Brexit… the Y2K bug of our time?

Deon Gouws - CIO, Credo Wealth - 21 June 2016

Over the past few weeks, we have received an increasing number of questions from clients about the upcoming Brexit referendum in the UK, as well as the way in which this may or may not have had an impact on how we manage portfolios at Credo.

These questions are totally fair, given the ultimate importance of the decision as well as the level of global interest sparked by this referendum.

Whilst we do not believe that this is a forum for political discourse, it's probably in order to make a few summary points in relation to the key issues at hand before addressing the investment questions as such.

I have personally made it my life's work over the past couple of months to try and read everything possible in order to make the most informed possible decision when I eventually enter my own cross on the ballot paper in a few days' time. In this regard, I take my inspiration from Sir Arthur Conan Doyle (most noted for creating the fictional detective Sherlock Holmes), when he said the following:

"The fatal mistake which the ordinary policeman makes is this: He gets his theory first, and then makes the facts fit it, instead of getting his facts first and making all his little observations and deductions until he is driven irresistibly by them into an elucidation in a direction he may never have originally contemplated."

Against this background, I have to admit that I probably also "got my theory first", as I found myself firmly in the Remain camp when I started researching the issues at hand. Having said that, and, having read countless articles in the meantime, a number of the facts simply wouldn't fit… which is why I'm afraid to say that I have ended up firmly in the confused camp.

The initial conviction as a Remainer seemed obvious enough to me. The consensus opinion has always been that Brexit would in all likelihood have a negative impact on for example the value of sterling as well as London property prices (at least in the short term). As a salaried employee in the UK as well as a home-owner in London, a vote against leaving the EU would thus boil down to "voting with my wallet", would it not?

The consensus expectations around negative economic consequences of a possible Brexit have also proved to be prescient to date: in the build-up to the referendum, the pound recently traded only a couple of percentage points above its weakest level since the UK left the Exchange Rate Mechanism in 1992 (it has only been marginally weaker on two occasions, namely the bursting of the tech bubble in 2001 and the Global Financial Crisis in 2008/2009). House prices have also been faltering, especially at the top end (even though there are other contributing factors that are also relevant in this instance, including the recent hike in stamp duty).

So why has my initial conviction been tested so much? Why has it become increasingly difficult to really understand the relative merits and disadvantages of a possible Brexit, as I've been reading more and more about the topic?

One of the main reasons for the confusion simply boils down to many of the key statements made by senior politicians on either side of the debate. Without going into any of the detail, suffice it to say that both camps appear to have been guilty of much hyperbole, quoting all sorts of supposed facts and forecast figures that are highly debatable. The same criticism may of course be valid in relation to a large proportion of politicians and their pronouncements over time, but seldom has it been so clear (in my opinion, at least) that the public has been fed highly selective truths by all and sundry, typically articulated from a position of a clear vested interest.

Putting the politicians aside, how about "following the money"? As a participant in financial markets, this typically tends to be the preferred strategy when having to make a decision; accordingly, what have businesspeople been saying?

Once again, the answer is not clear-cut. Whilst it would appear that the vast majority of CEOs of large listed enterprises are firmly against a Brexit vote, entrepreneurs appear to be more divided.

One can probably rationalise the fact that most captains of industry – those in charge of large institutions – do not want to experience the short-term volatility related to a possible Brexit. Most of these individuals are professional managers who tend to think in terms of relatively limited time frames after all, with huge swathes of share options typically vesting in the next five to seven years (if not sooner). Regardless of the possible longer term benefits of Britain leaving the EU, why "rock the boat" at this stage, with so many millions at stake?

Entrepreneurs, on the other hand, are a more diverse bunch. I have had conversations with a few of them favouring Brexit: some of these people think decades ahead, and therefore they don't really care about any volatility in the short-term (many of them favour Brexit). Others who are involved in more cutting edge industries such as technology (where unencumbered movement of talent across borders – notably to and from continental Europe – happens to be key to their continued success), are typically firmly against Brexit.

At a more macro level, it is interesting to note that practically every significant economic policy and research body has come out strongly in favour of the Remain camp. This includes the Bank of England, Her Majesty's Treasury, the Confederation of British Industry, the Institute for Fiscal Studies, the London School of Economics, the World Bank, the International Monetary Fund and the Organisation for Economic Co-operation and Development... a pretty impressive list, to say the least.

Whilst I respect the considerable collective brainpower within these esteemed organisations, I would point out that most of their leaders and spokespeople would in all likelihood have studied the same economics and/or politics syllabi at a small number of Ivy League and Oxbridge institutions. Is there anyone out there who really expects them to come up with a range of radically different conclusions?

Please don't get me wrong: *I have nothing against economists (some of my best friends know economists)* but given their dismal track record as a profession in forecasting even the simplest of variables, I would not place too much faith in projections relating to a totally unprecedented course of events playing out over the next number of years.

