PERSPECTIVE

A Brief Take on Brexit and Emerging Markets

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On Friday, June 24, financial markets around the world awoke to a post-Brexit hangover. The United Kingdom had voted to leave the European Union (EU), leaving many investors surprised, including me. I had believed the negatives of the United Kingdom leaving the EU appeared to outweigh the positives, and I thought the British people would see it that way, too.

The uncertainty of the situation and what comes next hit all markets in the wake of the vote, and emerging markets were not exempt, with the MSCI Emerging Markets Index experiencing a sharp decline. However, I believe once the initial shock wears off, the longer-term impact should be more limited since emerging markets' trade and investment are widely diversified; the amount of trade with the United Kingdom is relatively small for most emerging market countries.

However, some specific emerging markets have greater ties to the United Kingdom, and the impact could be felt more acutely in those countries. Some of the Southeast Asian nations with historic ties to the United Kingdom could be negatively impacted. Specific companies with operations in the United Kingdom could be impacted—banks, for example, that have property investments in the United Kingdom (or branches there) that help fund their projects.

If trade ties are broken, manufacturers located in the United Kingdom may pull up stakes, as they could find more benefits to remaining within the EU. There could be a silver lining for some emerging-market countries. Some manufacturing and services could move to Eastern European emerging market countries from the United Kingdom, since those countries are in the EU and their costs are lower in Eastern Europe.

This event does not impact my view of emerging markets generally speaking or the investment potential I see for the long term. I believe the Brexit vote shows the world that political instability is not concentrated in emerging markets—it can be found even in developed markets. While volatility may be with us for a while, in my view, the markets will readjust. Part of the near-term volatility is related to the surprise element of the vote; the markets simply didn't price in the leave scenario properly.

In my view, the Brexit vote should not impact monetary policy in emerging markets or in the United States that much. After the volatility of Brexit is over, the US Federal Reserve will likely continue its policy analyses based on the numbers coming out of the United States on employment, growth and inflation. The big question for market observers, of course, is the knock-on effect in the EU. If it is perceived that other members may decide to leave the EU, then the uncertainty will continue and that could be bad for European and US markets. However, it is my view that emerging markets should be able to differentiate themselves, and individual countries should be able to bounce back based on their unique fundamentals.

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