



# EUROPE'S SPRING REVOLUTION AND 'THE LONG GOODBYE'



Michael Browne, Portfolio Manager,  
Legg Mason Martin Currie European  
Absolute Alpha Fund



Steve Frost, Portfolio Manager,  
Legg Mason Martin Currie European  
Absolute Alpha Fund

Today it has been confirmed that the UK has voted to leave the European Union (EU). Following the result and the ensuing uncertainty, we can expect heightened volatility in the markets. Below we consider the impact on our European Long/Short strategy, the UK and EU political scene and the markets.

## Our positioning

In the run up to yesterday's referendum, having seen equity markets rise in anticipation of a 'Remain' vote, we became concerned that the market moves on 24 June would be either up 3% or down 9%, a ratio that was not in favour of being overly net long. We materially reduced our net exposure from 48% to 28% and our gross exposure from 114% to 95% ahead of the vote. We also reduced our exposure to companies with material UK earnings, where we are now only 2% net long.

## A long goodbye

British voters, particularly in the Midlands and North of England, have shown their anger regarding the effects of globalisation, austerity and an increasingly London-centric country. The full process of leaving the EU involves revoking Article 50 of the Treaty of Lisbon, but the official process will only start once the Conservative party has a new leader to replace David Cameron (who resigned hours after the result was confirmed). Matthew Elliott, the chief of the official Vote Leave campaign, stated he sees no rush to trigger Article 50. UK Independence Party leader Nigel Farage is pushing for a pro-Brexit government to be established quickly.

Economists are cutting forecasts for UK economic growth, going into negative territory for 2017. We estimate this will impact European growth as well, by 0.5%.

## Politics

The greatest risk comes from unstable UK politics, given David Cameron's resignation. It is likely that Boris Johnson, former London mayor and a prominent 'Leave' campaigner will become the new Conservative leader before the party's conference in October. We should now expect a larger civil service, required to replace the previous areas of EU competence. Both Labour and Conservative parties will see inner party turmoil, and the UK risks eventually having a weak multi-party coalition.

Europe has a horrible habit of finding issues every couple of years which engender a loss of business confidence whether it be a crisis over Greek government debt, Cypriot banks, the Italian financial sector, and now Brexit. We see this as a much wider overall process of trying to find political consensus across Europe, which gives businesses the confidence to go out and invest.

## Macro

Input-cost inflation will be provoked by sterling weakness, although output pricing power of goods & services in a weak economy remains to be seen. Eventually, less immigration will tighten the supply for low-end jobs and could create some wage inflation. It is our view that there will be a recession in the UK in 2017, driven by weaker business investment. As a result of the referendum, we believe there will be pressure to reduce Europe-led austerity, which could be a major positive catalyst. The weak euro and relocation of Foreign Direct Investment away from the UK to Germany will help the German economy.

## Credit

The Bank of England (BoE) will certainly act to buy UK government bonds (gilts). Market speculation is that

quantitative easing (QE) may rise. The BoE has said that an additional £250 billion is available through its normal facilities. Initially, yields on 10-year gilts have fallen while yields on 10-year German bunds have fallen below zero. An environment of falling yields and flattening yield curves does not stimulate banks to lend and is bad news for bank earnings. Other central banks are also ready to act, as noted by the Bank of Japan governor Haruhiko Kuroda.

### Corporate earnings

It is too early to know exactly how corporate earnings will be influenced by slower European growth. We expect economically sensitive companies in the UK with low margins, stretched balance sheets in fragmented markets and relying on a positive investment cycle, to suffer the most. On the positive side, there will be companies where earnings benefit from currency weakness, which in turn boosts profit translation & transaction effects.

### M&A

UK assets will look cheap, due to the decline of sterling. We would expect an increase in takeover activity, notably by both US dollar-based and Asian companies. The same is likely to apply to continental Europe, given the euro weakness.

### Our response

Despite much negativity around European equities, there can, in fact, be grounds for optimism and an economic recovery might eventually be helped by this referendum, as austerity disappears. Our qualitative 'traffic light' system, which allows us to take a strategic view on the economic outlook, shows that some of our indicators are moving away from a neutral stance to more bullish territory. Corporate costs are well managed, investor exposures are underweight and credit spreads are low.

We will be looking to increase both long and short holdings and have been researching a list of names over the last few months that would be attractive to us in this new environment. Our research focus is on European-centred business models, particularly those which are growing at a faster rate than GDP, with strong market share, pricing power and a low risk of being affected by problems from emerging markets. We are also looking to buy those companies which are now over discounting risks to their business models.

### To conclude

First and foremost, we have focused on protecting capital by reducing the balance sheet and net exposure through this initial period of uncertainty. As a pan-European strategy we have the flexibility to focus on those countries and companies which are either less exposed to impact of the Brexit, or will benefit from it, looking for opportunities to buy decent companies and take short positions on those that will see increased challenges driven by the economic impact of this landmark event.

Source for positioning: Martin Currie as at 23 June 2016. Data from representative account using internal data from Martin Currie systems.

The views expressed are opinions of Steve Frost and Michael Browne as of the date of this material and are subject to change based on market and other conditions without notice and may differ from other investment professionals or from those of the firm as a whole.

---

#### IMPORTANT INFORMATION:

This is a sub-fund of Legg Mason Global Funds plc ("LMGF plc"), an umbrella fund with segregated liability between sub-funds, established as an open-ended investment company with variable capital, organised as an undertaking for collective investment in transferable securities ("UCITS") under the laws of Ireland as a public limited company pursuant to the Irish Companies Acts and UCITS regulations. LMGF plc is authorised in Ireland by the Central Bank of Ireland.

It should be noted that the value of investments and the income from them may go down as well as up. Investing in a sub-fund involves investment risks, including the possible loss of the amount invested. Past performance is not a reliable indicator of future results.

The information and data in this material has been prepared from sources believed reliable but is not guaranteed in any way by any Legg Mason, Inc. company or affiliate (together "Legg Mason"). No representation is made that the information is correct as of any time subsequent to its date.

Individual securities mentioned are intended as examples only and are not to be taken as advice nor are they intended as a recommendation to buy or sell any investment or interest.

Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situations or needs of investors.

Before investing investors should read in their entirety LMGF plc's application form and a sub-fund's share class KIID and the Prospectus (which describe the investment objective and risk factors in full). These and other relevant documents may be obtained free of charge in English, French, German, Greek, Italian, Norwegian and Spanish from LMGF plc's registered office at Riverside Two, Sir John Rogerson's Quay, Grand Canal Dock, Dublin 2, Ireland, from LMGF plc's administrator, BNY Mellon Investment Servicing (International) Limited, at the same address or from [www.leggmasonglobal.com](http://www.leggmasonglobal.com).

This material is not intended for any person or use that would be contrary to local law or regulation. Legg Mason is not responsible and takes no liability for the onward transmission of this material. This material does not constitute an offer or solicitation by anyone in any jurisdiction in which such offer or solicitation is not lawful or in which the person making such offer or solicitation is not qualified to do so or to anyone to whom it is unlawful to make such offer or solicitation.

Issued and approved by Legg Mason Investments (Europe) Limited, registered office 201 Bishopsgate, London, EC2M 3AB. Registered in England and Wales, Company No. 1732037. Authorised and regulated by the UK Financial Conduct Authority.

**This information is only for use by professional clients, eligible counterparties or qualified investors. It is not aimed at, or for use by, retail clients.** F16038\_MC\_Brexit\_Comment