Gluskin Sheff

"Fog in the channel. Europe cut off"

As you are now aware, the UK has voted to leave the EU by a margin of 52% to 48%. UK Prime Minister David Cameron has resigned. There will be a Conservative leadership conference in October and the UK Government will wait until a new leader is in place before invoking Article 50 of the EU Treaty. Not surprisingly, world markets have sold off as a result. Bonds, Currencies and Equities are all down. Gold is up. There is not an inconsiderable amount of fear out there. And yet while the markets have responded in a panicked way, we remain calm this morning. In fact, we have been prepared for this event for several months and see this Brexit sell off as an opportunity for several reasons.

First, the outcome of this vote is not a "Lehman" moment. To be clear, Europe is now fragmented, the UK will face serious economic consequences, and the future of the European trade block is now uncertain. There are risks in play that will have to be navigated, namely, an elevated uncertainty about how existing institutional relationships will change, and an overhang in the coming year regarding the entire EU framework. But while the Lehman crisis was a bankruptcy caused by excessive financial leverage, Brexit is not about business insolvency or even a financial event - it is about shifting politics. Unlike in 2008, this is not an existential crisis in the Global Financial System but rather a political event that will now play out over the course of several years.

Second, the first order economic impacts of this event will likely not be as severe as markets are telegraphing. Certainly the odds of a UK recession have gone up significantly, but in fairness the UK had been struggling to generate growth over the past six months as consumption and investment decisions were deferred ahead of the vote. More importantly, rules of trade remain fundamentally in place, demand for British goods remains strong, and the repricing of the Pound is likely to be stimulative in the near term.

"This will take more than a few days to sort itself out in the markets. But the shock that this vote has ushered in is chiefly political"

Third, central banks have already signaled that they will be exceedingly accommodative to the financial system in the days and months to come. This is important because above all else, it signals that whatever the political outcomes of Brexit may be, the central banks are committed to an orderly process. This is a good thing for markets.

We have been positioned defensively for the past few months in advance of this event and our Co-Chief Investment Officers were in Europe less than a week ago gathering intelligence in preparation for the vote. Today we are positioned as follows: First, we reduced our exposure to the International portfolio significantly in February and again in March. Second, we hedged our currency exposure to the pound and euro. Third, we have been carrying elevated levels of cash in our North American and International equity portfolios (which we will now seek to redeploy). Fourth, we lowered risk in our credit portfolios by reducing overall leverage and reducing our exposure to European securities. Finally, we significantly increased our exposure to Canadian equities which, although not immune to Brexit impacts, are well positioned to benefit given their limited exposure to Europe and the perception of Canada as a 'safe haven'.

To be clear, this will take more than a few days to sort itself out in the markets. But it is important to remember that the shock that this vote has ushered in is chiefly political. While we shouldn't discount this, the market's struggle to reprice this new political risk will lead to opportunities. We are focused on valuations and we will be buyers of strong businesses with limited exposure to the UK when they trade at cheaper prices. In credit markets, we are going to use this as an opportunity to buy corporate bonds that are mispricing the Brexit consequences. It is at times like this that we are confident that our investment process - with its focus on risk-adjusted returns and capital preservation - will benefit you, our clients.