The British people have officially voted to leave the European Union (EU). While Scotland, Northern Ireland and London supported remaining in the EU, Wales and the remainder of England overwhelmingly voted to leave. At final tally, 52% voted "Leave" versus 48% "Remain". British PM David Cameron, a staunch supporter of remaining in the EU, announced his resignation following the vote, and expects to officially step down by the Tory Conference in October. Markets, having largely priced in a "Remain" vote earlier in the week, dropped sharply across the board as the results were released. The Sterling hit 30-year lows and most markets saw significant volatility in early trading hours. Despite the market's sharp reaction to the event, very little has actually been established. We expect the recent volatility to be temporary, and that most long-term risks relate to potential unintended consequences of renegotiation of trade agreements and other pacts. At this time, we do not see sufficient justification to change our overall portfolio positioning.

Trade

We believe that the potential disruption of trade is one of the most tangible issues of the vote. The EU is the UK's largest trading partner, receiving nearly half (44.4%) of UK exports. Free access to the single market has been mutually advantageous for most EU and UK companies – particularly the sizable UK Financial sector. Further, the UK has trade agreements with 53 outside countries through its EU membership - including Canada and Vietnam.

Importantly, Brexit does not nullify any trade agreements immediately. According to Article 50 of the Lisbon Treaty, the UK will have at least two years to negotiate a new relationship with the EU, during which all treaties will remain in effect. Because Cameron is leaving the execution of Article 50 to his successor, this makes October 2018 the earliest date the UK could technically exit the EU. The negotiating process will likely be extensive and drawn out, allowing time for the market to adjust. The UK's current lack of a trade representative will require the creation and staffing of a new ministry, delaying the start of negotiations and likely postponing the realised exit date toward the end of 2018.

In the event that a new trade deal does not materialise within the allotted two years, Britain has the advantage of having a "most favoured nation" status at the World Trade Organisation (WTO). This status gives Britain access to low tariffs and minimal administrative barriers with fellow WTO members and acts as an effective safety net for trade. The UK has already made moves to ensure this status continues, reducing most tariffs and barriers to WTO norms. While in the long-term, trade deals will be put in place, this status could help protect Britain's near-term future.

On the Transatlantic Trade and Investment Partnership (TTIP), Brexit will have little impact. The TTIP was always going to require approval by all EU member-states and has been unlikely to come to fruition in the foreseeable future, with or without UK membership in the EU. Trade deals between multiple parties are always difficult to complete — there are simply too many competing interests.

UK Fundamentals

Despite all of the uncertainty, we would note that the UK benefits from having a strong fundamental economy. While growth slowed slightly in Q1 (+1.4% from +2.4% in Q4), the UK has had 13 consecutive quarters of GDP growth. Underlying this growth is the strong UK labour market. The unemployment rate at its lowest level in this market cycle, and aggregate wages continue growing around 2.0% y/y. Yield curves are still positively sloped, suggesting lending should support growth looking forward. Even in the event of a credit downgrade, we think the UK's free markets, rule of law, stable property rights, liquid capital markets, low corporate taxes and a highly trained work force ultimately make it a desirable place for investment. These should remain intact regardless of the outcome of the referendum, especially after the UK renegotiates any broken trade contracts. As the Brexit fog lifts, we expect investors will see economic fundamentals like these more clearly, and the fear of major Brexit fallout will give way to relief.

Political Impacts

On the political front, British Prime Minister David Cameron has said he would resign after Britain voted to leave the EU, anticipating a replacement by October. Leadership contests take time, and it is impossible to know today who will win. Former London Mayor and leader of the Tories' "Leave" campaign, Boris Johnson, is a leading candidate to replace David Cameron. The Leave campaign gave Mr. Johnson exposure to a much wider UK audience than he previously had as London Mayor. Johnson has said he is interested in the position if the post were to become available. Brexit campaigner and Justice Secretary Michael Gove is a potential contender. While Gove is well respected, some members of his party are concerned he would not be able to appeal to and win votes from the whole country. "Remain" campaigners Home Secretary Theresa May and Chancellor George Osborne are also possible candidates—although both do not poll well in conservative home polls. More candidates will likely emerge in the coming days.

