Manulife Asset Management

Global Multi-Sector Fixed Income Team

What drives the uncertainty stemming from the referendum results?

For the UK firstly there's the political impact; Prime Minister and leader of the Remain camp David Cameron has promptly tendered his resignation, saying that the country has made a 'clear decision to take a different path' from what he had supported in the referendum and as such the country needs fresh leadership 'to take it in this direction' [i]

Second, and of more a medium term concern for the UK, is the economic impact from the referendum decision. The economic damage is widely expected to be real but the scale is unknown.

Lastly, and perhaps the largest concern from the referendum result, is around spillover effects, first within the EU but also for the global economy as a whole. Political leaders in many other countries have previously expressed interest in their own chance at a referendum on the EU, and the success of the UK's Leave vote will only embolden them (rhetoric from France, Italy Denmark and Netherlands has already begun.[ii]

On a global basis, in the immediate aftermath of the Brexit vote, we have heard some firm tones verbally from central banks about how they stand at the ready to act but we've seen limited actual action so far. Bank of England (BoE) Governor Mark Carney noted that it's expected that there will be volatility as developments unfold but that the Treasury and BoE have their contingency plans ready and that the BoE 'will not hesitate to take additional measures as required.[iii] The Bank will consider if any additional policy responses are needed 'in the coming weeks', which implies no emergency rate cut as some had expected, with the next MPC meeting July 14. We fully expect the response of each central bank around the world to be fluid over the coming days, weeks and months.

We have been maintaining a defensive posture based on the expectation that the volatility over the past 12+ months would continue as result of uncertainty in global growth, diverging central bank policies around the world (including the speed and path of rate hikes in the US) and targeted market events, such as the "Brexit". This meant we have been cautious towards non-investment grade exposure and emerging markets debt over the past 2+ years. We also paid particular attention to the issue of duration, and a conservative stance with regards to foreign currency risk. This posture served us well to protect on the downside in 2015 and should provide stability in light of today's market volatility and sell-off in risk assets.

We also believe that a focus on high quality positions in government and supranational debt (e.g. Australia, Canada, US municipals) could help to balance volatility due to exposures in US corporate bonds and emerging markets issues. One other way of managing volatility is to focus on more stable sectors and avoid lower quality debt. Similarly, within emerging markets, it makes sense to avoid lower quality and less liquid countries. Lastly, given the currency swings, hedging is important.

Looking forward, the team will continue to embrace a defensive posture in the short-term given the uncertainty of the immediate impact on the UK and Eurozone economies as well as the longer -term implications to the global economy and future changes to central bank policies (for example, the US Federal Reserve is more likely to postpone any near term rate hike and high quality government bonds should remain well-bid as investors look for safe havens). With many sectors and countries bond and currency valuations experiencing dislocations overnight, it could also create opportunities to add risk in both fixed income and currency markets, albeit on the margin, in the coming weeks and months, but will be selective and patient in doing so.

---

[i] (Source: UK Government: EU Referendum Outcome: Prime Minister's Statement, June 24, 2016)[i].

[ii] (Source: Express: Brexit Spreads across Europe: Italy, France, Holland and Denmark All Call for Referendums, June 24, 2016)

[iii] (Source: Bank of England: Statement from the Governor of the Bank of England following the EU Referendum Result, June 24)