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Vontobel Viewpoints

The UK Votes Exit

Vontobel Asset Management

The initial reaction to the UK's vote to exit the European Union (EU) has been surprise, markets sharply risk off, the Prime Minister has decided to stand down, the head of the British opposition Labour Party is being challenged, and there has been an avalanche of comments as to why the vote is bad. With 52% of the UK referendum voting for an exit from the EU, British voters have done what no politician we can think of, would have been capable of. One of the central roles of democracy is to act as a pressure valve when a significant proportion of the population is unhappy. Something was deeply troubling a large portion of the public, and almost no one could or would lift a finger. The UK/EU structure had left almost no ability to make changes to ease the pressure building up on a number of issues, particularly controlling the rate of immigration.

This paper will focus on how our portfolios are positioned as we enter what is expected to be a volatile period. The challenges ahead for the UK are not necessarily the same as those faced by UK companies, as they have the ability to shift production overseas if needed to overcome future barriers.

We feel our portfolios are well placed to weather the uncertain period ahead. Our focus on long term investments into stable and predictable growth companies has kept the earnings underlying our Global, International and European equity portfolios well diversified, relatively well insulated from cyclical swings, low direct exposure to the demand from any single EU market, and a high weighting to Consumer Staples companies.

Before going further – a quick look at questions of probability and timing of any new trade framework. A lot is in the air with politics, which is harder to interpret given that both France and Germany have elections next year and will need to play to their domestic voters.

1. Does the UK government invoke Article 50 to separate from the EU?
2. When will it invoke Article 50?
3. What kind of trade deal will result with the EU?
4. How long will it take to conclude negotiations?

Article 50 binding? Article 50 is the part of the EU's Lisbon Treaty that sets a time frame for a country to negotiate an exit and follow on framework. However, the UK referendum was non-binding on the government to invoke Article 50. Should the government successfully negotiate a sharply better deal with the EU, there is potential for a second referendum. We do not bank on it as it would likely require rolling back the EU freedom of movement and residence rules, but it is worth mentioning as we see it as the 'Goldilocks Scenario'.

When? There is no time frame for the government to invoke Article 50. The Prime Minister stated he does not intend to launch the process while in office, and intends to step down by October. This gives three months of negotiating space and we anticipate a new Prime Minister would not be in a rush unless the uncertainty was damaging demand. If there is not an agreement that might swing a second referendum, then we assume Article 50 will be invoked by year end. Donald Tusk, President of the European Council, has clarified that during negotiations the UK remains within the EU, complete with its access to the common market, and EU rules. We feel pressure from upset EU ministers for a quick move is unlikely to result in any change to this timing.

What trade deal? We assume the least attractive scenario – which is no deal – and the UK trades with the EU under World Trade Organization (WTO) most favored nation rules, complete with some new barriers. This would likely result in some companies having to move operations into EU countries along with extra costs, but over the longer term we would not expect leading companies to lose market share.

How long to negotiate? Article 50 gives a country two years to sort out an exit deal once invoked, and can be extended as long as both parties wish (all 27 countries on one side need to agree – not easy to achieve). If it is not extended, then the UK leaves without a trade deal after two years. We expect it will take longer, maybe two to five years, which doesn't mean much except large structural changes will not happen rapidly and would likely be telegraphed well before a deal is concluded.

Weights - Top Sector and Bottom 4 GICS Sectors (June 23, 2016)					
	#1	#7	#8	#9	#10
	Staples	Energy	Industrials	Telco	Utilities
Global Strategy	32%	0%	0%	0%	0%
	Staples	Materials	Energy	Telco	Utilities
International Strategy	42%	1%	0%	0%	0%
	Staples	Materials	Energy	Telco	Utilities
Europe Strategy	42%	5%	0%	0%	0%

Source
Vontobel Asset Management

Based on representative portfolios

Portfolio Positioning

We are keeping an eye on our holdings with large exposure to both the UK and the non-UK EU as we suspect structural changes to both areas are likely. In fact, we feel the potential for change across the EU could be more disruptive than broadly anticipated, particularly for the weaker economies. Fortunately, the banking system across the EU has been strengthened substantially since 2008 and we feel a banking crisis is unlikely. But unfortunately, interest rates are still at very low levels and, therefore, there is little central banks can do to stimulate demand – so if there is a fall in business and consumer confidence across the UK and EU as a result of uncertainty, we assume the outcome will likely be a recession. At this point, we see no reason for an economic crisis.

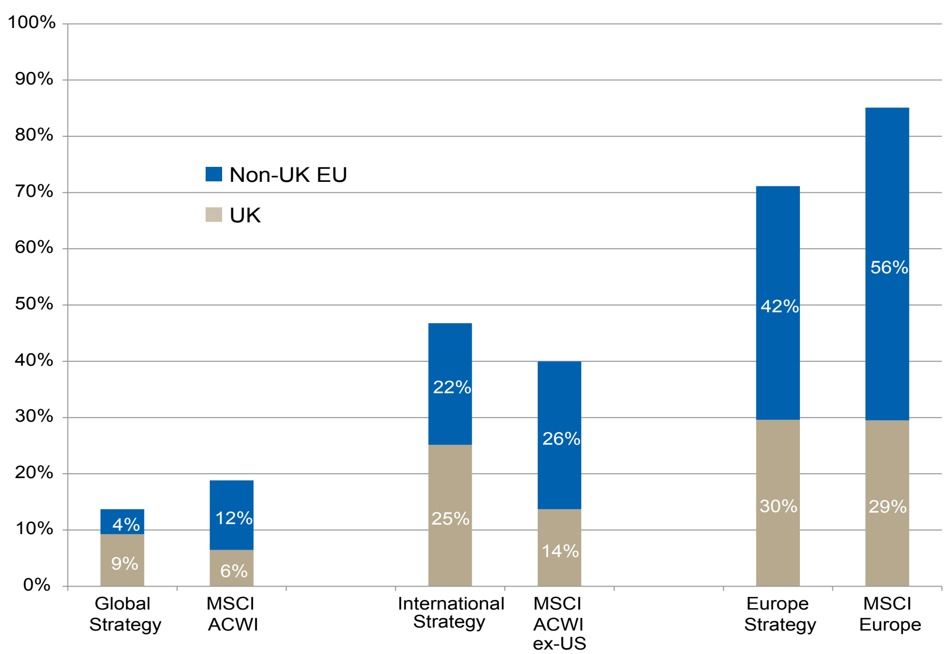
Our Global, International and European portfolios are heavily weighed towards less cyclical companies as illustrated by sector weights. Our portfolios are heavily skewed towards Consumer Staples and away from the more cyclical Energy, Materials and Industrials sectors, as well as the Utilities and Telecom sectors that we find generally capital intensive, with regulated and politically sensitive pricing.

