Should They Stay or Should They Go?

The outcome of Britain’s June 23 referendum on whether to remain a member of the European Union (EU) or leave could rock the British markets and increase global market volatility for some time to come, in our view. While we view it as unlikely, an exit is certainly possible and something to be aware of in the near-term. Our DAA service is modestly overweight return-seeking assets, but has diversified exposure in response to uncertainty over market direction for several reasons, including Brexit.

Market Roundup

- **Stock markets were mixed in May.** US stock markets rose in May on positive economic indicators, including the highest new home sales since 2008, and continued strength in both home prices and oil. The housing market recovery, which we noted last month, bears watching.

- **International developed and emerging markets fell in US dollar terms in May due to weak economic growth and US dollar appreciation; international developed remains down year-to-date.** US markets have been strongest year-to-date (Display 1).

- **Oil prices climbed due to global supply disruptions.** The WTI price of crude oil reached nearly $50, a new high for the year, toward the end of May. Other commodities also strengthened. Real assets, which include commodities, commodity-producing securities, and real estate securities, retreated in the month but remain far ahead year-to-date.

- **Returns on high-grade bonds were flat in May but strong year-to-date.** Yields fell year-to-date, but were flat in May despite Federal Reserve comments on potential interest-rate hikes.

- **High-yield bond returns were up slightly in May and are up strongly year-to-date.** Rising oil prices and the search for yield have helped to sustain the rally from its February low.

- **The US dollar strengthened slightly in May and is down 4% year-to-date against a trade-weighted basket of currencies.** Recent comments from several Federal Reserve officials indicate that an interest-rate hike may come sooner than currently expected, signaling a possible retreat from a recent dovish view of monetary policy.

Brexit Risk

One event that could roll the markets is the UK referendum on June 23 on whether to remain in or leave the European Union. While unlikely in our view, a vote in favor of “Brexit” could tip the UK into recession and increase global market volatility.

Bernstein clients have limited direct exposure to British markets across their diversified accounts. More broadly, in the potentially more volatile environment ahead, short-term market moves can create opportunities for our actively managed portfolios, and our Dynamic Asset Allocation (DAA) service seeks to keep our overall portfolio volatility close to the client’s target range.

The Background

The UK referendum is an attempt to address increased concerns that the cost of Membership in the EU has become too great and that Britain could do better on its own.

Display 1

<table>
<thead>
<tr>
<th>US Stocks Do Best in May</th>
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<tbody>
<tr>
<td>Index Returns in US Dollars</td>
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<tr>
<td>Stocks</td>
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<tr>
<td>US</td>
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<tr>
<td>Intl Developed Markets</td>
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<tr>
<td>Emerging Markets</td>
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<tr>
<td>Bonds</td>
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<td>Municipal</td>
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<tr>
<td>Taxable</td>
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<tr>
<td>Alternatives</td>
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<tr>
<td>Funds of Hedge Funds</td>
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<tr>
<td>Real Assets</td>
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</table>

*Past performance is not necessarily indicative of future results.

US stocks are represented by the S&P 500 Index; international developed-market stocks by the Morgan Stanley Capital International (MSCI) EAFE Index of developed markets in Europe, Australasia, and the Far East; emerging-market stocks by the MSCI Emerging Markets Index; municipal bonds by the Lipper Short/Intermediate Blended Municipal Fund Average; taxable bonds by the Barclays US Aggregate Bond Index; hedge funds by the Hedge Fund Research Inc.’s (HFRI’s) Fund of Funds Composite Index; and real assets by an equally weighted blend of the MSCI ACWI Commodity Producers Index, FTSE EPRA/NAREIT Global Real Estate Index, and Dow Jones-UBS Commodity Index. See “Information About MSCI” at the end of this report.

*The data are not yet available.

Source: Barclays, Dow Jones, FTSE, HFRI, Lipper, MSCI, Standard & Poor’s, and AB
of membership in the EU outweighs the benefits received. In particular, opponents of EU membership have pointed to the high cost of regulation, high contributions to the EU budget, and fears related to lack of control over immigration. Conversely, supporters note that the UK benefits from trade with the EU (its largest trade partner) and from trade agreements between the EU and the rest of the world. They also say that the UK has greater global influence as part of the EU.

While the outcome is far from certain, polls have slightly favored “Remain” for several months, and the margin in favor of “Remain” has expanded recently (Display 2). Bookmaker odds have taken a similar turn and are now roughly 80/20 in favor of remaining in the EU.

