Focus: Brexit Trumped?

I will attempt to address the two unknowns currently troubling investors! Hopefully this note will placate investor concerns. Given current research and views expressed in the public domain with regard to the two potential "black swan" events on the immediate horizon – namely a Trump Presidency and Brexit.

I will address Trump first, given that his view of foreign policy is essentially based on an anti-globalisation stance and for those who fear an irrational Trump, bear in mind that an "unconventional president" will be subject to the US constitution which is specifically designed with checks and balances to negate such an individual.

All three of Trump's signature policy positions, as we understand them, should be bullish for the USD:

1) Increased deficit-financed infrastructure spending,
2) A more restrictive immigration policy,
3) Trade protectionism.

The bottom line is that implementation of these policies could well cause the US economy to overheat, triggering the Fed to raise real rates more aggressively than it otherwise would; therefore it would be marginally negative for treasuries.

Firstly, equities could well rally in the near term following a Trump victory due to increased fiscal stimulus, but are unfortunately likely to face longer-term headwinds stemming from increasing trade protectionism, a strengthening dollar, and rising labour costs. Ironically, the one asset that could suffer the most from a Trump victory is gold on the back of a strong USD and rising real interest rates.

Secondly , given a Trump presidency is a possibility and if he becomes the next US President, then it is anticipated that he would generally take a fairly soft stance towards high-skilled immigrants, focusing instead on curbing illegal immigration through increased border security (the much derided wall) and the rollout of a mandatory national e-verify system (more and very effective = e-wall). This resulting lack of competition at the lower end will boost the wages of US low-skilled workers, a very attractive outcome for the US blue collared worker.

Thirdly, heightened trade protectionism would also reduce the US trade deficit. Lower spending on imports would weaken demand for foreign currency placing further upward pressure on the dollar.

Therefore stay long on the US Dollar and US equities in the short term.

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With regard to Brexit, the decision of Boris Johnson to support the “leave” side of the Brexit debate gives that campaign an identifiable, charismatic leader. This may well contribute to a close and passionate debate and, under this scenario, polls could prove close until the final vote. Ultimately however, we believe Britain votes to “stay” and the market indicates this to be the correct assumption, given the recovery in GBP and bond yields in spite of their ongoing volatility.

Referendum-wise, this dichotomy becomes important as changes in factors, such as currency, domestic consumer, business confidence and bond yields, affect each segment in very different ways. A positive scenario for the GBP would be where post Cameron’s EU deal, the Brexit debate evolves in earnest and the UK later votes to stay in the EU. The risk premium (such as implied volatility) would likely decline, markets could probably reprice the BoE for interest rate increases earlier and some short positions that have been built up on Brexit concerns would likely be covered.

On the beneficiaries’ side for equities, in the run up to the 23rd of June Referendum and in the short term only, we would focus on defensives such as pharmaceuticals and consumer staples. We would avoid Real estate investment trusts (REITS, which are very sensitive to any weakness in sentiment or UK capital inflow risks), retail (where data is softening already), homebuilders, financials (also very sensitive to consumer health) – almost as sensitive as UK small/mid-caps are the areas of the UK market where sentiment is likely to wane.

The liquid UK equity complex can be split into two segments:

(a) A very international index (80% of revenues come from outside the UK) – the FTSE 100 and

(b) A more domestically focused index (45% of revenues come from outside the UK) – the FTSE 250.

Therefore our preference is for the FTSE 100 which is primarily focused on large-cap exporters, over more domestic, midcap indices (i.e. FTSE 250 index). However, assuming an IN Vote is decisive, then one could focus on financials and participate in the recovery / rebound which puts the focus back on Eurozone equities. We also anticipate Eurozone equities to outperform. In terms of sectors, we retain our preference for IT and financials.

In conclusion, both events, in my opinion, should be regarded as a tail risk rather than a central scenario with regard to one’s long term portfolio strategy, however unsettling they may seem in the short term. I remain of the view that an investor should look through and filter the chatter around short term events and focus on the long term strategy by reminding oneself of the following three questions:

a. What is the portfolio aiming for and why?

b. How will it get there?

c. What resources will it need to achieve the desired outcome?

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