Our Global, International and European portfolios are all overweight the UK and underweight Non-UK EU companies, relative to their benchmarks.

However, as a result of our focus on stable and more predictable growth companies, our holdings are dominated by large multi-national corporations (MNCs), with broadly diversified earnings streams. While UK listed, they are driven by global trends and not solely by UK and Europe. As of 23 June, the number of UK domestic focused companies (where UK revenue >25% of total) held within our representative accounts were: Global strategy 0 of 45 holdings, International strategy 4 of 45 holdings, and our European strategy 5 of 43 holdings.

Having considered the potential impact of an Exit vote for every stock we hold, we did not make any Brexit risk changes ahead of the referendum.

Vontobel Country Weights - Strategies vs Benchmarks (23 June 2016)



Source
FactSet

Note: Switzerland and Norway not included as EU

Based on representative portfolios

The Company Level

There are a number of areas we look at when considering new risks faced by our UK and European investment companies, including:

1. Foreign exchange
2. Consumer and business confidence
3. Regulatory change

Foreign Exchange: the GBP sold off sharply in reaction to the vote, reaching US$1.36 on 24 June, the lowest level against the dollar since 1985[1]. Near term FX impacts are quick to see with valuations reflecting a lower value of GBP denominated earnings and assets in USD terms. We do not invest with a view on short term FX moves. We believe that over our longer term investment horizon, FX moves reflect inflation differentials. For us, this has been helpful in our investing approach, with a focus on growth in real terms, rather than trying to make calls on short term swings often driven by unpredictable sentiment.

UK MNCs are less impacted by GBP weakness than domestic focused businesses as their foreign earnings translate into higher figures in GBP terms. MNCs can also benefit from the dilution of GBP central costs. Over the longer term, if the currency remains weak, this would be helpful for the relatively large UK export and tourism industries.

We note that while the value of foreign earnings should not be impacted by the fall of the GBP, in the near term this is not always the case as the market will often not differentiate in hectic markets – which can create mispriced conditions we may look to take advantage of.

Consumer and business confidence: is expected to impact demand, inventory levels and GDP growth. Due to uncertainty, we feel a fall in consumer and business confidence is likely in both the UK and non-UK EU countries. We do not anticipate a sharp recession as structural changes will take a while to become visible and the banking system is in decent shape.

Regulatory change: too early to read but thinking ahead – some regulations could be reduced for UK companies making life easier, especially for smaller companies on an exit. Regulations that could impact future GDP growth include the restriction of labor into the UK. This could reduce the supply of workers willing to take lower paid jobs, leading to upwards pressure on wages as well as reducing general consumer demand as well as for large ticket items such as housing, and autos from what it otherwise would have been. Another example of a risk is that the financial services industry could also be impacted if it loses the ability to passport its services to EU customers through UK based operations, which could require expanding or establishing new operations somewhere in the EU.

UK Focused Names Held Across Various Portfolios

Persimmon is a UK house builder with nationwide operations outside of London, and the only major UK homebuilder that did not raise equity during the 2008 slow down. We feel the focus on lower price point housing and operating outside of London should provide some cushion in case of a slowdown. The company has a strong balance sheet, has been generating strong cash flow and has an established program to return cash to shareholders. However, consumer nervousness could reduce the demand for new homes and lower forecast earnings growth rates.

Lloyds Banking Group is the largest retail bank in the UK and we believe one of the most solid retail banks in Europe. The company has around 25% of the UK savings market, 20% of UK mortgages and is capitalized with a strong Tier 1 capital ratio of 13% at year end 2015[2]. The company's growth could be impacted over the medium term by a slowdown in demand for new mortgages. A further headwind could come in the form of lower interest rates continuing to hold lending margins down. However, since the bank has the vast majority of its business from within the UK, we do not anticipate it would face pressure to shift any significant operations outside of the UK.

Domino's Pizza Group Plc operates an affordable convenience business of pizza delivery. We believe the company can continue its growth driven by new stores (net 21 stores added in 2015[3]), and digital sales. A slowdown in general consumer confidence could have an impact on high recent same store sales growth. There is also a risk on the cost side, should a fall in immigration lead to higher salary demands.

We will continue to actively review the outlook for our UK and European focused holdings and have no reason to hold any name if we do not have high conviction in its investment case.

June 28, 2016

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[1] Data source Bloomberg
[2] Company 2015 annual report and Morningstar Equity Research
[3] Company 2015 annual report: 65 stores opened for net increase of 21

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