Britain Votes to Leave the European Union

Paul Hancock, CFP® | June 24, 2016

Many of us awoke this morning to the news of the British decision to leave the European Union. After a marriage of more than four decades, 72% of voters turned out to "leave" the EU by a slim margin of 52% to 48%. No doubt, the people have spoken. The vote also propelled the British Prime Minister David Cameron to resign.

The 52% that voted to leave the European Union felt that remaining in the European Union meant less sovereignty, less control over immigration, increased crime and possibly even a higher risk of terrorism. Did they really know exactly what they were voting for? Probably not. Do they also know the consequences of the outcome of this vote? Absolutely not. However, the system was setup to allow only a simple majority vote to allow the U.K. to leave a four decade long relationship with the European Union. Kenneth Rogoff argued strongly this morning that the system should not allow a vote of this magnitude to be decided by a simple majority. Rogoff says,

"This isn't democracy; it is Russian roulette for republics. A decision of enormous consequence – far greater even than amending a country's constitution (of course, the United Kingdom lacks a written one) – has been made without any appropriate checks and balances."

The fallout from the vote will almost certainly be slower economic growth. However, the events today should not be thought of as a "one-off" radical decision from the Briton's. Look no further than Donald Trump and the US Republican Party as having a similar message to voters. Mohammed El-Erian notes that the U.K. vote could also embolden other anti-establishment movements in Europe. In the long run, the European Union should survive, but short-term this political uncertainty leads to financial uncertainty and most likely lower global economic growth.

The immediate impact on global financial markets in the early hours of Friday morning was very negative. Interestingly though, as the U.S. markets opened, the reaction in many markets was calmer than expected. The talking heads on CNBC would tell you otherwise, but a lot of the negative reaction in the markets today are linked to wrong bets made by levered traders as the market rallied during the week leading up to the vote on Friday.

As I wrote earlier this year historically speaking, short-term market dislocations are much more common than we think. A 5% or greater correction should happen more than 50% of the time. What's so shocking on days like today is the feeling we feel as investors when we see stock prices going down. As individual investors with long-term time horizons, it's imperative to keep calm during difficult markets. The immediate response should be to do nothing. Selling stocks when they are dropping lock in unnecessary losses. As I have stressed in the past, a properly diversified portfolio is a weapon against difficult markets.

That uneasy, negative feeling is even more pronounced in June of 2016 because we haven't experienced many extremely negative market reactions since 2009. Some would argue that central banks have lulled the markets into a feeling of complacency over the past seven years. I tend to agree, although a lack of political will to get anything done on the fiscal side in the U.S. is also to blame. Jim Grant who has been outspoken against central banks said this morning,

"It's a great day for humility. I've thought for some time that markets were anesthetized by central banks, and they've lost a little bit of their capacity to look into the future," Grant said. "What was so striking about the events of the past week is the fact that markets were just flat wrong. Markets, proverbially, were able to see through things that individuals were not and markets were absolutely wrong on this."

Financial markets hate uncertainty. The fallout from the "leave" vote has certainly created a lot of political, economic, and financial uncertainty. The natural response from financial markets to uncertainty is almost always negative. Today's decision politically speaking, is one that is beginning to resonate across the globe. As Mohamed El-Erian said this morning,

"The "leave" decision is about much more than a narrow majority of citizens refusing to follow their political leaders. It should be seen as a notable rejection of the political and business elites, as well as "expert opinion." And it also illustrates the regional divides that prevail following a period of low growth, especially growth that has benefited some groups more than others."

Financial markets have long been impacted by political decisions. Political parties will clash, power will be shifted among individuals and parties that make up countries. Those countries that fight for capitalism will inevitably have days like today.

It's imperative as investors to stay focused on the long-term and avoid making rash decisions on short-term events. Investors should instead focus on things that they can control:

- A balanced portfolio that includes lower risk assets such as bonds and cash provides ballast when risk assets suffer.
- Keeping a core of a portfolio indexed for low costs and tax efficiency.
- Keep an eye on valuation levels across asset classes and at appropriate times take action where valuation levels appear to be dislocated from fundamentals.
- Trust the skill of a chosen manager to find and exploit opportunities in difficult market environments.

References

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Index Date Sources: MSCI, Russell, Standard & Poors, Morningstar, Kwanti, Barclays, Hatteras

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