Opportunity in the aftershock

Percival Stanion reveals that after the Brexit shockwave lies opportunity for pension fund investors

Britain's vote to leave the European Union has sent shockwaves through financial markets. Sterling hit a 31-year low against the US dollar and anxieties over the repercussions for the UK economy and political uncertainty have kept markets volatile.

In the run up to the vote we had cut risks in our portfolio and added gold as well as hedging instruments, including a European volatility index. These instruments have protected our portfolio from a sharp sell-off in risky assets following the 'Leave' decision.

While financial markets have stabilised somewhat, volatility and uncertainty are likely to be a continuing trend in the coming months. We also face a number of political risks in the coming months, with an Italian constitutional referendum in October and French and German general elections due next year.

However, every cloud has a silver lining. As the dust settles, the market correction, as well as the wider political and economic ramification of the Brexit, may provide us with an attractive opportunity to add risks.

Firstly, the climate for investment is likely to stay benign for longer than anticipated. Following the vote, investors are pricing in the likelihood that the Federal Reserve will keep interest rates on hold for some time, at least until next year. Easier-than-expected monetary policy from the US should dampen the strength of the dollar, supporting emerging economies.

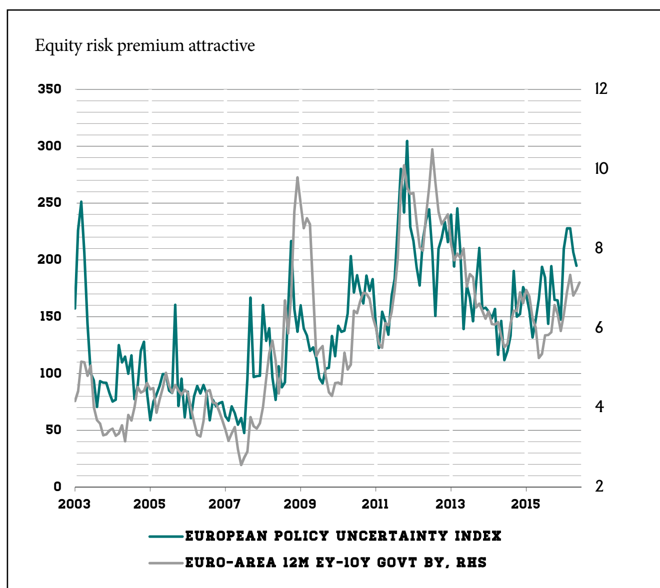
Secondly, the shock defenestration of the political establishment in the UK, in my view, makes it easier for policymakers in Europe and other parts of the world to implement popular and radical initiatives to support the economy.

Talk of recapitalising Italian banks is a case in point. Italy's undercapitalised banks, with €360 billion of bad loans, need help. However, a long list of stringent EU rules constrains the ability of government to rescue them. For example, the government cannot inject capital into the country's banks without triggering an onerous EU 'bail-in' clause, where bank creditors are required to shoulder losses to limit the burden of taxpayers. After the Brexit vote, Italian Prime Minister Matteo Renzi may be able to push its EU partners to approve his otherwise controversial recapitalisation plans which include suspension of 'bail-in' rules.

Finally, post-Brexit turmoil may push European governments to adopt fiscal stimulus to boost growth. In continental Europe, the economic outlook remains weak and the European Central Bank is running out of options as we believe cutting interest rates further into negative territory would be counterproductive.

Against this backdrop, pressure will increase on governments to boost demand by increasing spending, in pro-growth projects such as infrastructure. In Europe, public spending on infrastructure is some 15 per cent below its pre-crisis peak. Business communities in the UK are already urging the government to commit to infrastructure spending in a move to shore up confidence. Critically, there is probably no better time for governments to invest in infrastructure. With the average yield on government bonds close to 1 per cent, borrowing costs are at historic lows. Raw material prices have also slumped.

The 'Leave' vote has no doubt unleashed widespread chaos in Europe's political and economic landscape. However, under the smokescreen of Brexit, impediments to badly-needed change and reform in Europe and elsewhere may be removed. This, if it happens, will bring attractive opportunities for investors in the long term.



Source: Pictet Asset Management, Datastream, June 2016.

Written by Percival Stanion, head of international multi asset, Pictet Asset Management

In association with

PICTET Asset Management