→ A red, white and blue domino

Vimal Gor

We will be writing a much longer piece in this month's Newsletter but given the volatility we thought it was worth sending this quick update on our thoughts and portfolio positioning.

The Brexit vote showed the fault lines that have opened up in Britain across age, education, location and class and these divisions are present and growing across the rest of the western world. To view this as a protest vote would be to underestimate the feeling of abandonment that many sectors of society feel right now and are showing up in many countries as support for far left and far right parties. As inequality rises and the benefits of central bank policies accrue to a small wealthy subset the rise of the disenfranchised was only a matter of time.

Like the single domino falling, Brexit will have ramifications in a range of areas, emphasised by the sheer unexpectedness of the result. As at Asian open on Friday, betting odds moved to 90% expecting Bremain. Friday's markets also showed the reaction: globally bonds rallied 20-25bp, equity markets sold off 3-10% and the US Dollar recovered by 3%. Sterling was off 8% to below 1.37 against the US Dollar, after printing a low of 1.32.

The economic effect on the UK will be immediate. Uncertainty and higher credit costs will slow investment and hiring plans. There is a very high likelihood the UK will fall into recession this year as a result of this. But the key issue is how the Europeans handle this outcome. If Europe comes out on the offensive to make an example of Britain it will further lose the confidence of its people and the autocratic manner in which it acts may well backfire. As more Eurosceptic nations are emboldened to call for their own referendums the pendulum way well swing towards less rather than more integration.

The market effects are broader than just on the UK. I think it's clear that this outcome unlocks further central bank easing, firstly in the UK, Europe and Japan, then the US. Central banks have been itching for a reason to play with more negative rates and helicopter money and this gives it to them. The key question is does this flood of liquidity support asset markets or not, i.e., are the central banks impotent or do they still have credibility? To summarise, I think it will drive bond yields much lower but this has limited effect on risk assets. To buy this dip in risk assets you have to believe that the worst is behind us, both economically and politically. I think the risks are rising on both fronts. As you know my view is that the US is in recession right now, and that the world is slowing. People will blame Brexit for the coming weakness but that is mistaken as it was already there, but Brexit certainly makes it worse.

On Friday morning we believed that the market had largely priced in 'Remain' and as such the risk reward was very attractive. The portfolios

were therefore long duration (in Europe and Australia) and short Euro and AUD against the USD. These trades have worked well and most of the portfolios have generated strong performance so far this month. We are sure the markets will remain extremely volatile and the portfolios are very well placed to benefit from this. Key trades for me are long front end in Europe and Australia, and long 30-year bonds in the US, as a safe haven yield grab story. Long USD and JPY in currencies, against everything else, but certainly the Euro.

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About BTIM's Income & Fixed Interest Boutique

BT Investment Management's Income & Fixed Interest team of ten dedicated professionals, led by Vimal Gor, manage the #1 performing Australian composite bond fund of 2014 and 2011.

For the latest Market Insights from Vimal Gor and his team visit btim.com.au/education-and-resources/

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