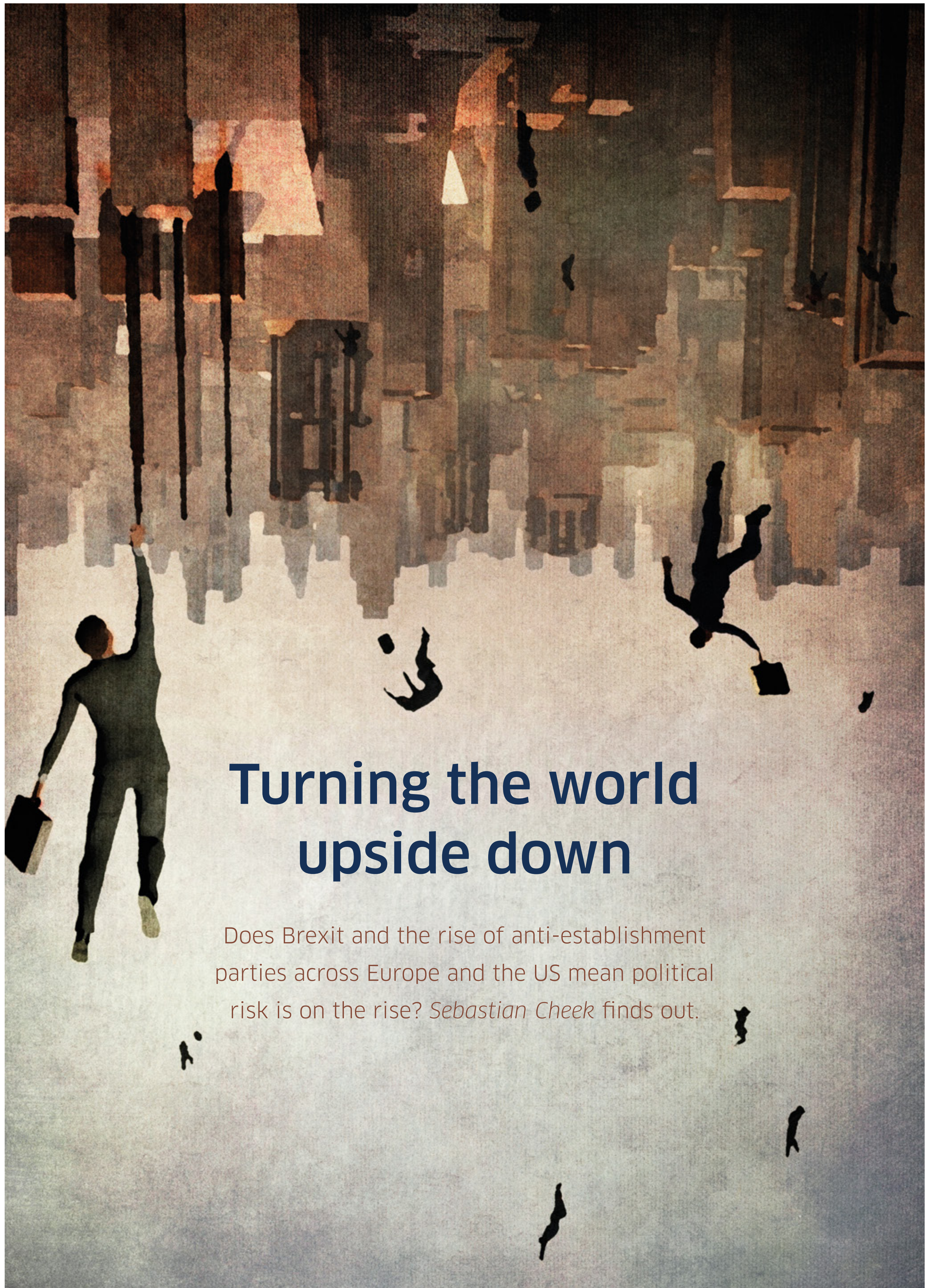

Turning the world upside down

Does Brexit and the rise of anti-establishment parties across Europe and the US mean political risk is on the rise? *Sebastian Cheek* finds out.

It would be no exaggeration to say the UK's vote to leave the European Union (EU) on 23 June caused outright chaos across financial markets around the world. Investors hit the panic button as the realisation hit home that the UK had done the unthinkable and decided to go it alone.

The immediate aftermath was effectively summed up in a tweet by Matthew Goodwin, a professor of politics at the University of Kent, who quoted an FT journalist as saying: "It's a rather strange day. The Prime Minister resigning is only our third most important story."

