# THE MARKET IMPACT OF THE BREXIT VOTE

**In a long-anticipated referendum, voters in Britain have decided their country should exit the European Union. Rick Lacaille, Global Chief Investment Officer, discusses some of the immediate and longer-term impacts for global investment markets.**

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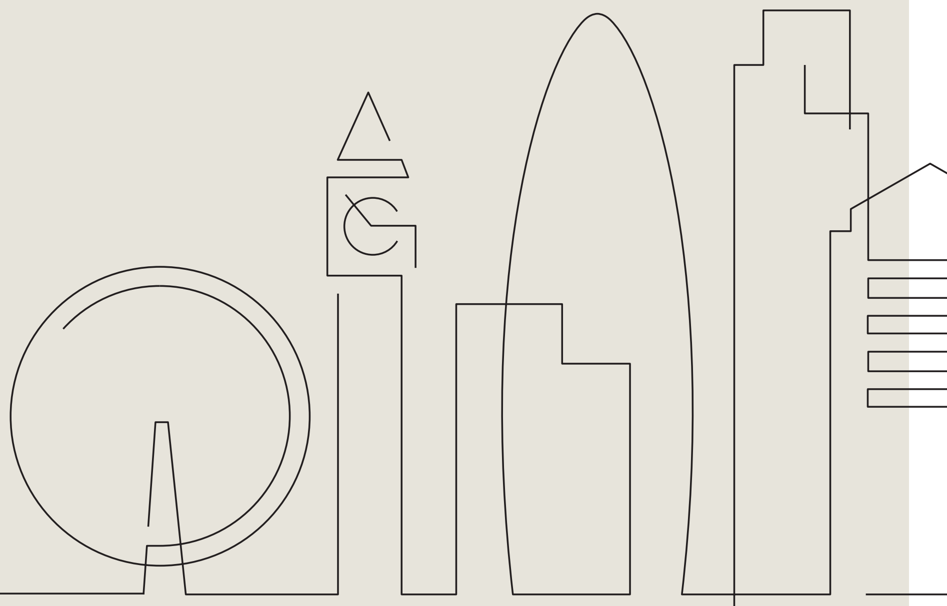

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## What are the immediate and longer-term implications of the vote?

- A close vote was anticipated because of recent polling and had contributed to investor uncertainty and some market volatility. Nonetheless. the vote to exit will be met with surprise by markets. Short-term falls in risk assets are to be expected as markets digest the implications of the vote.
- Over the longer term, article 50 of the Lisbon Treaty gives the UK between 24 and 36 months to leave the EU. Even if triggered immediately, we could see a protracted period of political machinations and trade negotiations — so uncertainty will continue to affect markets over the medium term.
- While the vote to leave has immediate market implications, over the longer term observers will be wary of the impact the vote has on other nationalist and protectionist movements — both in Europe and elsewhere (e.g. US, Russia). In Europe, nationalist parties will feature prominently in elections next year in Germany and France.
- There is the potential for knock-on consequences for market-moving issues like trade, labour mobility and foreign investment. How the EU strikes a balance between facilitating a swift UK exit to reduce risk as quickly as possible, and discouraging similar movements in other countries, will be important.
- In the weeks leading up to the vote a range of international financial and trade bodies including the IMF, World Bank, Bank of England and WTO laid out concerns of a UK exit from the EU. These included risks to global growth, trade, foreign investment and financial market stability. The exit vote realises the potential for these projections to unfold.

## How are currency markets likely to react?

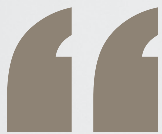
- Currency is likely to bear the initial brunt of market reaction.
- Currency option markets had shown heightened volatility around the vote, but suggested a return to more normal levels of volatility later in the year — so the exit vote will be a surprise.
- We expect a quite rapid downward movement in sterling.
- The euro will also come under pressure against the US dollar as the Brexit vote emphasises other potential instabilities in Europe. However the euro is likely to strengthen against sterling.
- It is likely that the US dollar will benefit — as much by default as anything but also fundamentals will return to monetary divergence — with the US likely to raise rates faster than Europe, where any hike rates is likely to be pushed out.
- If sterling becomes significantly undervalued some opportunities may emerge. How far the currency is justified in falling will ultimately depend on how longer-term trade and other re-negotiations with the EU progress.
- In our active accounts we had already limited sterling positions and sought to avoid rolling hedges around the time of the vote in case liquidity became stressed.
- Our discussions with clients continue to focus on the appropriate currency hedge ratio — either long-term strategic or medium-term tactical, including dynamic strategic hedging.

## What can we expect from global equity markets?

- While polling had suggested a close outcome, equity markets globally had not priced in a significant chance of a leave vote. Implied volatility was relatively low. There is the potential therefore for significant negative market moves in the short term. The UK and European markets are likely to be hit hardest but global markets will also come under strain as investors digest the news.
- We anticipate financial firms to be the most exposed to the any rise in volatility, as are sectors that are sensitive to potential changes in economic growth — like consumer discretionary, autos and airlines.

## Will bond markets come under particular pressure?

- Some risk had been priced into bond markets but this was not significant. The exit vote and the reigniting of concerns about the durability of the EU will be negative for bond markets, particularly corporates.
- In the short term, we anticipate a flight to quality fixed income assets, including Gilts, Treasuries and Bunds, at the expense of peripheral European bonds, and credit markets.
- Any action by the Bank of England to directly address market stress as a result of Brexit could help Gilts at the short end. While the Bank explicitly indicated that early action on interest rates would be unlikely, other policy moves could be implemented if market liquidity becomes problematic.
- We see the potential for significant underperformance in credit markets in the short term. Longer term, underperformance is likely to continue to be more related to prevailing macroeconomic risks.
- The UK corporate market has already been challenged from a liquidity perspective due to a decline in issuance longer term. We continue to engage with UK clients about the potential benefits of more global credit exposures.



Overall, the Brexit vote will add to volatility, particularly in the short term, but also as the process towards Brexit unfolds over coming months. Longer term, volatility is likely to remain a feature of markets as they contend with broader global growth concerns, the capacity of central banks to stimulate economies and other geopolitical events.

# GLOSSARY

**Brexit** - The concept of the United Kingdom leaving the European Union.

**Bunds** - German government bonds.

**Currency Hedge Ratio** - The extent to which currency movements are protected against exchange-rate movements.

**Currency Option** - Derivative giving the right, but not the obligation, to exchange currency at a predetermined rate.

**Dynamic Strategic Hedging** - Technique that seeks to dynamically adjust a currency hedge ratio to optimise results.

**Gilts** - United Kingdom government bonds.

**Monetary Divergence** - Differences in countries' approach to mechanisms such as interest or inflation rates.

**Volatility** - Variations in market levels.

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