The U.K.'s Exit Looms: What Investors Need to Know

A Fidelity panel discusses the uncertainties set in motion by the U.K.'s Leave vote and the potential implications for investors

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KEY TAKEAWAYS

- The Brexit vote spurs a period of economic and political uncertainty for the U.K. and EU; volatility likely to rise across global asset markets in the near term as a result.
- The Leave vote may be perceived as a step toward deglobalization, a trend that may give rise to slower long-term global GDP growth and potential stagflation.
- Although uncertainties abound, market liquidity appears strong and the global banking system is sound and well-capitalized.
- Heightened volatility may create opportunities to uncover relative winners with a bottom-up, company-by-company approach to stock selection, and Fidelity portfolios are well-positioned.

The referendum vote by the United Kingdom (U.K.) to exit the European Union (EU), or "Brexit," reverberated throughout global markets. As markets digested the vote, a panel of Fidelity investment leaders met to discuss the decision and its implications for investors. Brian Leite, Head of Institutional Portfolio Management, moderated the discussion.

BRIAN LEITE (Moderator): Let's begin by putting this Leave vote into context. What does it mean in practical terms and what are the next steps politically for the U.K.?

TOM NOLAN: Although the referendum has no official legal bearing, it is highly likely that parliament will now move to set the ball rolling for a breakaway from the EU. David Cameron also announced he will resign as prime minister by October, opening the doors for a Conservative leadership election this summer and with it, further political uncertainty.

Once the U.K. formally submits a notice of withdrawal, official separation will likely take approximately two years. Within that time frame, investors should prepare for deep uncertainty surrounding exit negotiations. These discussions will involve trade, business, and legal agreements between the U.K. and continental Europe, and may become very challenging for the U.K.

BRIAN LEITE: Does Brexit increase the likelihood that other EU member countries will follow suit?

TOM NOLAN: Europe's economic low points following the 2007-08 financial crisis and the sovereign-debt crisis have incited widespread nationalist sentiment. However, for another country to leave the EU, we would probably first need to see an election where a party takes office on the premise of holding a referendum. There are a handful of countries where that could take place, foremost Denmark and the Netherlands. I believe an exit is unlikely for core EU countries, such as France and Germany, where nationalist parties appear far less likely to win control despite growing popularity.

BRIAN LEITE: We've seen dramatic movement of the pound and other currencies following the vote. How should investors be thinking about currency risk?

TOM NOLAN: The sharp decline in the pound, specifically relative to the U.S. dollar, may be a result of the U.K.'s large borrowing need from abroad. Given the uncertainty of future trade arrangements between the U.K. and the rest of the world, it's possible there may be reduced foreign direct investment into the U.K. over the next couple of years and a slowdown of inflows more broadly, which may put downward pressure on the pound.

Currency markets are digesting the implications of this vote, and we've seen a risk-off move. Moving forward, the markets will likely be reconciling what Brexit might mean for the path of future Fed rate hikes, for European Central Bank (ECB) policy, and for growth more broadly. The euro and the Chinese yuan will be benchmarks for how investors perceive these potential risk drivers.

BRIAN LEITE: What are the potential implications for the global economy and the U.S. economy, specifically?

LISA EMSBO-MATTINGLY: The U.K. stepping away from the EU is a strong deglobalization signal. A shift away from globalization and free trade has negative implications for long-term global growth and asset return expectations. If this deglobalization trend continues, we may see more of a stagflationary global environment on a secular basis—characterized by slower GDP growth and rising inflation.

Will Brexit cause a global or U.S. recession? There will be some negative consequences in the U.S., which is currently experiencing a mix of mid- and late-cycle dynamics, but this vote is unlikely to push the U.S. into recession. The dollar strength and decline in energy prices in the wake of the vote may hamper our export markets and commodity-based sectors. But the U.S. household sector, which represents about 70% of U.S. GDP, is still exhibiting broad strength. U.S. consumers' real incomes are still quite strong and may even improve as a result of the vote.

However, inflation-risk concerns in the U.S. have been percolating under the surface, primarily driven by labor-market tightening and rebounding energy prices. These pressures have warned of potentially rising late-cycle dynamics. The Leave vote pushes these concerns off into the future, as the Fed will likely continue to be very cautious. In fact, the market appears to be pricing in zero rate hikes in 2016 and minimal tightening in 2017, which may actually extend the mid-cycle in the U.S., rather than bring forward the late cycle or a recession.

