Brexit Aftermath: The Reflex Reaction To An Unwelcome Surprise

A few days ago, the citizens of the United Kingdom (UK) voted to leave the European Union (EU) in a referendum nicknamed the "Brexit" (British-exit).

The decision to leave the EU came as surprise to most, including in the financial sector, as many indications were predicting the vote to be very close but tip in favor of the “Remain” crowd.[1] The day following the vote the British pound fell to its lowest value in 30 years and stock markets around the world opened to sudden price drops.

Spain's IBEX 35 index fared the worst with a 12.65% loss for the day. China's CSI 300 was among the least affected with a daily change of -1.29%.

US markets, less affected than Europe, saw indexes like the S&P 500 end the day -3.59%.[2]
Since then, as you’d expect, the markets are digesting the news in their usual volatile fashion.

Part of what made the single-day downward moves more dramatic was that those same indexes had been sharply up in advance of the vote, on rumors that private polling had predicted the Brexit initiative would fail. For example, the day before the vote the S&P 500 had gained +1.28% in one session, contributing about one-third of its gain for all of 2016.[3]

"The Market Doesn't Like Uncertainty"

Nobody knows for certain what the Brexit will mean for the British economy in the short- or long-term. At worst, it will require politicians to ratify new trade agreements, something both sides want.

At best, it may lead to a boom in business brought about by unforeseen opportunities. But for the US economy it will likely have little lasting effect over longer time periods – since we're not part of the EU, our trade agreements with the UK are not affected.

This demonstrates how the sharp drops in our domestic stock indexes were most likely reflex reactions to a surprise outcome – one that was not expected by politicians, financial analysts, and pundits on either side of the Atlantic.[4] The rapid short-term moves are also a stark reminder that trying to time event-driven market moves or guess what's around the corner for the global economy is inherently difficult and dangerous.

As we discussed in our previous newsletter, unexpected news almost always results in a dramatic reaction in the stock market – whether up or down. The old chestnut goes "the market doesn't like uncertainty." We say it's the market reacting, but it's really a reflection of investors (many of whom are merely speculators) who are trying to guess what's going to happen in the next day, week or month.

Unfortunately for those who let their emotions guide their investing, getting out of the market right after a sharp drop makes their worst financial fears a reality – by locking in a loss. Our reality, as disciplined investors, is that we expect randomness and uncertainty to be the only reliable constant. They are the primary ingredients for why a risk premium in stocks should persist over time.

What To Do Now
Imagine if your investing timeline was only one session, and last Friday was your only day. Your portfolio would have sustained a significant loss. But if you're investing for the next 10, 20, or even 30 years, the Brexit selloff, while unsettling, will likely fade in significance, taking its place among the many historical dips – both large and small – that have occurred since the dawn of investing. Chances are the indexes will soon begin recovering their value as many businesses realize that their operations are not directly affected by the Brexit and those that are affected find ways to adapt and move on.

The varying degrees to which international indexes were influenced by the Brexit vote also help illustrate why it's important to have a truly diversified portfolio and a commitment to stay disciplined through unprecedented global news events.

It's natural to have concerns when it seems everybody around you is worried about what will happen next. But as disciplined, long-term investors, we know that an unknowable future is precisely the "risk" part of the risk/return equation on which we rely to generate long-term wealth.

So, if you find yourself fretting about the scary headlines or swayed by the endless market commentary, know that most investors are feeling exactly the same. But also take comfort in knowing that your investments are managed in a disciplined, evidence-based fashion that is not influenced by short-term news cycles or the drama du jour. When viewed years hence with the benefit of historical perspective, Brexit may have no more long-term significance than the "S&L Crisis" of the late 1980s or the "Asian Contagion" and "Russian Debt Crisis" of the 1990s – and we all remember those, right?

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1. http://go.efficientadvisors.com/e/91522/ain-heads-polls-221619184-html/2ybkw5/136949312

2. http://go.efficientadvisors.com/e/91522/indices-major-indices/2ybkw7/136949312

3. http://go.efficientadvisors.com/e/91522/indices-5ESPXTR-ytd-return/2ybkw9/136949312

4. http://go.efficientadvisors.com/e/91522/edoes-global-markets-86323890-/2ybkwc/136949312

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