MIRABAUD EQUITIES UK

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The scale of the market's reaction this morning indicates both the degree of surprise as well as the degree to which markets had assumed that it was self-evident that a vote to exit would be disruptive and therefore unlikely. Today began with extreme market volatility and very limited liquidity; throughout the day much of that has settled down such that we now have a somewhat clearer picture of pricing on which to make some judgements. The impact on portfolios on the day is a 4% hit to relative performance, or a 7% decline overall (at time of writing). This is composed of a ~20% decline in more domestically facing businesses, and small rises in many more stable, international businesses.

The biggest certainty we can address is that the UK now faces a period of uncertainty. The Prime Minister has indicated his resignation and will leave the process of negotiating our exit from the EU to his successor. There is a reasonable possibility that even this will be postponed until we have had a general election. Meanwhile, a second referendum on independence in Scotland looks inevitable, and a first in Northern Ireland not inconceivable. We would expect this to manifest itself in delayed decision making across the private sector, both by companies and individuals. This will impact hiring staff, making large purchases or investments, and commencing construction projects.

Helpfully, the Governor of the Bank of England was very swift to address one of the biggest areas of uncertainty. The Bank believes the UK banks to be robust and solvent, and will supply (implicitly unlimited) financial support to the banking system to prevent a credit freeze. Nevertheless, we are still likely to see an increase in borrowing costs for consumers and smaller businesses. As a result, we expect a relatively quick downward adjustment in activity levels, but not a continuing spiral downwards, though a relatively prolonged period to recovery as we wait for clarity on the political situation.

The other certainty is that sterling has weakened sharply, especially against the US dollar. We would expect the dollar to remain a safe haven currency and sterling to remain weak, putting further pressure on the consumer as petrol prices as well as the price of other imports, such as food, clothing and electricals rise. Consumer spending will be under pressure.

Effectively, this means a becalmed economy, or possibly a shallow recession, in the UK. There is a possibility of contagion into wider global economic activity; it seems sensible to forecast a degree of risk aversion and delayed investment, but anything worse seems unlikely. We would expect much of the world to get on with business as usual. The EU itself would be the area we are most concerned about, as campaigns to exit the EU or Eurozone, are invigorated by success in the UK. However, yet again, this will result in interest rates probably remaining lower for longer.

The impact on the portfolio in the short term is centred on a sharp sell-off in London centred real estate as well as house builders nationally and "financials" generally. Offsetting this is strong performance from the overseas earners. However, this is heavily biased towards already expensive large, defensive businesses (tobacco, beverages, food and pharmaceuticals) where we have limited exposure; with general risk aversion weighing against more cyclical or smaller businesses despite a similar, if not greater, fundamental benefit from foreign exchange. In the coming weeks we expect this risk aversion to settle, which would be beneficial to performance as many of these businesses will see a significant improvement in profitability.

As we highlighted a few months ago, many international businesses listed in the UK look very inexpensive today compared to their international peer group. This has become even more the case today. Unhelpfully, many domestic facing businesses, whose valuations are also undemanding, look set for a period during which things get worse before they get better. We are in the process of shifting the weighting of the portfolio towards the inexpensive international opportunities, whilst being mindful that this is not the end of the world for the UK and, although times may be tough for a few months, our domestic holdings have strong balance sheets and robust franchises which will see them succeed as the UK adjusts to a new normal.

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