We had begun to see some positive economic momentum across continental Europe; however, the Leave vote is an unfortunate negative shock for those markets that will likely play out over the next several quarters. One potential silver lining for Europe is that EU leaders may now shift their policy focus toward more of a pro-growth stance, which may open the door for pro-cyclical fiscal policy and provide a buffer for the negative shock coming out of the U.K.

BRIAN LEITE: What does this mean for the U.K. economy?

LISA EMSBO-MATTINGLY: Cyclically, the U.K. economy will likely enter recession as a result of the vote. The decline of the pound will make exports from the U.K. appear cheaper to foreign consumers, which could benefit the U.K. export sector in the short term. But the U.K. is walking away from many key trade partnerships. At the same time, employment and business investment may suffer amid the uncertainty, and inflation is likely to rise significantly.

BRIAN LEITE: Are there any particular equity sectors or industries in the U.K. that may benefit over the long term as a result of this vote?

TIM COHEN: Within the U.K., there are no clear winners on an absolute basis. There may be relative winners and losers, but a shift toward deglobalization and lower GDP growth (without strong policy responses) are negative for any company or industry in the U.K. and around the world.

The U.K. is, of course, in the eye of the storm. There will likely be a loss of both consumer and corporate confidence, particularly during this initial adjustment period of exit and trade negotiations. This loss of confidence may also impact labor markets and pressure earnings, particularly those of more domestically focused, cyclical companies.

U.K. bank stocks have also been hit hard, likely due to the risk of a credit cycle picking up amid a potential lower-confidence, lower-GDP, and lower-employment environment. Companies with real estate exposure to the U.K. may also face headwinds. As multinationals consider where they want to operate business and locate their headquarters, the London and broader U.K. markets may be pressured by the uncertainty surrounding the future trade terms between the U.K. and the rest of Europe.

Some companies and industries, however, may fare better than others. For example, larger exporters and multinationals that conduct a good portion of their business outside of the U.K. should be better off. They will have the benefit of some of their earnings coming from stronger currency markets, such as the U.S., Japan, and the rest of Europe. Also, to the extent that companies' costs are pound-based, they may become somewhat more competitive with global peers. And more-defensive industries and higher-quality companies tend to be better positioned than their cyclical counterparts during periods of uncertainty.

BRIAN LEITE: What are some potential impacts on corporate earnings in the U.K., Europe, and the U.S.?

TIM COHEN: Just as all of Europe is an important trading partner for the U.K., the reverse is also true. So, the political and policy uncertainty, slower GDP growth, and lower earnings are risks that may reverberate across the rest of Europe as well. The markets have told a similar story. In U.S.-dollar terms, U.K. and continental-European stocks fell by roughly the same amount in the first trading day following the vote.

Within the U.S., again, there don't appear to be any absolute winners because lower global GDP growth and less global trade are negatives across the board. Further dollar strength will be a drag on U.S. corporate earnings. The inverse effect may also be true: U.S. multinationals may be less cost-competitive in a stronger-dollar environment.

So, U.S. multinationals may see more pressure, while defensive sectors that are less exposed to the global economy may have relatively better earnings outlooks over the next couple of years.

BRIAN LEITE: How will equity valuations, both internationally and domestically, be influenced by the vote?

TIM COHEN: It's a bit too early to tell and even more difficult to gauge in aggregate. But dislocations like this often create opportunities on a stock-by-stock basis. Ahead of the vote, European stocks were priced at approximately a 10% discount to the U.S. That discount has widened over the past couple of years. In the first trading day following the vote, European stocks fell another 10%. So, barring any changes in earnings, European stocks would appear to look 10% better.

We do, however, expect to see an impact on earnings, but we don't plan to make an aggregate call on where U.K. or European earnings are heading. We will continue over the next several weeks and months to analyze stocks on a company-by-company basis. We will look into each company's currency mix. What markets are they operating in? Where is their cost structure? What impact will currency movement have on them? How will potential future policy responses affect them? It will take selectivity among companies to find investment opportunities.

BRIAN LEITE: How are Fidelity international equity portfolios currently positioned? Have changes been made recently in anticipation of a Brexit vote?

TIM COHEN: We weren't expecting or hoping for this situation. However, our portfolios—our international portfolios, specifically—are reasonably well-positioned. They've been overweight quality companies, defensive sectors, and companies with more U.S. exposure. They've also been underweight banks and cyclicals across Europe and Japan because, even before the vote, we weren't optimistic about their outlooks.

In the U.S., defensive, bond-like sectors of the market—such as utilities, REITs, certain telecom companies with higher dividend yields—have been very sensitive to bond market moves. And given the rally in the bond market and the overall flight to safety and quality, these market segments may also benefit.

