Brexit - how will markets react?

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'In-Out' referendum

The Conservative party won the General Election on 15 May 2015 with a manifesto that promised an 'In-Out' referendum on Britain's membership of the European Union (EU).

Towards the end of the year, Prime Minster David Cameron began negotiations with European leaders to obtain a revised deal for the UK within the EU treaties. These negotiations concluded on 19 February 2016, effectively firing the starting gun for the "Remain" and "Leave" campaigns.

Subsequent developments in the referendum campaign have spooked financial markets and led to increased volatility. The factors that are causing the most commotion are the tightening of opinion polls and the political manoeuvrings in the Tory party, especially the defection of the London Mayor Boris Johnson to the pro-Brexit camp.

Having said that, there are still many "don't knows", and both sides have made little progress in persuading voters on specific issues such as immigration, sovereignty, economic prosperity or the risks from terrorism.[1]

Market concerns

The principal reason why the markets are concerned about the prospect of Brexit is uncertainty.

Firstly, if Britain voted to leave the EU in June, there would be a minimum 2-year negotiation period with the EU. If Britain leaves the EU there would have to be renegotiations of trade agreements not only with the EU but with all other countries that Britain currently trades with under an EU trade agreement.

Secondly, the consequences for inward investment, including foreign direct investment (FDI) are highly uncertain. The EU is the largest source of inward FDI for the UK, and the financial sector is the main recipient of FDI, receiving 26% of all inward FDI in the years 2010-14.[2] Thus financial services are therefore especially exposed to Brexit risk. In the worst case scenario, there could be a loss of access for such services to the EU, including crucially the 'pass-porting' of financial products.

The third issue of concern is the huge current account deficit run by the UK, currently 7% of GDP. This deficit is financed by FDI and other capital inflows, which may be reduced if the UK is a less attractive investment proposition post-Brexit, leading to serious consequences for the pound.

Outlook for sterling

If there is a Brexit, sterling would most likely take most of the pressure. Since last December the pound has already lost 12.8% against the euro, but the euro is up nearly 7% against the US dollar since last November, and the pound has traded sideways against the dollar for most of the past three months.

Since February's announcement that the Brexit referendum will take place on the 23 June, sterling has seen a rise in volatility and declines against its peers, not just the euro. For example, the day after the announcement of the referendum date, sterling fell 1.3% against the dollar. However, the weakening of sterling is also a consequence of the persistent low inflation in the UK and the postponement of the prospect of any interest rate rises by the Bank of England (BoE).

The BoE's signalling has been consistently dovish since December's Inflation Report. Some analysts have suggested that sterling may even reach parity with the euro (from its current level of 1.25) if there is a vote to leave. Conversely, in the case of a vote to stay there would more likely be a rise in the value of sterling.

1 Prof John Curtice http://whatukthinks.org/eu/has-either-side-made-progress-with-their-arguments-in-the-eu-campaign
2 UBS: UK Economic and Market Outlook – Sliding into June 23rd? (p. 55) by David Tinsley, March 2016

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Implications for equities

According to UBS, 17% of revenues of all UK-listed corporates are derived from sales to the EU.[3] Therefore maintaining common market access in case of an exit is critically important.

However, a weaker sterling would also benefit exporters and weaken demand for imports. Obviously, companies with big exposures to the continent are more vulnerable, such as airlines and financials.

Sectors that rely on EU migrants for labour such as construction and hospitality are also exposed, whereas the energy and commodity sectors and those that export outside of Europe are likely to see benefits from the weaker currency.

Bond market

A UK exit would almost certainly see a rise in UK gilt and corporate bond yields initially, due to a rise in the risk premium or even a flight to safety that might ensue. However, yield increases would probably be limited, due to Britain's long history as a deep, liquid and transparent market for debt.

Up to now, the rise in yields has been very small. In fact, 10-year gilt yields have fallen from 1.96% at yearend to 1.40% in mid-April, and the spread between gilts and US Treasuries has actually narrowed so far in 2016.

If there is a vote to leave, inflation would probably see a short-term rise from a weaker pound, but the BoE would be unlikely to raise interest rates against a background of weaker output caused by secession from the EU.

The BoE might even restart quantitative easing if output suffered serious diverse effects, which would – at least initially – cause a fall in yields.

[3] UBS: UK Economic and Market Outlook – Sliding into June 23rd? (p. 60) by David Tinsley, March 2016

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