June 24, 2016

MARKET UPDATE

BREXIT BECOMES REALITY

HIGHLIGHTS

- The UK vote to leave the European Union ("Brexit") has unleashed political and economic uncertainty for the UK and EU.
- The vote triggered ripple effects across the globe, with investors decreasing portfolio risk and looking for safe havens.
- AB takes an active approach to investing, analyzing individual holdings and portfolio exposures and adjusting positions as necessary. At the same time, volatility creates potential buying opportunities. Our research may uncover appealing individual securities where the current global retreat to safety has resulted in a market overreaction that now provides some appealing securities at attractive prices.

MACRO OVERVIEW

On Thursday, June 23, the UK voted in a popular referendum to leave the European Union (EU). Britain's prime minister, David Cameron, who campaigned for the UK to stay, said on Friday morning that Britain must now prepare for a negotiation with the EU. He also announced plans to resign in three months.

The referendum vote triggered a spike in volatility across global financial markets. Risk assets fell sharply. In currency markets, the euro declined and the pound sterling tumbled, while the Japanese yen rallied. Investors shifted toward safe havens, pushing up prices for gold and sovereign debt. As markets cope with heightened volatility in the coming days, we believe that it's important for investors to maintain a long-term perspective.

The political consequences of the referendum will take time to work through. The Lisbon Treaty, which governs membership of the EU, states that once a country has formally declared it wants to leave, it must negotiate its terms of departure with the other 27 member states. (Note: departing Primer Minister David Cameron, has declined to make that formal declaration of departure, also known as Article 50, and leaders of the Leave campaign have been reluctant to discuss any specific timing on this.)

As a result, the departure process could last for up to two years—and potentially much longer. The complicated and protracted nature of Brexit raises multiple economic and political uncertainties—not just for the UK, but also for other EU member states.

ECONOMIC IMPACT

UK:
For the UK, Brexit is almost certain to weigh on near-term growth. But even in the UK, how much of an effect it will have is hard to gauge, which is why we don't expect any immediate action from the Bank of England beyond the provision of short-term liquidity support. Rate cuts are a possibility later this year, as is another round of quantitative easing if things get really bad. But first, the BoE will want to see some data.

Global:
The impact of Brexit on the global economy will, in large part, be determined by the reaction of financial markets. While the initial market reaction has been sharply negative, we don't think this is a Lehman-like event. Brexit has always been a "known" unknown for which central banks have had a long time to prepare, and they have more tools at their disposal and greater coordination across countries than they did during the global financial crisis of 2008. Ultimately, we expect Brexit to act as a small drag on the global economy. But it could nudge other central banks—particularly the European Central Bank—to loosen policy even further. In other words, rates could be "low for longer."

EU:
A final question is whether or not Brexit spells the beginning of the end for the EU. Brexit is unlikely, in our view, to set off a wave of copycat referendums in other countries, although there have already been rumblings in other EU countries for their own departure referendums. However, there is little or no appetite for this among current EU governments. But it might act as a wake-up call for the EU and push it toward more fundamental reform, particularly in the areas where it has overreached. It may also force it to focus more intently on the different aims and ambitions of its disparate membership, particularly with respect to deeper integration. If so, the EU might even emerge stronger. But we are clearly entering a difficult period in which political risk is likely to remain a recurring feature of the European (and global) investment landscape.

FINANCIAL MARKET IMPACT

Since financial markets dislike nothing more than uncertainty, a period of considerable financial market turbulence looks likely. The consequences of the Brexit vote are complex and unpredictable, making it hard to determine exactly how markets will react over the longer term.

While much of the rhetoric during the referendum campaign focused on the potentially disastrous consequences of Brexit, politicians and policymakers alike are now likely to do everything they can to calm financial markets. We believe investors should not overreact to current volatility.

ASSET CLASS PERSPECTIVES

Equities:
The unprecedented move to leave the EU will clearly have unpredictable consequences for the global economy, markets, currencies and individual companies. While the initial shock is already hitting UK and European equities hard, over the long term we don't think Brexit will undermine returns for every UK-listed stock.

