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Insight

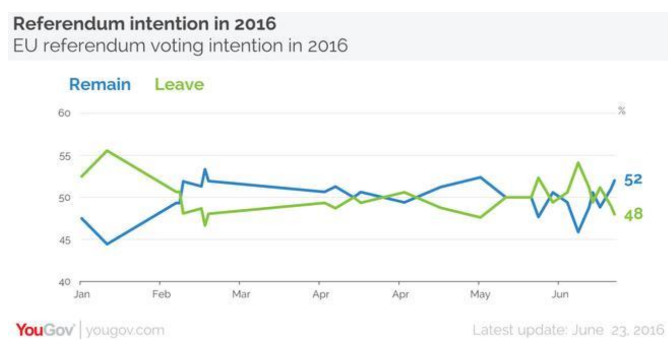
Is Brexit Contagious?

-Manchester Capital Management Strategy Team

The "Brexit" vote on June 23, 2016, whereby the United Kingdom voted to exit the European Union was a significant global event. As business wrapped on the East Coast that day, we shifted our attention "across the pond" and awaited the election results. Pre-election polling predicted a majority of U.K. citizens would decide to "remain" in the E.U. versus "leave." Polls closed at 5 PM in Great Britain, so with results coming before midnight our time we prepared to spend the wee hours of the night tracking the outcome.

In the end, "leave" carried the day, garnering 51.9% of the vote. Global equity markets sold off, interest rates fell, and investors hunkered down to re-assess this new, unprecedented environment.

Global strategists generally advocated caution in the event of a "leave" vote. Most expected the U.K. to experience a recession, a large rise in unemployment, rampant inflation, and a need to craft an emergency budget curtailing spending. Ten months later, none of those predictions have come to pass, though we are still very early in the actual exit process. While the British pound did lose about 10% of its value versus the euro and 15% versus the U.S. dollar, inflation has been modest with March's consumer price index showing a 2.3% increase. The U.K. economy grew 2.0% last year and has seen positive growth for 16 consecutive quarters. Jobs remain plentiful with the unemployment rate at 4.8%.



June 23, 216 – This poll, last updated before the official results were released, shows the close race in the EU Referendum vote with the vote to remain in the lead. The majority of polls taken in the final weeks predicted a vote of "stay."

The real test for the U.K. economy is still to come. On March 29th, the U.K. triggered Article 50 of the Treaty of Lisbon, the formal mechanism for any member country to notify the E.U. of its intention to leave the union. Once invoked, Article 50 gives the leaving country two years to negotiate its exit. While the decision to leave the E.U. has so far been a "net neutral" for the U.K., the arduous task of undoing 43 years' worth of treaties and agreements covering thousands of subjects has just begun.

Meanwhile, right wing populist parties in other European countries had been gaining ground in uprisings similar to those seen in both the Brexit vote and our Presidential election. In the Netherlands, Geert Wilders' Freedom Party vowed to call a referendum on E.U. membership and end immigration from Muslim countries. In the end, Prime Minister Mark Rutte was re-elected, due in part to his subsuming part of Wilders' agenda of being tougher on immigration.

In France, Marine Le Pen's National Front party is also pro-E.U. referendum and anti-Islam. Eleven candidates (only five of whom were invited to a recent debate) are running in the April 23rd general election. The top two candidates will compete in a run-off election on May 7th. Recent polls have Le Pen making it to the run-off but losing badly at that point.

In Germany, the Alternative for Germany movement has been a vocal critic of Angela Merkel, supporting strict border controls and yet another referendum on E.U. membership but Merkel seems secure after softening her stance on the freedom of movement of E.U. citizens between countries.

The good news for European financial markets is that politicians appear to have less of a "tin ear" and are adjusting their platforms to acknowledge the concerns of their constituents. As political risks fade, investors are focusing on an improving economic backdrop. European markets are benefitting from numerous tailwinds:

- strong economic momentum
- earnings growth aided by a weak euro
- attractive valuations
- better consumer sentiment

We feel the risk/reward trade-off is favorable enough to increase exposure to Europe as past examples of crisis aversion have shown us what can quickly happen to markets. European stock markets have defied skeptics by rising since the Brexit vote yet still trade at a meaningful valuation discount relative to U.S. markets. Unlike the U.S., Europe is not raising rates and there is a cyclical tilt to their markets.

We have seen numerous positive surprises in the economic data. The April release of the Eurozone Purchasing Managers Index, a measure of manufacturing, showed output and new orders reaching levels not seen in six years. Improved GDP growth from higher exports should boost employment and income. Consumer confidence continues to improve gradually from the lows seen last March.

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While the risk of rising populism upsetting the balance in the E.U. remains, we are more optimistic than we were on the morning after the Brexit vote. We wish the U.K. well in orchestrating a graceful exit over the next two years and hope we do not have any more late nights watching European election results.