimistic back to optimistic, shocks like this one do tend to pass quickly. As ever it's the USA and China that decide global growth. The UK in all probability will see growth slip back; current expectations are for a mild recession to be met with cuts in interest rates, not good but not disastrous either.

Housing Market

The biggest driver of the UK economy is the housing market. Shares of housebuilding companies have fallen by c30% since the vote. This implies a fall of about 10% in house prices. This seems somewhat extreme given that prior shocks have knocked about 5% off average house prices. Nationwide reports that the amount of houses on sale is at the lowest level for 30 years and new construction remains below the level needed for population growth. The stamp duty changes in the last Budget, with hindsight, look to be foolhardy and a new Chancellor may well reverse them. London for overseas buyers has just got very cheap, especially given the yield that is available.

Yield

We have long reported that shares in the key American market are expensive, and profits are falling, therefore based on historic precedent, share prices should by now have fallen to reflect this fact. They haven't, why not? It's all about yield. Bonds yield effectively zero; equities offer a yield well above inflation and potentially income growth as well. You can borrow money for nothing, buy a basket of defensive shares yielding 3.5% or so and provided you can put up with some short term volatility you are getting paid for doing nothing. Hence share prices have not collapsed. A mild recession will hurt corporate profits but the real question is will it hurt them enough to cut dividends and thus remove the support from the market? Brexit is a shock, will cause uncertainty, and may slow the global economy down. But considered analysis from the majority of commentators/economists/strategists suggests the impact will be limited.

SRS
Strategic Retirement Solutions

Market View

Global Trade

In all the post referendum "catastrophising" the opportunity arising from Brexit has been lost. A UK built Range Rover that sells in London for c£100,000 sells for £300,000 in Beijing. Import duty in China (just one of a series of extra costs) is 25%. The potential for a trade deal with China and even India would more than outweigh any loss of trade from the EU. The opening up of Europe's largest consumer market to true free trade would be transformational for the UK economy. Margaret Thatcher's removal of exchange controls is an example of the UK leading economic change. The EU has been a major block to the development of globalisation.

The City

More doom and gloom surrounds the future of the City of London as a centre for financial trade. This relates to the possible loss of the EU Bank Passport and the ending of euro clearing. Banks may have to physically move into the EU post an actual Brexit, but that means moving the location of the banking licence not the staff. An office with a Company Secretary in Dublin will almost do the task. The City relies on skilled people, they come to London because they speak English, the time zone is right and the telecommunication infrastructure works. The banks have made a huge capital investment in technology that they will be loath to move. The legality of banking is more favorable in London than anywhere else in the world; the complexities of hypothecation and re-hypothecation give the City a legal edge that Dublin, Paris or Frankfurt can't match. Euro clearing will undoubtedly move should a full Brexit actually happen, however, London is rapidly building Yuan clearing. The City is the ultimate survivor; it has geographic, technical and legal advantages no other City including New York can match.

What does this mean for Europe?

There are two Europes, those who use the euro as their currency (the Eurozone) and those who don't. It is the latter group who could easily join the UK at the negotiating table. As we mentioned last month Denmark and Sweden are also net payers-in to the EU. The biggest risk, however, lies in the Netherlands, Italy and France. All three have elections within the next 12 months and have sizeable anti-EU opposition. Brexit could yet lead to political turmoil in the EU. However, this could and should be the catalyst for change in Europe. There have been several newspaper articles across Europe suggesting that UK has done the right thing and is sensibly the first to jump off a sinking ship.
The markets have quickly worked out that this could be the problem and the solution lies in Europe not London. Our view has always been that Europe needs a Federal government with tax raising and bond issuing powers, but this will suit only a small core of European countries. A joint statement from the German and French Foreign Ministers is already suggesting even greater central powers for the Commission, particularly over borders, security and financial stability, all areas Britain would have vetoed. Europe needs two tiers, a smaller Federal State and a wider free trade area. The Brexit vote isn't the end of Britain in Europe. It is the start of a process that might ultimately, many years down the road, lead to the UK leaving. But it might also mean that the UK stays in Europe, and with the sort of terms Cameron should have got in the first place.

Implications for Markets

Markets were relatively calm on the Friday after Brexit. The initial fall in the FTSE 100 was met with bargain hunting investors. This was certainly not the crash that was widely forecasted. However, in some pockets within the London market there were crash-like falls. Banks and house builders saw falls of c25%. Yet in terms of relative performance London did better than the European markets. Economies rely on confidence which is hard to encourage and easy to lose. Equity markets meanwhile are expensive, are in the period of weak seasonality, worried that QE is no longer working and the US is not performing as it should. So we have may have further falls to come. However, this will not be because of Brexit, but because shares are fundamentally expensive. The third quarter is nearly always the weakest one for share prices, Brexit will not help, neither will the US Presidential Election and both would be used as the excuse. However, the real issue is lack of growth, this referendum should be wake-up call for governments around the world to stop "bashing" banks and start spending again. The Brexit vote will soon pass from memory and markets will realise that for the UK nothing has actually changed and possibly might never do so. **June 2016**

SRS
Strategic Retirement Solutions

Market View