Indeed, strangeness and uncertainty continued as one resignation followed another in the 'leave' camp. Theresa May's succession of David Cameron as Prime Minister on 12 July did little to clarify the future direction of the UK, with May claiming Brexit would go ahead, but Article 50 would not be triggered until next year.

With big elections in France, Germany and possibly Italy and The Netherlands next year, not to mention the controversial US presidential race and an attempted coup in Turkey this year, the political picture across the globe remains uncertain.

But what is clear is Britain's decision to leave the EU has flipped the concept of political risk in financial markets on its head. Developed markets usually viewed safer than their developing counterparts are now fraught with political risk and investors need to question how this affects their portfolios.

THE FALLOUT

On 24 June, the day after the referendum, the FTSE 100 took a battering, shedding 8% (£120bn) in its biggest opening slump since the financial crisis. But it rebounded to a 10-month high on 1 July, hitting its best level (6,577.83) since the previous August – a 7.2% increase between 27 June and 1 July.

Meanwhile, on 6 July the pound plunged to its lowest level against the dollar in 31 years, bottoming out at $1.28, while UK gilts plummeted below 1% to 0.8% for the first time in history. Two ratings agencies – Standard and Poors and Fitch – downgraded UK government debt.

The Bank of England (BoE) governor Mark Carney immediately tried to quell fears of a meltdown, saying the Bank had been "well prepared" for a leave vote. However, the bank's subsequent financial stability report on 5 July said Brexit risks had "begun to crystallise" and described the current outlook for UK financial stability as "challenging". As a result, the BoE eased the capital control rules on UK banks to encourage additional lending to the tune of £150bn.

The bank also lowered rates by a further 25bps on 4 August, their lowest level in its 322-year history.

CONTAGION

As Ruth van de Belt, an investment strategist at Kempen Capital Management, points out, the dissatisfaction among voters that led to Brexit is not just a UK or European phenomenon; the US is also growing support for anti-establishment parties on both sides of the political spectrum.

"We do not believe that this dissatisfaction will dissipate quickly," she says. "Given the large number of political events scheduled for the coming 18 months, we anticipate that political uncertainty will remain high."

Van de Belt believes increasing political fragmentation is making it more difficult to form stable government coalitions creating, what she terms, a "high risk of a risk-off sentiment flaring up prior to important referenda and elections".

FLIGHT TO SAFETY

In the short term, volatility has hit UK pension funds hard, particularly when it comes to deficits. Following Brexit, panicked investors piled into gilts which pushed yields down and liabilities up.

According to Hymans Robertson, UK pension scheme liabilities hit an all-time high of £2.3trn on the Monday following the referendum result – the worst it has been by about £25bn. Meanwhile, figures from Mercer reveal FTSE 350 deficits hit a record £119bn in June, driven by a fall in both government and corporate bond yields.

"Some investors are effectively forced into buying gilts because of the way financial regulations work," says Hymans Robertson partner, Patrick Bloomfield. "Perversely, higher gilt prices could increase demand for them, pushing gilt prices higher still and potentially sending pension liabilities further north."

Punter Southall Investment Consulting believes that in the post-Brexit environment schemes should ideally hedge 100% of interest and inflation risk – or 50% as an absolute minimum.

"Anything lower is deemed to be a bold bet on markets and leaves a scheme exposed to the potential for interest rate and inflation rate risks to be the dominant source of volatility within the portfolio," it says.

DON'T OVERLOOK SMALL CAPS

The FTSE 100 might have swiftly bounced back, but its composition is largely blue chip companies and arguably therefore, not the best barometer for UK plc. It is lower down the cap scale where UK companies find themselves at the sharp end of the Brexit fallout.

However, Gervais Williams, managing director and manager of Miton's UK Multi Cap Income fund, fears investors are punishing all UK small caps without considering valuations of individual stocks or growth prospects.

He says: "It appears that markets are pricing in a recession for the UK and there has been some indiscriminate selling across sectors and companies which are deemed most vulnerable to a downturn. At present the market is not really differentiating between the valuation of individual small cap companies because most are assumed to be domestic earners."

He believes active fund managers can find attractive opportunities during these periods, but markets will need more political certainty both domestically and with regard to Brexit before they stabilise.

"We expect that this may take the next three to six months to filter through," he adds.

ON SHAKY GROUND

One of the sectors hardest hit by Brexit was UK commercial property and a number of large asset managers suspended trading on

their real estate funds as investors rushed to exit the asset class.

While the majority of these were retail funds, the suspensions raise serious questions around liquidity in open-ended funds investing in long-term property assets, as Keenan Vyas, director in the Real Estate Advisory Group at financial advisory firm Duff & Phelps points out.