A noisy leadership campaign could impact sentiment, but whoever wins, the result should be largely the same: gridlock. The Conservative party is deeply split, and divisions will not improve overnight. The leadership change could also trigger new elections—allowable under extraordinary circumstances under the Fixed-Term Parliaments Act—as Tory leadership remembers the flak Gordon Brown received for not asking voters for a new mandate after he took the reins from Tony Blair.

While political uncertainty likely lingers as this situation develops, a gridlocked government—regardless of its leaders—is a positive for markets. Uncertainty over personalities impacts sentiment. But it also forestalls radical legislation, which, all else equal, reduces legislative risk for markets. The leadership contest will also delay the start of official negotiations with the EU, as Cameron said his successor will be responsible for invoking Article 50. This slows the process further, giving markets even more time to slowly discount the eventuality of Brexit.

The Future of the UK

The vote also brought to light questions about the future of the United Kingdom. Among the four constituent countries, England and Wales voted to leave while Scotland and Northern Ireland strongly supported staying. Scotland in particular previously voted to remain in the UK, largely as a result of believing the UK would remain in the EU. Scotland’s aging population benefits greatly from EU immigrants and agricultural subsidies, and its industrial base depends on access to the single market. First Minister Nicola Sturgeon has already begun calling for a second referendum.

Unionist support could fall in Northern Ireland, which benefits tremendously from a lack of border controls with the Republic. Leaving the EU, as many have noted, likely means reinstating the border, ending the free movement of goods and people that has boosted both sides. Sinn Feín, the nationalist party, has said the vote nullifies Westminster’s mandate “to represent the economic or political interests of people in Northern Ireland,” and deputy First Minister Martin McGuinness has called for a referendum on a united Ireland. Some argue an essentially English decision to reinstate Northern Irish border controls would violate the Good Friday Accords. The security, political and economic implications for both sides are unknown.

Impact on the EU

For most other EU countries, trade is once again the primary issue. Countries with disproportionately large trade relationships with the UK have the most to lose – including Germany, the Netherlands, and Ireland. For Germany, the UK is not only its largest trading partner in Europe (particularly for the automotive sector) but also a political ally in the European Parliament. Germany and the UK have traditionally been the pro-free market voices in the Council of Ministers, counterbalanced by the French led pro-regulation forces. A Brexit would shift this balance, potentially lowering Germany’s political influence.

Some fear Brexit could act as a catalyst to other countries’ Eurosceptic parties, adding legitimacy and providing a blueprint for leaving the EU. Parties in France, the Netherlands, Italy, Spain, Denmark, Austria, the Czech Republic, Germany and others have voiced support for the UK’s decision. While at this point it is difficult to make confident predictions, the UK’s relationship with the EU was notably different from most other countries. Countries also part of the EMU would face more significant headwinds, such as changing currencies, and their departure would likely have larger implications for the EU at large.

Logistically, leaving the EU is largely a two-step process. First, a member country votes internally, via a popular referendum (as in the UK) or through parliament on whether it still wants EU membership. There is no uniform method for calling a referendum across member countries. Each EU country has its own rules for calling a referendum written in its constitutional law and each country’s set of rules is different. The rules cover both the process of initiating a vote and how quickly the voting can commence after a decision. Most countries require a certain number of registered voters to petition for a referendum, which varies from country to country (e.g. Italy requires 500,000 signatures while the Netherlands requires 300,000). Some referendums are non-binding recommendations and still require a bill passed through parliament (as in the UK), while others are binding. Following the internal decision, the member country would announce its decision to the EU and initiate the formal withdrawal process – article 50 of the Lisbon Treaty.

In the long-term, it is unclear whether a Brexit helps or hurts other countries’ Eurosceptic movements, especially given the initial reactions of the market and second-guessing of many UK voters. Perhaps countries will have opportunistic politicians who push quickly to seize the moment, or maybe the lot of them will wait to see how Britain fares in the coming months and years before moving forward with anything meaningful. If Britain faces no major negative repercussions in the long-term, other countries will be more likely to at least entertain the possibility of leaving. This would certainly weaken the unity and future of the EU. Alternatively, other countries may realise how painful the process of leaving is, even for the UK – the fifth largest economy in the world. In either case, it’s all speculation at the moment on events that could be years in the making.

