Market Update

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European Union Referendum

Aaron Barnfather, Managing Director, Portfolio Manager/Analyst
Alan Custis, Managing Director, Portfolio Manager/Analyst
Laura Somers-Edgar, CFA, Vice President, Client Portfolio Manager

Brexit Result

Over the past four months, voters and investors alike have grappled with the potential impact of yesterday's referendum on the United Kingdom's continued membership of the European Union.

Today's result suggests we will now have the opportunity to test the accuracy of these predictions after 51.9% of voters opted to Leave the European Union. This outcome creates considerable uncertainty for the coming weeks, months, and perhaps even years. This upheaval may also be exacerbated by the fact that recent movements in currency and equity markets suggested the consensus view was for voters to choose to Remain.

The greatest impact is likely to be felt in sterling and UK equities (especially those with domestic exposure), but also in the euro, European equities, peripheral European bonds, and global equities.

The outcome is not binding, and therefore we cannot rule out wider political ramifications or even a second referendum at a later date, but this would create further uncertainty.

Below we review the process for leaving and consider the implications for the political landscape, financial markets, and the UK economy.

Process for Leaving

There is considerable uncertainty surrounding the process that will now follow, as there is no precedent of a member state leaving the European Union. The key question is when Article 50 of the Lisbon Treaty (which sets out the process for a member state to leave the European Union in broad terms) will be invoked, giving notice that the United Kingdom intends to leave the European Union. This action then sets in motion a two-year time frame for negotiations to take place, after which the United Kingdom would cease to be a member of the European Union unless an extension is unanimously agreed upon by all member states. It could also end sooner by agreement, but given the complexity of these negotiations this seems unlikely.

The two-year limit exists to prevent Article 50 being used as a bargaining chip by a member trying to negotiate more favourable terms, which also reduces the likelihood of an extension being agreed. With elections taking place in many countries it is likely that other members will pressure the United Kingdom to act quickly, but they are unable to force the United Kingdom to start the process of leaving. Spain has a general election on 26 June, with elections in Netherlands (general) and France (presidential) by next spring, and a constitutional referendum on the structure of Italy's senate will be held by October.

The second question—which is clearly entwined with the first—is whether there is a change of leadership in the ruling Conservative Party, or a vote of no confidence leading to a general election. Some view this as inevitable given that the government backed the Remain campaign and that Prime Minister David Cameron and Chancellor George Osborne were both very involved in the campaign.

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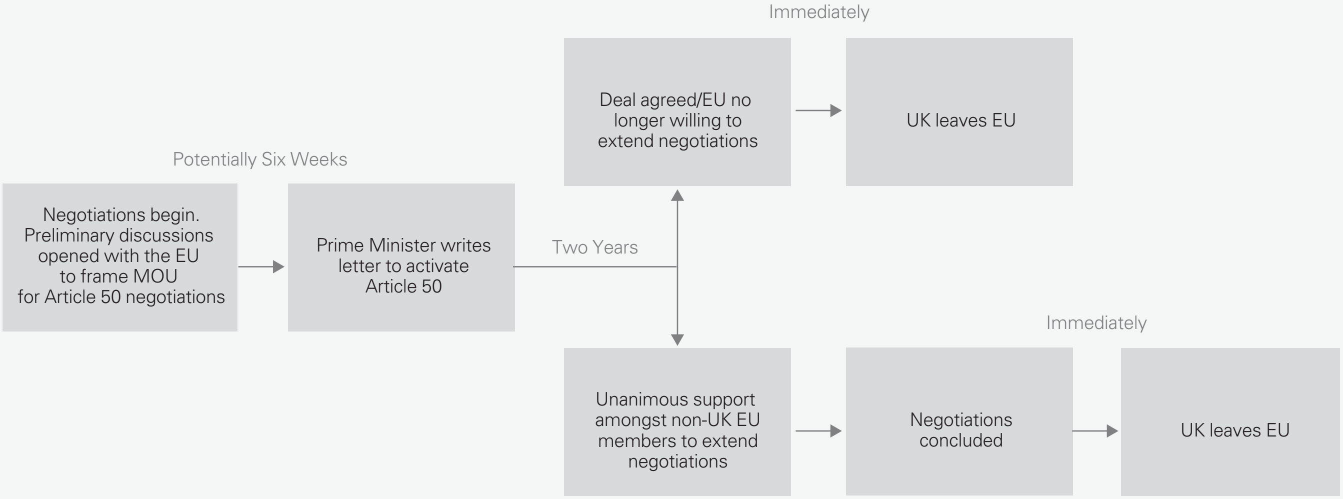
Exhibits 1 and 2 below, provided by Credit Suisse, show the process as it *should* occur, and the rather more complicated reality:

