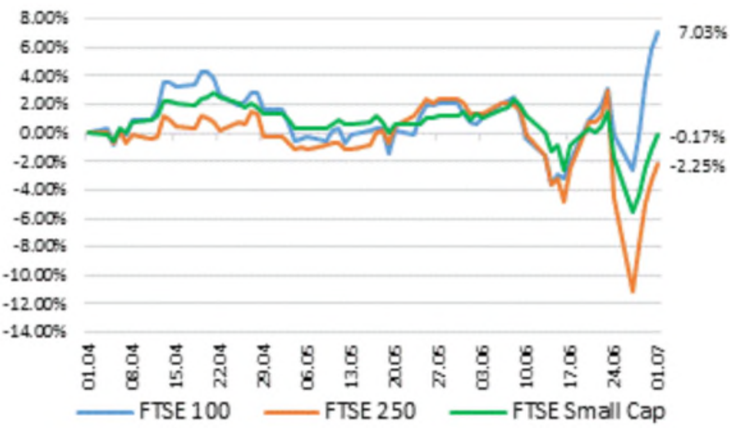
Unsurprisingly, the build-up to and the fallout from the EU referendum has dominated our lives since February and is likely to do so for many years to come. We have read many reports suggesting what the future may hold for the UK economy and for various asset classes now that the decision to Leave has been taken, but none of these reports can realistically provide concrete answers to so many difficult questions. In this report we assess the impact so far and look at the immediate effect on the differing asset classes and sub sectors of the equity markets.

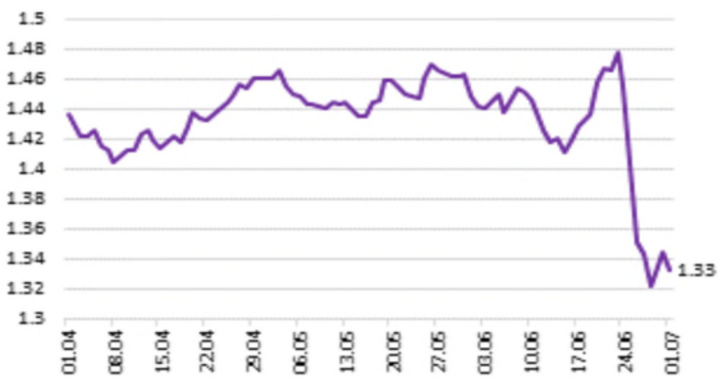
Although some high profile pro-Brexit hedge fund managers benefitted from the volatility and steep declines in markets on June 24th, the global equity market losses on the day of the result were greater in aggregate than those suffered on the day that Lehman collapsed in 2008. By close of play on the Monday after the vote the S&P Global Broad Market Index had suffered its largest two-day loss in history. Then some parts of the market swiftly recovered. Having taken a battering on the day, the beleaguered FTSE 100 regained lost ground and clawed back a large proportion of the initial losses, recently breaking back through 12-month highs. This doesn't tell the whole story because most other major markets have performed poorly since Brexit - notably Europe, Japan and the FTSE 250 index. Whilst these markets have rallied somewhat after the initial shock they have still not reclaimed their previous pre-Brexit levels.

Why has the UK FTSE 100 performed so well whilst the UK FTSE 250 and smaller companies have performed poorly?



The answer lies in our currency. The most significant loser from the decision to leave the EU has been sterling, which has fallen over 10% against the US dollar since the announcement and currently sits at a 30-year low.

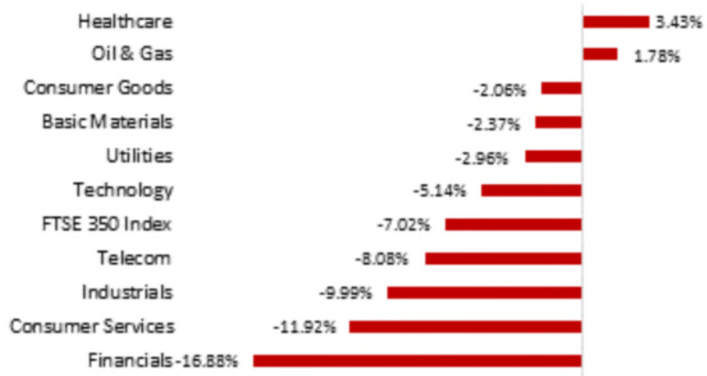
Sterling falls to 30-year lows against the US dollar post Brexit:



It is the weakness of sterling that has led to very differentiated performance across asset classes and individual share prices in the UK. Why? Because there has been a significant rotation out of those FTSE 100 companies whose earnings are predominantly in the UK and into those UK listed companies that have a predominance of overseas earnings.

The main beneficiaries of the strength of the US$ have been gold miners, healthcare stocks and oil companies, all of which have their underlying goods priced in US$. In contrast individual stocks within sectors such as housebuilders, insurers and financials have reacted poorly because a far greater proportion of the companies within these sectors derive their earnings from domestic demand.