BRIAN LEITE: What implications, if any, do you see for U.K. and other European sovereign debt?

TOM NOLAN: A weaker currency is one of the risks for U.K. bond investors. The economy's high and sticky import propensity will see inflation rise over the next year. However, investors will also be weighing a weak macroeconomic outlook and rising risk of recession against this. I believe this uncertainty should trump any inflation concerns, which is constructive for U.K. government bonds.

Foreign investors own nearly 30% of outstanding U.K. public debt, and this foreign appetite may wane amid the uncertainty and currency weakness. However, foreign inflows into U.K. government bonds have been reasonable year to date, despite Brexit risks. And with few alternatives, domestic demand for the product will likely offset foreign outflows. I expect the Bank of England (BOE) to be vigilant in its policy and consider quantitative easing (QE) should any concern arise about the yield curve. I don't see U.K. credit risk as a particular issue for investors over the long term. Although we likely will see rating agency downgrades in the next few months, I believe the likelihood of multiple or significant downgrades is low.

The near-term environment also should be constructive for German government bonds. For EU sovereign debt more broadly, existing ECB QE appears to have had some influence in containing yields. The central bank will continue to be vigilant, but we could see more volatility in the days and weeks ahead, particularly in peripheral government bond markets.

BRIAN LEITE: Do you foresee any implications for liquidity in the asset markets?

LISA EMSBO-MATTINGLY: During situations like these, central bank policymakers around the world stand ready to respond aggressively. The BOE, for example, has announced a significant liquidity provision—about half of what they provided during the 2007-08 financial crisis. Significant policy responses by other central banks are also likely. Strong central bank policy action is a demonstration of the proper functioning of the financial system. We are not seeing the same dislocations that we saw during other negative shocks—such as during the financial crisis and the collapse of Lehman Brothers. This does not appear to be a systemic event.

TOM NOLAN: Since the vote, in general, the order size that could be put through the market was somewhat lower than normal; the bid-offer spread was somewhat wider than normal, but still reasonable considering the level of volatility. As you move out on the credit spectrum and toward peripheral government bond markets, there is less liquidity, but the market is still functioning well.

TIM COHEN: There are important differences between what's happening now and what happened following the collapse of Lehman Brothers. Current concerns surround the pace of GDP growth, future terms of trade and business, and possible credit downgrades. When you think about what happened with Lehman Brothers on the heels of the mortgage crisis in the U.S., bank balance sheets that were already highly levered took large losses on the asset side. There were real concerns about bank liquidity and solvency. We are coming into this situation with a very healthy level of liquidity in the market, with strong bank balance sheets and very accommodative central bank policies. In many cases, banks' equity capital is double that of what it was heading into the 2007-08 financial crisis. Risk appetites around the world have been affected, and justifiably so. We will likely see normal credit-cycle losses in parts of the world, but I do not believe that the functionality of the banking system is at risk.

BRIAN LEITE: What are the key takeaways for investors?

LISA EMSBO-MATTINGLY: The longer-term implications are that our global growth assumptions may come down a notch, while our inflation expectations may come up a notch, all else being equal. The free flow of trade is very important in a deflationary or low-inflation environment.

Investors should closely monitor monetary and fiscal policy responses and the political storyline. The U.K. will now need to negotiate trade agreements with a spurned EU. And it remains to be seen how the EU will respond and how challenging these discussions may become.

TOM NOLAN: From a fixed-income perspective, the political issue around European integration probably comes down to willingness-to-pay events as opposed to ability-to-pay events, when reconciling appropriate discount rates. I believe that today's eurozone policymakers are unlikely to let things fall apart. However, they may need market pressure to take action, so investors should keep that in mind. That environment should be constructive for core duration.

In the currency space, all eyes will be on the euro. On one hand, it may be risk-sensitive and may become somewhat weaker versus the dollar. On the other hand, the eurozone has a large current-account surplus in a relatively disinflationary world, which would tend to support the currency over time.

TIM COHEN: This is a good reminder that from an equity perspective, top-down, macroeconomic calls are difficult to get right consistently. It's important to keep in mind that we've been through many situations like this one. We think long term and take a bottom-up, company-by-company approach to stock picking. We are leveraging our management contacts around the world to understand how they're reacting to the vote and what the competitive dynamics might be in a new world. Of course, there will be some shuffling around of relative winners and losers in our portfolios but, overall, we believe that the companies we own were well-positioned before the vote and will continue to be.

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