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# INSIGHT

VIEWPOINTS

## Brexit Implications for U.S. Equities: A Roundtable Discussion

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### Introduction – Michael Reilly

The momentous U.K. Brexit vote to leave the European Union has led to a spike in global financial market volatility and a flight to safety due largely to concerns about the durability of the European Union and the euro, and U.S. stocks have suffered from the resulting "risk-off" environment. While the manner in which the U.K. extracts itself from the E.U. remains to be determined, the altered relationship is likely to have only limited impact on direct trade flows between the U.S. and the U.K., which is the 7th largest trading partner of the U.S., representing about 3% of U.S. exports. To be sure, the indirect impact of the Brexit decision lies primarily in the resulting strength of the U.S. dollar which, should it persist, would serve as a headwind to U.S. corporate earnings given that approximately 30% and 40% of S&P 500 company sales and profits, respectively, are derived from non-U.S. sources. While the U.S. equity market is likely to remain quite volatile as the far-ranging implications of Brexit come more clearly into view, there is also likely to be greater focus on the relative attractiveness of U.S. stocks, notwithstanding the uncertainty associated with the upcoming U.S. presidential election. For many companies, the Brexit decision will have little to no impact on their fundamentals, and knee-jerk "risk-off" stock price declines may represent attractive opportunities to initiate or add to positions on weakness. Also, while U.S. stocks had been grappling with the prospect of additional Fed interest rate hikes prior to the Brexit vote, the heightened uncertainty which has now enveloped the U.K. and the E.U. may dim already weak global growth expectations which, together with a stronger dollar, may limit the U.S. Fed's determination to boost rates.

To consider the potential impact of the U.K.'s exit from the European Union, I posed a series of questions to some of my Equity Group colleagues, who share their viewpoints.

## How do you expect the Brexit vote to impact U.S. equities in the near to medium term?

**Diane Jaffee:** Uncertainty creates volatility. While both Canada and Mexico are the U.S.'s largest trading partners, the U.K. and Europe exports represent approximately 5% of U.S. GDP and nearly 15% of S&P 500 revenues. More importantly, they are both politically strategic partners. Clearly, the U.K. and the other Eurozone members are just beginning the difficult and complicated unwind. While all the details are still left to be determined, I believe the U.S. remains a relative haven both as a united economy and currency.

**Craig Blum:** The outcome of the Brexit vote is, in our opinion, symptomatic of a much larger structural problem that is tangling up markets. That problem takes the form of an enormous global sovereign debt overhang that is creating a deflationary undertow across global economies. This outsized debt burden is helping to create persistently weak nominal GDP growth wrapped up in a troubling question that is creeping into capital markets: Will the world be able to grow its way out of this debt overhang or will there be some other forced deleveraging that force feeds a solution to us?

Our forward view starts with an investment landscape that we believe to be mechanically altered. Equity investors are being forced to deal with markets that remain meaningfully disordered and unable to properly value the long-term earnings power observable across a multitude of high quality businesses. Unfortunately, the Brexit vote will (over the short term) probably prolong the market's general unwillingness to capitalize substantial future cash flow into current-period equity prices. This is precisely what has been giving us the stubborn drag on growth stocks that we have been battling for some time.

**Iman Brivanlou:** In the near- to medium-term, I believe that two main outcomes of the Brexit vote will be a strengthening of the USD, and a tightening of financial conditions. The latter is likely to ensue as uncertainty over the details and dynamics of the U.K.'s unwind weigh on the financial sector and cause a retrenchment in the availability of credit. These negative factors will be partially offset by a potential "flight to quality" to the U.S., as investors will likely favor geographies with less of the governance/integration overhangs that have just been unveiled in the U.K. and the E.U., as well as proactive steps by the major central banks to ensure ample liquidity for the financial sector. Over a slightly longer term, one cannot ignore the risk that Brexit will eventually lead to a further dissolution of the U.K. and the European Union as a whole, and result in a more meaningful or widespread slowdown in economic activity. With the increase in uncertainty, I envision that the recent rally will reverse and that we have likely seen the peak in equities over at least the medium-term.

## The decision to leave the E.U. is already having an impact on the U.S. dollar. How will that impact equity markets, and are there sectors that can better withstand a stronger dollar?

**Craig Blum:** U.S. equity markets have been dealing with the complications of a stronger dollar for years. While the translational hit to revenue and profits can appear severe over the short term, the economic impact to most well-managed companies should normalize over the long-term provided we eventually get stability in foreign exchange markets so that year-on-year comparisons can again reflect true organic growth.

With obvious variability across each business, we have seen management teams successfully hedge large portions of bookings, revenue and profits. Additionally, multi-national companies often recognize both revenues and expenses in a single currency which provides some element of natural operational hedging before profits are translated back to U.S. dollars.