Many of the largest companies in UK benchmarks generate their earnings globally and are not especially exposed to the UK domestic economy or the euro area. Still, UK companies with greater exposure to the domestic market may suffer a big blow as the market digests the consequences of the Brexit vote.

In the run-up to the referendum, our equity portfolio teams identified which holdings would likely be most vulnerable to the fallout from a vote to leave the EU. Now, as markets are reacting to the decision, our teams are intensifying their scrutiny of holdings in the UK, Europe and elsewhere that could be hurt most by Brexit, as well as looking for potential buying opportunities where security prices may have overreacted.

Fixed Income:
Political risks remain elevated globally and liquidity in financial markets remains challenged, which exaggerates price movements. But extraordinarily accommodative central bank policies should help to temper some of the turbulence. We will be keeping a close watch on central banks' policy response to the news. The Bank of England had contingency plans in place that we now expect to be implemented. Other central banks are also likely to act to calm market nerves.

Risk assets may continue to sell off in the near term, and safe havens such as government bonds may continue to rally. But we do not expect a prolonged dislocation in the global financial markets. We are watching the European financial markets closely. At this point it is difficult to gauge the magnitude of the spillover effects to risk assets in the region most immediately affected by Brexit. We are also closely monitoring short-term funding markets for any signs of stress, investor flows and central bank response.

We will be carefully analyzing select corporate bonds—particularly securities issued by financial institutions and more lowly-rated (below investment grade) credit. And we continue to favor shorting the British pound, which is bearing the brunt of Brexit-related uncertainties.

Multi Asset:
Our Multi-Asset Team favors a highly diversified overweight to equities, including US and emerging markets, which have shown greater resilience to Brexit concerns. And exposures to risk-seeking assets include holdings like high-yield bonds and real estate may mitigate steep equity market falls.

We favor a reduction in exposure to the pound sterling and the euro as the polls approached. We also believe in increased exposure to the yen and the US dollar—both of which are safe-haven currencies.

BALANCING NEAR-TERM VOLATILITY WITH LONG TERM OBJECTIVE

Successful investment management requires preparing for the unexpected. We have been consistent in our view that market volatility and continued market surprises are to be expected, and ensure were positioned for this uncertain situation. With volatility and dispersion likely to stay high, our investment teams will be on the lookout for attractive opportunities to capitalize on.

RISKS TO CONSIDER

Market Risk: The market values of the portfolio's holdings rise and fall from day to day, so investments may lose value. **Interest-Rate Risk:** As interest rates rise, bond prices fall and vice versa—long-term securities tend to rise and fall more than short-term securities. The values of mortgage-related and asset-backed securities are particularly sensitive to changes in interest rates due to prepayment risk. **Credit Risk:** A bond's credit rating reflects the issuer's ability to make timely payments of interest or principal—the lower the rating, the higher the risk of default. If the issuer's financial strength deteriorates, the issuer's rating may be lowered and the bond's value may decline. **Allocation Risk:** Allocating to different types of assets may have a large impact on returns if one of these asset classes significantly underperforms the others. **Foreign (Non-US) Risk:** Non-US securities may be more volatile because of political, regulatory, market and economic uncertainties associated with such securities. Fluctuations in currency exchange rates may negatively affect the value of the investment or reduce returns. These risks are magnified in emerging or developing markets. **Derivatives Risk:** Investments in derivative instruments such as options, futures, forwards or swaps can be riskier than traditional investments, and may be more volatile, especially in a down market. **Leverage Risk:** Trying to enhance investment returns by borrowing money or using other leverage tools may magnify both gains and losses, resulting in greater volatility. **Below-Investment-Grade Securities Risk:** Investments in fixed-income securities with lower ratings (commonly known as "junk bonds") tend to have a higher probability that an issuer will default or fail to meet its payment obligations.