June 27, 2016

Early thoughts on Brexit outcome

- The uncertainty relating to the economic impact of the U.K.'s vote to exit the European Union has spilled over onto financial markets. It is no surprise that the early reaction has been adverse.

- The implication of the U.K.'s decision is not like that previously faced by Greece: there is no suggestion of a repudiation of debt or bank bankruptcy. Given that the U.K. has its own currency, this provides continuity and monetary stability. There is no direct repercussion on the Euro.

- We caution investors against embracing too negative a view based on these developments. The world economic and financial system is on a more stable footing following the financial crisis. The macroeconomic backdrop of low interest rates, low inflation and low commodity prices remains favourable and conducive to growth.

- The brunt of the negative economic impact will likely be felt by the U.K rather than Europe. While 44% of UK exports are shipped to the EU (13% of UK GDP), only about 6% of EU exports are directed to the UK (3% of EU GDP). Business confidence in the UK may well adversely impact corporate investments (10% of UK GDP) until the "rules" of doing business are clarified. Some part of the UK financial industry (8% of UK GDP) may also be at risk.

- It is too early to draw conclusions regarding the domino effect on European secessionist movements and/or the existential risk to the Eurozone. Past efforts to support Greece and other peripheral European members demonstrate the recognition that European integration has been a success and there is a strong desire to maintain the common market.

- In the meantime, central banks will act quickly to provide liquidity should it be necessary. We believe the risk of global recession remains limited, although the risk of a U.K. recession has increased. Our economic outlook is for continued moderate global growth, led by a solid expansion in the U.S.

- In reviewing the implications for our portfolio, we note that only 4% of the non-Canadian equity portfolio is exposed to UK-domiciled companies. The majority of the holdings are multinationals with limited exposure to the UK's domestic economy. We do not own UK banks or hold pound sterling.

- Governments will remain stimulative and bond prices may well receive a temporary boost from safe haven flows. These price distortions, however, do not tempt us to alter our investment position. We remain of the opinion that long-term bonds are expensive and current yields do not compensate investors for inflation.

- Investors have had a volatile time with equities since 2006. The S&P 500 has declined by about 10% or more at least 7 times in the last decade and we have faced in 2009 the worst bear market since the Great Depression of 1929. Nonetheless, patience has been amply rewarded. The cumulative total return from January 2006 to today is 108%.

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