A polarised market. Sectors of the FTSE 350 that earn in US dollars perform well whilst domestic focused sectors collapse (2 days following Brexit):

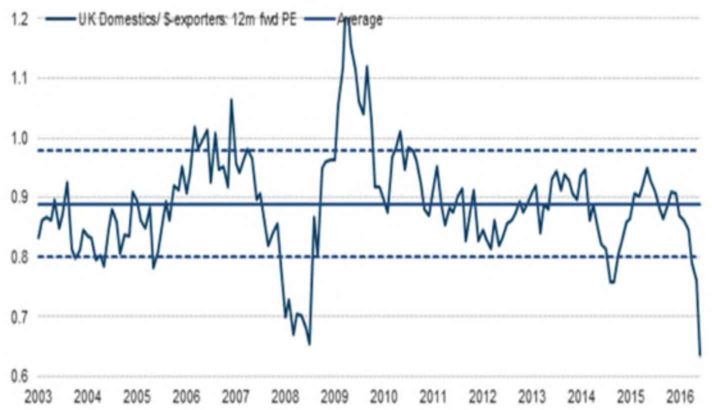


Since the FTSE 250 and Small Cap indices have both struggled, along with domestic focused FTSE 100 companies, this is an indication that there are major concerns about the health of the UK economy as a result of Brexit (reflected in the relative valuations of companies earning their profits in the UK) even though US dollar earning UK companies are due for a surge in profits because of sterling weakness.

As a result of the sell-off in these stocks this has led to UK domestic focused companies trading on depressed valuations even more extreme than in 2008-09 (see PE relative chart below).

This implies that this section of the market is now pricing in a UK recession.

UK Domestic stock valuations relative to the $ Exporters:



Whilst the Government and Bank of England's recent announcements of fiscal and monetary stimulus should help to cushion the impact of weaker investment activity it is difficult to ascertain if they have done enough to ensure any recession is relatively short lived. From our conversations with analysts and fund managers at the time of writing it has become apparent that a cut in interest rates of 0.25% is already priced in to the value of sterling. We believe that in addition to the interest rate cut, re-starting quantitative easing in the UK is a genuine possibility now and that this has not yet been factored in to the value of the pound.

It is unlikely that market confidence will be fully restored until we have a greater degree of clarity on the post Brexit model, regardless of what the recovery in the FTSE 100 suggests.

Overseas equity markets

In much the same way as we have seen UK markets rally due to sterling weakness, so we have seen Japanese markets weaken as the Yen has strengthened. The Yen is perceived as a safe currency in times of market stress (although frankly the rationale for this is unclear in today's markets) and Japanese equities are seen as a "risk-on" market. Since Brexit Japanese equities have fallen heavily, partly because investors sold down riskier assets in general and partly due to concerns about general growth in the Japanese economy. The Japanese Central Bank and Government are expected to do something soon to boost the economy, with possible increases in QE suggested as a starting point.

Similarly, Eurozone equities have performed poorly although the falls in the Eurostoxx 50 were more pronounced than a simple reflection of the strength of the euro Vs sterling. The UK accounts for 13% of Continental Europe's exports and with Brexit immediately after the vote economists cut their Eurozone GDP forecasts by circa 0.5%. We have major concerns about the prospects for Eurozone equities and indeed the euro as a result of Brexit and will be looking to reduce exposure shortly.

In contrast to Japan, Europe and the smaller companies in the UK, the US equity markets have now recovered to levels higher than they were pre-Brexit. The US economy is now approaching full employment and the most recent jobs data (non-farm payrolls) was very strong. This is an indication that the US economy is recovering fairly quickly but there are three outstanding issues yet to be addressed. Firstly, when will the Federal Reserve hike rates again? Strong domestic growth suggests sooner is better but Brexit has made this less certain. Secondly, US corporate earnings fell for the third straight quarter and this can be attributed to US dollar strength hurting US exporters. Thirdly the US election in November may rattle the markets as the big day approaches.

However, with economic growth so robust in the US, we believe that companies with US earnings are a safer place to be than those with either UK or European domestic earnings at present.

Further afield

Some of the bigger beneficiaries of Brexit have been in the Emerging Markets. With the possibility of Global Central Banks adding further monetary stimulus this has been viewed as a positive for riskier assets. This instinctively feels like a sentiment led rally though because for most emerging economies that are reliant on US dollar debt, the same issues still apply from two years ago. This rally also comes in spite of the fact that data emanating from China suggests its manufacturing sector growth had stalled in June.

An exception to this is India, which has been a major beneficiary of lower oil prices, although this is only now feeding through into equity market valuations. We believe that growth prospects for India are still high and continue to support the region as our only real exposure to emerging markets.