Exhibit 1

How "Brexit" Should Happen

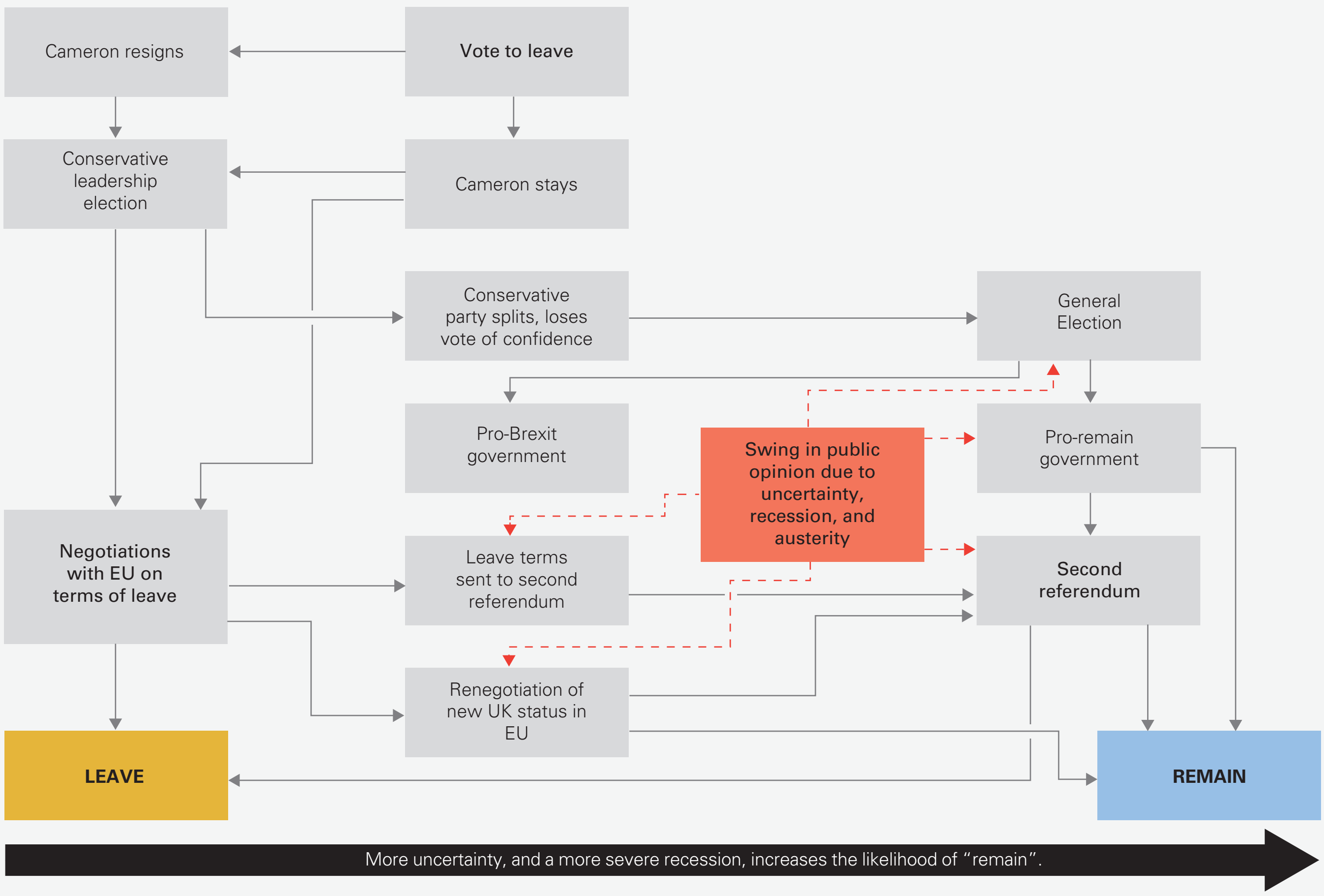


For illustrative purposes only

Source: Credit Suisse

Exhibit 2

UK Equity Market Response



For illustrative purposes only

Source: Credit Suisse

Financial Market Impacts

We expect sterling to fall sharply against the US dollar. The euro is also likely to weaken against the US dollar, although to a lesser extent.

UK equity markets are likely to weaken significantly and we can expect widespread declines. On a relative basis domestically focused stocks are likely to weaken more than exporters which stand to benefit from weaker sterling. But, in the immediate aftermath, we expect sentiment to override fundamentals and for selling to be indiscriminate. However, after the initial sell-off, we believe that small- and mid-cap stocks will subsequently underperform the large-cap FTSE 100 Index on a relative basis.

Equity market weakness is unlikely to be restricted to the United Kingdom, however, and we expect European and also global markets to react negatively as investors factor in a UK recession and start to question European integration. We expect the impact to also be felt in bond markets, particularly in peripheral Europe.

At the sector level, financials are likely to underperform given the potential impact from the loss of the EU's passporting regime. This would affect both UK and European-listed financials.

In *Brexit's Implications for Financial Markets and Beyond* we discuss the equity market impact at a sector level in more detail.

Longer-Term Economic Effects

The long-term effects on the UK's economy are an area of considerable uncertainty, and dependent on the timing (i.e., how soon the process begins, and how soon the United Kingdom actually leaves) and the terms of the new agreement with the European Union. Trade is a particularly important consideration.

The uncertainty around the timing of the UK's departure is likely to be negative for business and consumer confidence, and therefore decisions around hiring, investment, and significant purchases will probably be delayed. This will clearly have a detrimental effect on the domestic economy.

Investment Actions

As bottom-up investors, our focus will remain on identifying financially productive companies at attractive valuations. The past few months have resulted in volatility which has presented both challenges and opportunities, and we will continue to search for stock ideas where we believe market valuations are disconnected from the fundamental value of the businesses.

We will also be focused on talking to company management teams, as we have been doing for some time already, and seeking to understand the impact on their businesses and any action they are taking due to this turn of events.

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