"For retail funds in particular this presents a challenge as there is an expectation that investors can redeem at all times, as compared to certain institutional funds which can include lock-up periods," he says. "When this occurs there will be a need on the part of funds to balance managing liquidity and honouring the activities of investors."

But as long-term investors, pension funds should, in theory, be able to take advantage of the associated illiquidity premium.

According to Buck Consultants CIO Simon Hill, a property market correction could favour some investors. "If we see significant downward adjustments, there may well be opportunities to up their allocation to property," he says, "but we won't know until valuations come through."

BREXIT: A LOCALISED ISSUE?

For Mercer Investments head of asset allocation Rupert Watson, the UK leaving the EU is not a systemic event as it is unlikely to lead to major banking problems in the UK or elsewhere. More damaging than Brexit, he claims, would be if a country left the eurozone, which could potentially be as serious as 2008's banking crisis.

He explains: "[Brexit] is localised in the sense that if the UK grows slowly in the next few years and gets a deal, good or bad, that will have implications for UK gilts and currency, but it probably doesn't have implications for US equities, US bond yields or emerging markets. However, if a eurozone country was to leave the EU, that would be massively significant for the whole global economy and would be of an order of magnitude more serious."

Watson's message to investors is to diversify their portfolios and stress-test them against certain scenarios.

"If the eurozone gets much worse, are clients taking too much risk or not enough risk?" he asks. "Think, for example, about what happens if Le Pen [Marine] wins the French general election."

But Buck's Hill believes in the longer term the departure of the UK from the EU is actually a bigger problem for the EU in economic terms.

"[A country leaving the eurozone] would be a very sharp market event in the short term, but in terms of economic changes, [Brexit] has a bigger impact globally, but it will take some years for that to appear."

According to PAAMCO managing director Alper Ince, a bigger short-term issue for Europe, separate from Brexit, is the fact Italian banks are struggling to deal with bad debt and loans that are unlikely to be fully repaid.

"People are worried about Italian banks," says Ince. "The can has been kicked and we are getting close to the day of reckoning. They are trading at 0.3/0.4x book value and that is very low."

He adds savvy investors, such as some hedge funds, have made money in these distressed times, but those people were probably carrying low invested and tightly-hedged exposures on the back of worries over the outcome of the referendum.

RISE OF EMs?

As political and economic uncertainty continues to thrive in the UK and other developed markets, Ashmore Investment Management head of research Jan Dehn believes it is time investors woke up to the fact that developed markets are far from risk-free and that investors are simply not paid adequately.

"For example, between 2000 and the end of May 2016 European investment grade (IG) government bonds had twice the volatility of euro-denominated EM IG government bonds, yet paid investors only half the yield," he says.

Additionally, Lombard Odier Investment Managers head of global equities Didier Rabattu believes the increased loosening of monetary policies in developed markets and potential economic downturn following Brexit could kick-off an emerging market equity bull run.

"Brexit is likely to enable EM central banks to implement more accommodative policies as inflationary pressures recede further," he explains. "There will be strong similarities between Brexit and the events of September 2001 in the US in terms of market impact. The events of September 2001 were an exogenous risk to the US economy that drove the US into recession at a time when EM economies were emerging from four years of crisis. This was the starting point of a multi-year bull run for EM equities."

Insight Investment fixed income product specialist Andy Burgess believes many investors continue to overlook the risks associated with developed market bonds. This, he says, is at the expense of potential opportunities in emerging markets where attractive total returns can be found, despite the extra embedded risk premium.

"Investors tend to regard emerging markets as a homogenous asset class rather than a diverse opportunity set," he says. "Sentiment is often shaped by developments and news flow from a handful of markets. This broad brush approach results in many missed opportunities, in both local and hard currency debt."

The future direction of the UK following Brexit is still anyone's guess at the moment. The triggering of, and negotiations around, Article 50 remain to be seen and until the picture is clearer, uncertainty and volatility will become a mainstay for investors.

Many believe this will make emerging markets more attractive as the balance of political risk in developed and developing markets swings further towards the latter. But it is important to remember that while emerging markets have the scope to add value over the medium to long term, they are still risky.

As Mercer's Watson says: "[Emerging markets[very much have a role to play in client portfolios, but they are inherently volatile and prone to long periods of underperformance, so clients should not have so much that if things go wrong their funding level is badly hit."

The 14th Annual
Local Government Pension Investment Forum 2016

11 - 13 October 2016 | The Guoman Tower Hotel, London

Meet, learn & build relationships with 200+ influential members of the LGPS community

For more information and to register, please visit:

www.finance.knect365.com/local-government-pension-investment-forum

Quote VIP Code FKW53325PI to save 15%

Funds

Delivered by

KNect365 Finance