Markets’ Reaction

European Financials have taken the brunt of the negative short-term move, although, looking ahead, we do not expect markets’ near-term reaction to have much staying power. These fears centre around concerns that a UK recession could lead to higher bad debts and reduced loan growth, that narrowing yield curves lead to net interest margin compression, that overall capital markets activity slows and that additional operating costs increase from the movement of some headcount from the UK to EU.

To these, we note that banks have much stronger balance sheets and access to abundant central bank liquidity, which should provide ample resources to manage a lengthy negotiation process with the EU. The Bank of England announced it stands ready to provide £250 billion in short term liquidity and foreign currency. In addition, the European Central Bank’s existing TLTRO II (targeted long term refinancing operation) programme can lend up to around €1.6 trillion in low cost, long term loans to European banks. Underlying this, we expect European Financials holdings to benefit from a strengthening UK and European economy and continued bull market, which should boost loan growth, net interest margins, and capital markets activity in spite of recent concerns otherwise.

Sterling's immediate reaction was also extreme, but give it time. UK debt remains attractive because Britain is a developed market with strong property rights and rule of law, as well as deep and long-established financial markets. It is quite creditworthy and able to service debt, not only at today's rates but even higher ones. Right now more than $10 trillion of high-quality, liquid sovereign debt is trading at negative yields, so we believe many large global investors see gilts as an attractive option at roughly 1.37%.

In the near term, markets will likely see continued volatility as investors assess Brexit winners and losers, but completely unravelling the effects will take time. For now, the most immediate change will be increased uncertainty in the region. Globally, Brexit will likely not have sufficient power to derail global expansion. Corporate revenues and earnings should be better than most perceive, and sentiment should improve as uncertainty related to issues like China, resource prices and US elections should continue to abate.

While the unintended consequences of renegotiated trade and other pacts present risks, we view capital markets volatility related to Brexit as likely to be mostly short-term in nature and unlikely to fundamentally shift larger global equity market trends at this time. Again, as details emerge over the medium and longer term on how trade and other relationships will shift, this may cause us to change our view.

Source: FactSet, Bloomberg, ETF.com, Fisher Investments Research

Terms of Business

1. Fisher Investments Europe

Fisher Investments Europe Limited is registered in England and authorised and regulated by the Financial Conduct Authority (FCA). Fisher Investments Europe's FCA reference number is 191609. Fisher Investments Europe's permitted business is advising on investments, making arrangements with a view to transactions in investments, arranging investments, managing investments, and advising on pension transfers and pension opt-outs. You can check this on the FCA's online financial services register: www.fca.org.uk or by contacting the FCA on +44 20 7066 1000.

2. Communications

Fisher Investments Europe can be contacted by mail at 6-10 Whitfield Street, London W1T 2RE, or by telephone on 0800 144 4731. All communications with Fisher Investments Europe will be in English only.

3. Services

These Terms of Business explain the services offered to professional clients and will apply from when Fisher Investments Europe begins to advise you. As part of its services, Fisher Investments Europe seeks to:

a) Reasonably determine your client categorisation;

b) Understand your financial circumstances and investment aims to determine whether a full discretionary service and the proposed investment mandate and accompanying benchmark(s) are suitable for you;

c) Explain features of the investment approach;

d) Describe investment performance as it relates to your investment mandate;

e) Provide a full explanation of costs;

f) Assist in the completion of documentation;

g) Where specifically agreed, review your position periodically and suggest adjustments where appropriate.

4. Discretionary Investment Management Service and Investments

To help you achieve your financial goals, Fisher Investments Europe may offer its discretionary investment management services. In such case, Fisher Investments Europe will delegate the investment management function, as well as certain ancillary services, to its parent company, Fisher Asset Management, LLC, trading as Fisher Investments, which is based in the USA and regulated by the US Securities and Exchange Commission. Where appropriate, Fisher Investments Europe may recommend that you establish a discretionary investment management relationship directly with Fisher Investments. In such case, Fisher Investments Europe acts as an introducing firm. A separate investment management agreement will govern any discretionary investment management relationship whether with Fisher Investments Europe or with Fisher Investments. Subject to applicable regulations, for qualified investors Fisher Investments Europe may recommend an investment in an Undertaking for Collective Investment in Transferable Securities (UCITS) regulated by the Central Bank of Ireland and managed by Fisher Investments.