There are other arguments, relating to sovereignty and trade and investment and jobs and immigration and security and Britain's place in the world and the EU's supposed ban on bendy bananas. But for practically every good argument there would appear to be an equally compelling counter-argument. Most people will rationalise their response to any or all of these points, and take a position in accordance with their preconceived conviction – much like the policeman who gets his theory first and then makes the facts fit.

In the meantime, markets have been volatile as the odds of a Brexit outcome has waxed and waned over the past few weeks. To be sure, it would appear as if the potential decision of the UK to leave the EU was a catalyst for a "risk off" environment taking hold in the past week (only to start changing back to "risk on", as the pendulum seemed to start swinging back in favour of a Remain outcome in the last day or two).

It is a well-known fact that financial markets hate uncertainty, and the vexed Brexit question has certainly provided a very healthy dose of this in recent times (and who can blame them… as mentioned earlier in this piece, I even find myself in the confused camp when it comes to the Brexit question!).

When contemplating how to deal with this uncertainty as well as all the dramatic newspaper headlines and the resulting volatility, I am reminded of the situation in 1999 when financial markets were spooked by the so-called Y2K bug. Many people were extremely fearful that all information technology would freeze just as we popped the champagne corks and rolled into the new millennium, due to a small but supposedly significant quirk related to the date field in practically every computer program in the world.

We all know how that ended: the sun rose again on the 1st of January 2000, petrol pumps and cash machines and tills continued to function (not to mention computers!). Life carried on. And markets quickly recovered.

There are many examples: over the years, financial markets have fixated over one looming disaster after another, only to bounce back strongly once the perceived danger starts to dissipate. Recent examples include SARS in China (2003), bird flu in Asia (2004), swine flu in Mexico (2009), the Arab Spring (2011), the US fiscal cliff (2013), ebola in Africa (2014) and a possible Grexit (2012 & 2015).

All of this just underlines the words of Byron Wien when he said: *"Disasters have a way of not happening".*

My hunch is that we will very possibly see a similar scenario playing ▸▸

out after the Brexit referendum, regardless of outcome. If the Remain side wins, the pound as well as UK share prices are likely to enjoy a (further) relief rally following the relative weakness of the past month or two, only to settle into a more fundamentally based trading range once the outcome has been digested.

On the other hand, if the Leave side wins, the consensus expectation appears to be that both the pound and UK share prices are likely to decline at first, before potentially starting to recover and settle into a new trading range based on fundamentals once that particular outcome is fully understood. Bear in mind that the actual economic and other consequences of a Brexit decision will not be obvious for a couple of years (in terms of Clause 50 of the Lisbon Treaty, the UK will have no less than 2 years to negotiate the terms of a prospective exit from the EU).

The bottom line as I see it, is that a lot of the market volatility may start to dissipate relatively soon after the referendum, regardless of the outcome. If this seems like too sanguine a view, I would point out that I am not alone in holding such an opinion: two months ago, Lord Mervyn King (former Governor of the Bank of England) purveyed essentially the same message in an interview with Bloomberg. In his own words, drawing on lessons from history:

"I'm old enough to remember the referendum in Britain in 1975 on exactly the same issue. The one thing that both sides of the argument then were wrong about was that it would make a dramatic difference. It didn't."

This brings me to the question of how a possible Brexit may have played a part in the way that we've been positioning client portfolios at Credo. In a nutshell, it hasn't… and hopefully the discourse above has provided sufficient context in this regard.

In addition, we would like to stress that we build our portfolios at Credo on a bottom-up basis, taking into account company fundamentals when selecting securities. The bottom-line of all this, is that we believe our investments should over time be able to withstand most of the volatility that we see in markets, whatever the reason.

Ultimately we believe that a potential Brexit (and all the speculation and mixed messages from a variety of politicians in this regard, etc.) largely boils down to the kind of "noise" that we choose not to focus on when investing client portfolios. We acknowledge that money can potentially be made by those who take a short term trading view, call the outcome of the referendum correctly and position their portfolio accordingly (in terms of currency exposures, specific company investments etc.) - but that is simply not our philosophy.

At Credo, we prefer to take a longer term view (focusing on potential holding periods of 5 years, if not more) and invest in good quality businesses that we believe we understand and where we are able to gain exposure at reasonable valuations. In our view, very little if any of this is likely to be affected materially by the outcome of the referendum (that is if one ignores the shorter term noise referred to above): the businesses we invest in should continue to trade well, grow their profits and potentially enjoy multiple expansion over time.

For what it's worth, I would also point out that the majority of the counters that we've been adding to our equity portfolios over the past year or so have in fact been US companies, resulting in a situation where we are essentially overweight to the US at this point in time. Purely based on this, I would therefore suggest that the risk of a possible Brexit affecting our portfolios is somewhat limited, in any event.

In a few days' time, we will know the outcome of what has been arguably the most divisive political debate in the UK in a generation. Regardless of the result, however, it probably won't be the end of the world (just like the millennium bug ended up being a bit of an anti-climax 16 and a half years ago).

As Robert Frost famously said:

"In three words I can sum up everything I've learned about life:"

"IT GOES ON"