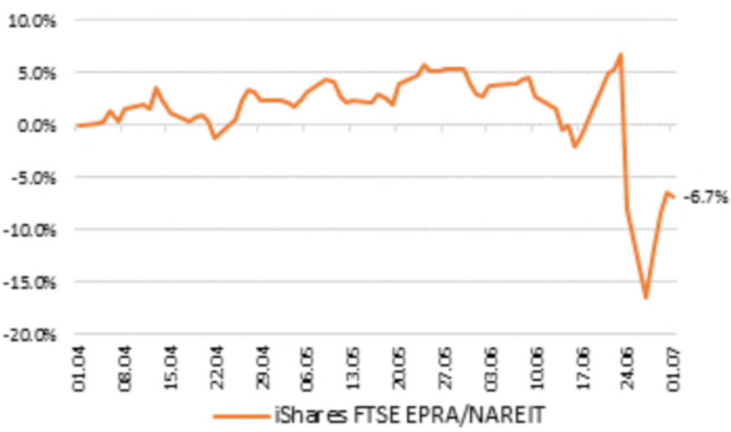
UK Commercial Property

UK commercial property has borne the brunt of the economic pessimism ensuing from the vote and in particular those funds that have a London bias. Perhaps this should be no surprise as property is typically a barometer for economic growth. The two largest Real Estate Investment Trusts, Land Securities and British Land fell 24% and 28% by the time the market closed on Monday 27th June and have continued to suffer in-line with weak domestic data that has been issued since. Great Portland Estates and Derwent London fell by 30% and 34%, whilst the more diversified property investment trusts fared little better, with F&C Commercial property falling by close to 20%.

Yet again, this is an indication that the market is worried about UK domestic growth.

Due to a wave of retail investor redemptions, all of the major UK property funds have closed to further redemptions in the short-term, which we believe to be a sensible move to protect remaining unit holders. The last time that property funds took such action was in 2007 before the credit crunch. Whilst this is a concerning comparison, we feel that the sector is better positioned now and that there will be some excellent opportunities to buy deeply discounted assets in a still relatively healthy property market.

UK property sector takes a hammering due to fears of a UK slowdown:



Fixed Income

The prospect of the Bank of England utilising negative interest rates and other Central Banks postponing any further rate rises this year have driven global government bond yields to record lows.

On the day prior to the referendum result, the 10-year US Treasury yield closed at 1.74% but since then Treasuries have continued to rally amidst the uncertainty to record lows of circa 1.35%. The picture is the same in the UK despite the major ratings agencies downgrading the UK's credit rating, with 10-year Gilt yields now trading at circa 0.8 % from pre-Brexit levels of 1.4%.

Other elements of the Fixed Income market have also fared well in the aftermath, with index-linked bonds in particular benefitting from the currency moves. It has been suggested that a 10% fall in the pound will add 1% to inflation as our imported goods become more expensive. The problem is that this inflation source is supply led inflation rather than demand led. Further stimulus from the Bank of England could compound this problem.

Corporate debt initially suffered alongside European equity markets but we have witnessed a steadying of the ship in the past week or so. Unlike other recent periods of equity market volatility, Brexit has not led to immediate concerns around distressed or forced selling in the corporate bond sector and indeed a number of larger companies, such as Lloyds and British American Tobacco, have issued new debt in the last week. Debt issuance is increasing, particularly in the US as companies take advantage of the opportunity to borrow at ultra-cheap levels for longer, ahead of possible rate hikes in the states.

With the aftermath of Brexit likely to cause issues for the global economy in the months ahead we are very comfortable owning a higher proportion of fixed interest investments in the current climate.

Commodities

Commodity prices have enjoyed mixed fortunes since the referendum, albeit in sterling terms the predominance of commodities stocks have witnessed a significant rally due to their high dollar earnings reliance.

Gold has also performed well, as is typically the case in times of economic uncertainty and on June 24th it rose by 4.7% albeit gains were somewhat pared back through the day.

However, the prices of oil, copper and other commodities fell, partly because they are denominated in dollars. Brent crude oil fell by 4.9% to $48.41 a barrel amid fears that Brexit will spill over into lower global economic growth and demand for crude and the products refined from it. It is not so much concerns about the slowdown in Britain that is affecting global oil prices, but if Europe as a whole suffers from a Brexit-related jolt to confidence the impact would be more severe; Europe accounts for about 14% of global oil consumption.

Summary

Market gains since Brexit can be attributed to investors rotating into companies with a bias for earnings in US dollars, along with a move into investments denominated in most currencies other than sterling. Our view is that the market gains from currency since Brexit have been overdone and that the UK market is artificially high as a result of the shift to US dollar earners in the FTSE 100. Remember that a shift in currency creates a one-off shift in company margins. It is not as a result of a better trading environment, greater efficiency or rising demand. This makes it feel to us that further rallies are predicated on further sterling weakness. Thus until the nature of the UK's relationship with Europe has been decided for sure, investing more globally than before and with less focus on our domestic market is a sensible course of action.