5. Client Categorisation

Fisher Investments Europe deals with both retail clients and professional clients. As a user of Fisher Investments Europe's institutional services, you have been categorised as a professional client. You have the right to request re-categorisation as a retail client which offers a higher degree of regulatory protection, but Fisher Investments Europe does not normally agree to requests of this kind.

6. Financial Services Compensation Scheme (FSCS)

The activities of Fisher Investments Europe are covered by the FSCS and therefore if (i) you are eligible to claim under the FSCS, (ii) you have a valid claim against us and (iii) we are unable to meet our liability towards you because of our financial circumstances, the FSCS will be able to compensate you for the full amount of your claim up to £50,000. However, since you have been categorised as a professional client, you are unlikely to be eligible. You can contact us or the FSCS in order to obtain more information regarding the conditions governing compensation and the formalities which must be completed to obtain compensation. Please note that the protections of the FSCS do not apply in relation to any services provided by Fisher Investments.

7. Custody and Execution

Neither Fisher Investments Europe nor Fisher Investments is authorised to hold client money. This means neither Fisher Investments Europe nor Fisher Investments can accept cheques made out to Fisher in respect of investments, nor can they handle cash. All client assets are held at external custodians where each client has a direct account in their own name. If you appoint Fisher Investments Europe or Fisher Investments as your discretionary asset manager, execution of transactions will be arranged through such custodians and brokers *and at such prices and commissions that Fisher Investments determines in good faith to be in your best interests. Further information regarding selection of brokers is set out in Fisher Investments' Form ADV Part 2.*

8. Risks

Investments in securities present numerous risks, including various market, currency, economic, political, business and other risks, and can be very volatile. Investing in securities can result in a loss, including a loss of principal. Using leverage to purchase and maintain larger security positions will increase exposure to market volatility and is not recommended.

9. Data Protection

To advise you on financial matters, Fisher Investments Europe may collect personal and sensitive information subject to the Data Protection Act 1998. By engaging in business with Fisher Investments Europe, you consent to Fisher Investments Europe processing your data, both manually and electronically, including transferring data outside the European Economic Area, including to its parent, Fisher Investments, in the United States, for the purposes of providing services and enabling Fisher Investments to provide services, maintaining records, analysing your financial situation, providing information to regulatory bodies and service providers assisting Fisher Investments Europe and/or Fisher Investments in providing services.

10. Conflicts of Interest

Fisher Investments Europe has a conflicts of interest policy to identify, manage and disclose conflicts of interest Fisher Investments Europe, Fisher Investments or any of their employees or representatives may have with a client of Fisher Investments Europe, or that may exist between two clients of Fisher Investments Europe. Fisher Investments Europe's conflicts of interest policy covers gifts and favours, outside employment, client privacy, inadvertent custody, marketing and sales activities, recommendations and advice, and portfolio management. In addition, Fisher Investments Europe provides a copy of Fisher Investments' Form ADV Parts 2A and 2B to all clients.

11. Fees

If you appoint Fisher Investments Europe as your discretionary investment manager, you will pay management fees to Fisher Investments Europe as detailed in the investment management agreement. Fisher Investments Europe will pay a portion of such management fees to Fisher Investments as the sub-manager. If you appoint Fisher Investments directly as your discretionary investment manager, you will pay management fees directly to Fisher Investments as detailed in the investment management agreement. If you invest in a UCITS fund managed by Fisher Investments, Fisher Investments will receive its management fee indirectly through the UCITS. Fisher Investments Europe does not charge a separate fee for its introducing or distribution services. You will also incur transaction and custody fees charged by brokers and custodians. However, any such additional fees will be payable directly to brokers/custodians, and neither Fisher Investments Europe nor Fisher Investments will share in any commission or other remuneration.

12. Termination

If you wish to cease using the services of Fisher Investments Europe or Fisher Investments at any time, then send notification and the arrangement will cease in accordance with the investment management agreement. However, if a transaction is in the middle of being arranged on your behalf at that time and it is too late to unwind it, then the transaction may need to be completed first.

13. Governing Law

These Terms of Business are governed by English law.