**Diane Jaffee:** A rising U.S. dollar will dampen multinational sales due to higher prices for foreign buyers. While some of the negative effects are softened with foreign exchange hedges or matching offshore revenues with on-site costs, there may still be an overall revenue decline solely for U.S. multinational companies, on average, leading to lower earnings and lower equity markets. However, nearly 85% of U.S. GDP is

domestically based, providing strong support even with the headwind of a stronger dollar. The sectors that can do better in that type of environment are U.S.-centric such as hard and soft good retailers along with industrial goods designated for internal consumption, health care, financials, telecoms, and utilities. Commodities priced in U.S. dollars and industries with U.S. dollar costs and foreign currency revenue will face greater pressure.

**Iman Brivanlou:** We witnessed the impact of a strengthening dollar on the economy and the U.S. stock market from mid-2014 through 2015 and by itself, the experience was not adverse. This time, I suspect that a simultaneous tightening of financial conditions and retrenchment of credit will weigh more heavily.

U.S. companies with a domestic footprint stand to benefit from Brexit given that the Fed tightening campaign will now likely be placed on hold until further clarity is gained with regard to the U.K./E.U. unwind. We would avoid investment in energy/commodities/materials at this juncture, as these are likely most vulnerable to a rising dollar. We would also proceed with caution in financials, given the potential for spillover from issues in Europe and the sensitivity of earnings to lower interest rates for many companies within the sector. Thematically, we are clearly in the "get defensive" camp and look to avoid pro-cyclicality.

## Following the U.K. vote, markets expect interest rates to remain very low for even longer. What does the continued low rate environment mean for equities?

**Iman Brivanlou:** Interest rates are a price – or at least, they should be. If rates are low as a result of a flight to safety, it means that the market is voting that the outlook for equities is not very bright – which is consistent with the equity price action that we have seen in the immediate aftermath of the Brexit vote. From a relative standpoint, a continued low rate environment would be beneficial for our investment universe of high dividend equities as yield would be a premium. In this context, utilities and REITs become very interesting, given their domestic geographic footprints.

**Diane Jaffee:** A continued low rate environment means a lower cost of capital for companies, as well as resources to grow with innovative ideas and investments or to pay off debt through refinancing. Financial companies earn lower net interest income in a low rate environment, but attractive lending rates may spur more borrowing and banks can increase net interest income through loans – not just deposits. All of which could paint a positive scenario for equities.

**Craig Blum:** The key features of abnormally low bond yields, negative and zero interest rate (NIRP and ZIRP) central bank policies and weak nominal GDP are all related to one another in a complex loop of cause and effect. They also help define a key (and large) error being made by policy makers across most developed markets. This is because when a monetary prop is held in place for too long, producers begin to consider the crutch an indication of fragility rather than a reason to invest and expand, and are thus more reluctant to deploy capital against growth opportunities.

We believe that these bad policies are producing a deflationary undertow and an unnecessary confusion around economic health. They create an emotional and reactionary market fixated on short term headlines rather than long-term cash earnings.

U.S. equities began the year with a disordered market filled with years of central bank distortion. This was already causing price discovery mechanisms to malfunction. The result was a collection of stock prices that didn't track fundamental progress the way they should. Instead, stock prices rose and fell with changing signals from central banks and related moves in bond yields.

Now, we have a new layer to place on top of the existing layer of dysfunction. We have major confusion and volatility in FX markets that are cutting the connection that stock prices had with central bank policy. So we are an additional "degree" removed from fundamental company specific factors.

We believe this entire collection of policies is harmful and should be retired. We need to stop addressing debt problems with additional debt. Leaders need to stop pretending NIRP and ZIRP are viable solutions to our self-inflicted structural challenges. They are not.

## What are the risks or opportunities for your portfolios?

**Diane Jaffee:** For the Relative Value portfolios, the U.K. and European distractions could subtract momentum from global growth and cause economically sensitive stocks and sectors to lag for a time. We remain steadfast in the search for value poised for growth philosophy and disciplined process and look forward to taking advantage of new market opportunities on our clients' behalf as temporary inefficiencies are revealed.

**Craig Blum:** Over the short-term, we expect to be impacted by the volatility just like every other portfolio of risk assets around the globe. However, we are also well prepared for such volatility, and continue to execute a well-honed and tested process when dealing with this environment.

While each quarter will always deliver some element of both disappointment and upside surprise, we remain confident in the material long-term mispricing that still exists across the portfolio as a whole. We continue to believe that, over the long-term, the current malfunctioning is unsustainable when held up against our fundamental modeling of the profit opportunity facing each portfolio company.

**Iman Brivanlou:** While we are cautious overall, our portfolio is comprised of high quality, well-managed companies with low demand elasticity (high pricing power), and generally lower than average cyclicality. Most of our names have purely domestic footprints. Also, our international exposure is through leading consumer staples and property-casualty insurance companies – again with tremendous demand stability. We view the competitive positions of these firms as strong and their competitive advantages as sustainable. Thus, if the market's selling accelerates or becomes indiscriminate, we would view this as an opportunity to initiate in similar ideas or add to existing positions. The main risk to us is systemic – it would be of little solace to potentially outperform if there is a substantial sell-off across equities.

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