// Mint Asset Management
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Mint view of Brexit

UK votes to Leave EU

The UK referendum on whether to stay in the EU (the Brexit vote) was 51.9% in favour of Leaving. This was not anticipated by the markets and reaction has been swift and severe – mainly in currency markets but also across all assets. The day before the vote, most markets had rallied materially – in the (mistaken) belief that the vote would be to Stay. Markets sold off after the referendum results became clear.

Interestingly, the UK share market (FTSE100) was only down a bit over 3% on Friday, although smaller companies on the UK exchange were down more than 7%. The contained reaction by the UK share market will partly be due to the large proportion of foreign earning companies cushioned by the falling GBP. In the USA the reaction continued Friday night with the American share markets down around 3.5%. The market reaction, while swift, was not as extreme as it could have been. The largest impacts were the GBP down ~8% (against the US$), and European share markets were down around 8% as well.

There is considerable uncertainty as to how the exit process will unfold, how long it will take, and what the broader political implications are for the UK and Europe. Uncertainty is generally a bad thing for markets and the hope is that some contingency planning by officials has been done, and there is a backstop plan in place. The exit process will start once Article 50 of the Lisbon Treaty is triggered (the Treaty governing the agreements and membership of the European Union). At the time of writing, the British have not yet invoked Article 50.

Mint Portfolio Positioning

Prior to the referendum we had considered portfolio positioning in the lead up (discussed on our investor call last Tuesday the 21st). We had viewed the vote as too close to call and accordingly positioned the portfolios relatively defensively, as we felt the market was pricing too high a chance of a vote to Stay in the EU.

The Mint Diversified Income Fund (MDIF) has 30% in cash - and 40% in short term fixed interest and cash overall - and only 4% in Trans-Tasman equities, 13% in Trans-Tasman listed property and nothing in Global equities. MDIF holds no UK or European shares and one European bond (Norwegian - outside the EU). In other words, MDIF is very defensively set. This type of market volatility throws up investment opportunities that we will be taking advantage of for the portfolio.

In the Mint Equity Fund we hold just under 20% cash, and around 20% in Australian shares. The Portfolio Manager has repositioned the fund over the last 6 months to hold larger cap liquid names – top 10 NZX stocks now make up 42% of the portfolio (or two-thirds of our NZ shares) to reduce potential liquidity risk in the small caps. ASX indices underperformed NZX on Friday (post Brexit) due to the large Bank and Resources weights in that benchmark, and we expect that will likely continue in the days ahead. The portfolio holds no Banks and the only resources exposures are small holdings in gold miners which should continue to benefit from the global uncertainty.

The Mint Property Fund has around 88% of the portfolio in New Zealand, 8% in Australia and 4% in cash. The NZ listed property sector has very little exposure to markets outside of New Zealand and Australia. The NZ listed property sector had, prior to Friday 24th June, already weakened considerably over the month as the market absorbed two capital raisings, the Investore IPO and the Vital Healthcare (VHP) Rights Issue. Aside from small holdings in Westfield and Goodman Group our Australian investments are

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largely domestic focussed with a high level of diversification across office, residential, industrial, retail, healthcare and manufactured home estates.

Performance

Currently the Mint Diversified Income Fund is slightly positive for the month to date, with the cash weighting offsetting the weakness in NZ and Australian equities and property stocks so far. The Mint Equity Fund is down moderately month to date, and ahead of the NZX50 benchmark so far. The Property Fund too is down moderately month-to-date, but is ahead of the NZX Property index.

During times of uncertainty and volatility and in the current low growth, and low interest rate environment the property sector tends to outperform. Our portfolio managers are reviewing a number of opportunities that this volatility is generating across all our portfolios, and we expect to deploy cash holdings into these opportunities in the ensuing days.

Implications for New Zealand

When the UK entered the EU in 1972 there was a significant economic impact on New Zealand as Britain was our largest trading partner at the time. Now Britain accounts for less than 5% of New Zealand's exports. From a pure economic perspective, the impacts on NZ are relatively low. However, NZ has a number companies with investments and businesses across Europe as well as the pure export/import trading relationship. These companies may experience some uncertainty in their operations, and revenues and asset values will vary with the volatility in currency exchange rates (e.g. an asset in GBP is worth 5% less in NZ$ terms as of Friday night).

There is potential for the Reserve Bank of New Zealand (RBNZ) to cut rates and/or at least stay hold for much longer. Global volatility events often result in commodity linked currencies (like the NZ$) being sold down. This hasn't happened as yet and the NZ$ has risen against the GBP and the Euro.

New Zealand will remain a desirable immigration and investment destination and will continue to be seen as a stable country, with positive economic performance, and positive interest rates. To that extent we expect capital inflows from offshore investors into New Zealand to continue.

Short term market implications

If markets become disorderly, then we expect co-ordinated intervention by the various central banks. We also expect that the UK would have an emergency budget at some point, and the Bank of England to undertake monetary easing fairly quickly. The US Federal Reserve is highly unlikely to raise rates in this environment – potentially not even for the rest of the year (with a US election looming later this year). The strength of the NZ$ coupled with these global events increases the likelihood that the RBNZ cuts our Official Cash Rate in August.

So far the market reaction has not been disorderly – the pull-back is consistent with the heightened uncertainty caused by the vote to Leave. We expect volatility across all assets to remain elevated and commodities to struggle in this environment. If the fallout continues the US$ and possibly Gold will be seen as safe-havens and are likely to continue rising. Bond rates should stay low at least until there is a clearer picture of the path ahead.

The contained reaction on Friday night could mean that this may just be a storm in a teacup (for markets that is) – particularly if the UK and European policy makers act swiftly with some definitive plans on the path ahead. Unfortunately, such definitive plans have not yet been forthcoming.

Longer term implications

While an exit by the UK is bad for the UK's economy in the short term; it is probably worse for the EU – in our view Europe needs Britain more than Britain needs the EU. It will also encourage other separatist/isolationist movements in Europe. So the longer term implications for the whole Euro experiment are not good.

The Brexit vote to some extent reflects a dissatisfaction amongst the populace with the prevailing state of the economy and heavy bureaucracy. This is not limited to the UK, and there are elections forthcoming in Spain, the Netherlands, France and Germany. With the European economy having been in the doldrums for some years now, the dissatisfaction vote seen in the Brexit decision could easily be seen also in the rest of Europe. To that end, the Brexit vote might turn into just another step in a swing back towards nationalism / isolationism in Europe, and away from the Globalisation policies that have been pursued for many years now.

There is already talk in Scotland of another referendum for independence from the UK. The first one was defeated in 2014 in part because separation from the UK back then was seen as inevitably meaning leaving the EU. In the Brexit vote last week the Scots voted to Stay in the EU by a significant majority, but the rest of the UK went the other way. So, they might use this as a chance to leave the UK and stay in the EU.

At the investment level, uncertainty will prevail until the terms of the UK's exit are finalized (the Lisbon Treaty allows for a 2-year period of exit / transition, starting once Article 50 is invoked). New tariffs and trade agreements need to be arranged, and will affect companies' revenue and margins. There is considerable potential for the European economy to backslide into recession. Public sector budgets (in the UK at least) will need to be redrawn.

All of this argues for investment caution. This is why markets have reacted the way they have, and may continue to do so. Conversely, this is why investment opportunities will arise.