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Global CIO Outlook
Brexit Reaction: Keep Calm and Carry On

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The British have had their vote, and now the financial markets are having theirs. The news that a majority of U.K. voters decided to leave the European Union was a surprise to almost everybody, and the selloff has been harsh. While this is a historic political event with geopolitical repercussions that we have yet to fully comprehend, from an investor's standpoint, we have seen this story before. Recent market activity is reminiscent of October 1987, when the Dow Jones Industrial Average crashed 22.7 percent in one day, bond yields plummeted, and central banks stepped in to provide emergency liquidity. The important thing to remember is that by the end of the year stocks were up 11.5 percent off the lows, and no recession ensued.

Expect the same this time around. Last week, the Bank of England pledged up to £250 billion to support the functioning of markets, while the European Central Bank and the Federal Reserve also announced they are standing by to provide liquidity support.

This might be a time that the markets reset to the new facts on the ground in Europe, but ultimately realize that the sky is not falling. In the long run there are certainly issues to be sorted through, but in the short run this volatility represents a buying opportunity for Treasurys and gold. I would keep powder dry for most lower-rated securities and stocks.

Policymakers have to sort out the practical aspects of the new relationship between the U.K. and the E.U.—including when to invoke Article 50 of the E.U.'s Lisbon Treaty, which would start the two-year clock on actually withdrawing from the Union. This might take some time, as lame-duck Prime Minister Cameron has said that his successor will be the one to trigger it. Regardless of the Brexit timetable, I believe that unshackling the U.K. from the E.U. has the potential to provide Britain with new economic freedom and growth in a few years, but this will likely follow a difficult period of transition that weakens it as a global competitor. Of greater concern is the possibility that Brexit will encourage the sizable anti-establishment movements

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in a number of E.U. countries to push for referendum votes of their own. This lingering uncertainty, along with the economic impact of potentially lower-quality trade relations between the U.K. and E.U. member nations, could add a risk premium to European financial assets for years to come.

While I think the current environment represents a buying opportunity, we are in a rough seasonal period for investing that does not end until September or October. I am also mindful of the possibility that other shoes might drop, such as the collapse of a major hedge fund that may have levered up on the wrong side of this outcome. Nevertheless, this is not going to be a Lehman moment. Global central banks are not only prepared to support market stability, but they also will likely support any banks that are under pressure. Interest rates around the world are likely to stay lower for longer, which will help to offset the confidence shock that Brexit represents. The Chinese yuan has quietly depreciated against the U.S. dollar, which will help Chinese growth conditions. These conditions are positive for credit markets in the near term and we will be focusing our research efforts accordingly on finding compelling relative value opportunities.

While financial markets are pricing in the probable short- and long-term investment consequences of Brexit, I cannot overstate the historical importance of this event. This has been a clear shot across the bow for the post-World War II consensus that free trade is beneficial to working-class living standards. Implicit in the Brexit vote, as well as the political environment in the United States, is the growing popular opinion that nationalism trumps globalization. This does not bode well for global long-term growth. The sky may not be falling, but storm clouds are brewing.

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