We, too, expect “Remain” to win. Similar referendums in Quebec (in 1995) and Scotland (in 2014) resulted in decisions to stay within Canada and the United Kingdom, respectively. This type of referendum has a status quo bias. While the Brexit vote takes place against a difficult backdrop—the migrant/refugee crisis and growing disaffection with the “establishment”—we expect the British electorate to reject a step into the unknown.

Among the wild cards that could lead to a “Leave” vote are an outbreak of violence by immigrants or a major terrorist attack.

**The Economic Impact**

If the “Leaves” have it, the exit process would be unwieldy and take at least two years. Trade agreements between the UK and EU, and between the UK and the rest of the world, would need to be negotiated, and the UK would need to write laws and regulations to replace existing EU mandates.

But the economic impact for the UK could be felt more quickly. Uncertainty associated with the vote is already apparent, as businesses have pulled back from investments requiring long-term commitments. The negative scenarios painted by advocates of remaining in the EU could become self-fulfilling, and the UK’s reliance on deficit financing leaves it vulnerable to any shock that could cut off the flow of foreign capital.

**The Market Reaction**

When the date for the referendum was announced in February, the market reaction showed fear of a negative impact on the UK: Equity market volatility spiked, government bond yields increased, credit default swap (CDS) spreads widened between UK and both French and German bonds, and the pound weakened (Display 3).

Year-to-date, UK equities have underperformed the global market, despite relatively good earnings revisions. UK stocks with largely domestic sales are trading at a discount vs. the broad UK market, as represented by the FTSE All-Share Index.

Since then, these markets have strengthened, suggesting that investors are assuming that voters will choose to remain. If they’re wrong, the markets are likely to react very negatively again.

There are also broader political implications that will reverberate globally. A decision to leave the EU would send political shockwaves across Europe and deal the EU its biggest setback ever. It could also embolden radical and separatist parties that have been gaining strength elsewhere in Europe, leading many to question the long-term outlook for the EU and the viability of the euro. The latter could set off another wave of the sovereign debt crisis. Even a majority for “Remain” may not close the debate, and could spur euroskeptics across the

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**Display 2**

**Average of Opinion Polls Leans Toward Remain**

<table>
<thead>
<tr>
<th>Remain</th>
<th>Leave</th>
<th>Undecided</th>
</tr>
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<tbody>
<tr>
<td>47.5%</td>
<td>42.5%</td>
<td>10.0%</td>
</tr>
</tbody>
</table>

As of May 29, 2016
Polling average is an adjusted aggregation of published opinion polls for the UK’s European Union membership referendum based on a combined sample of 18,470 people.
Source: NCPolitics.uk

**Display 3**

**The Pound Is Down on Concerns About Brexit**

British Pound Sterling / US Dollar Exchange Rate

Through May 25, 2016
Source: Bloomberg
EU to seek special deals like the one the UK got, which could gradually undermine the EU project.

More broadly, the entire Brexit process could decrease investors’ appetite for risk and contribute to higher volatility longer term, consistent with our expectation of modest equity returns with greater volatility.

Bernstein clients have limited exposure to British stocks and bonds, and DAA is slightly underweight the British pound. For active managers, a spike in volatility can serve as an opportunity to buy assets that become attractively priced in the face of increased, short-term risk aversion. Our research teams have worked toward understanding how a Brexit scenario would affect individual companies, and would use that information to their advantage if a sell-off were to occur.

**DAA Update**

Our DAA service has diversified exposure in response to uncertainty over market direction for several reasons, including Brexit (*Display 4*).

DAA’s current equity allocations are close to strategic targets, as a result of adding to our position in high-yield bonds. We are slightly underweight in investment-grade bonds. The allocation to high-yield provides some exposure to equity market upside, with less downside risk. In addition, we have a small holding in equity index call options that provides equity exposure but should mitigate the impact of a market drop—and these options are relatively inexpensive.

Of course, should Brexit or some other event surprise the market, DAA remains nimble and gives us the ability to adjust allocations appropriately.

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**Display 4**

**DAA Shifted Back to Return-Seeking Assets**

Adjustments Made Within DAA* (April 2010–May 2016)

<table>
<thead>
<tr>
<th>Year-End</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>Current</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return-Seeking Weight</td>
<td>(10)%</td>
<td>10%</td>
<td>0%</td>
<td></td>
<td></td>
<td></td>
<td>Current</td>
</tr>
</tbody>
</table>

*Adjustments are to the return-seeking exposure of a moderate portfolio, defined as a portfolio with a long-term strategic allocation of 56% to global equities (the MSCI World Index), 40% to bonds (the Barclays US Aggregate Treasury Index), and 4% to a custom real asset index that includes commodities, commodity producers, and global REITs.

Source: AB
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