Market Insight: Brexit update

Bradford & Marzec
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The British people have spoken. Despite what you may have read, it was an unambiguous decision. In light of the wide-reaching implication, the Brexit referendum of 2016 was poetic in its simplicity:

One eligible man or woman voter = one vote

LEAVE or REMAIN

Majority wins

72.2% turnout

Result: 51.9% LEAVE / 48.1% REMAIN

That's it. Notwithstanding what we may read, and in the face of all the speculation, it appears that **Brexit will happen!** The next few months will likely see endless speculation about various forms of challenges to the vote. From an investment perspective, we believe it's wise to move forward with the assumption that Brexit will proceed.

Key investment takeaways

- We expect volatility to continue as the markets absorb the broad and yet to be determined outcomes of the Brexit.
- We remain cautious on United Kingdom and European exposure in general at current valuations, especially the banking sector.
- We anticipate some sympathetic widening in the U.S. markets and in general limited spillover in the U.S. Thus far, U.S. credit has not widened materially and liquidity is fairly poor.
- We remain neutral duration with an overweight in credit duration exposure.
- We expect policy makers to continue to show easing signs across the globe. In the last three months, 17 countries have lowered interest rates, with 11 occurring in the last month.

The recap

Last week was eventful to be sure. Here is a brief recap of the political landscape and the potential impact across Europe.

Making sense of the political realities

- It was inevitable that the credibility of the existing Parliament was going to be challenged if Brexit passed in the general election, given the fact that 75% of Members of Parliament had voted to remain. While there was some speculation that Parliament could block Brexit, last week made it clear that Parliament currently lacks a clear mandate from the people.
- Additionally, the Labour party is in disarray. The leader, Jeremy Corbyn, increasingly looks like a fish up a tree, and 11 of his shadow cabinet have resigned as of the last count. The situation is a great example of the hubris of a politician completely out of touch with the electorate (and some would argue this caused Brexit in the first place!).
- What is clear is that the vote is done….there will be no second referendum. There will also be no general election before October 2016.
- Speculation about policy direction is fairly irrelevant until a new cabinet is in place. The new Prime Minister will be elected by the Members of the Conservative Party, who will in turn nominate a Pro-Brexit cabinet. This will be the body that sets the terms of the UK's departure and importantly, decides on the timing of the invocation of Article 50 of the Lisbon Treaty (the untested procedure governing how a member withdraws from the EU), which begins the estimated two-year withdrawal process.

- Uncertainty will dissipate as the Brexit policy framework is formulated and disseminated to the markets. This will not happen until there is a new Prime Minister and a new cabinet so market volatility is likely at least until September 2016. The faster the strongly Pro-Remain Members of Parliament are replaced, the more meaningful the output from Parliament will become.

The potential ripple effect on other (political) outcomes

Scotland

- If one excludes the Scottish vote from the overall tally, the referendum result was a resounding unambiguous 53% Leave / 47% Remain in England, Northern Ireland and Wales.
- There is some speculation that Scotland could veto Brexit. Whether it could or not is constitutionally unclear, but is extremely unlikely. There is also speculation about whether Scotland would hold a second referendum on leaving the UK. While this is possible, the outcome won't necessarily be a foregone conclusion to separate. Scotland voted to remain in the EU as part of the UK, not as a separate country. Secondly, by the time a second referendum takes place, the EU could have changed materially. Given these factors, a second referendum for Scotland to leave the UK does not necessarily portend a different outcome from the 2014 referendum result, which saw a 55% Remain and 45% Leave vote.
- One final irony. If a second Scottish referendum takes place and is described as a 'Scottish Independence' referendum it would be anything but that. Scotland is a net financial drain on the UK and runs a far higher budget deficit than the rest of the UK. In return for subsidies from the EU, the European Commission (EC) would likely demand a very high degree of control over Scottish affairs. The exaggerated representation presently enjoyed by Scotland in the UK Parliament would not be remotely replicated as part of Europe. In contrast, as a bi-product of the UK's current voting structure, the Scottish National Party has a disproportionately large representation in Parliament.

Spanish elections

- The Spanish elections did not really reflect any significant shift towards populism for two reasons. First, it was probably too soon for any post-Brexit messaging to infiltrate the political dialogue. Second, the Spanish economy has experienced a significant bounce in GDP in the last year, despite extremely high levels of unemployment. Conversely, this weekend's result also did not see a clear majority win for the Conservative party government, which was the purpose of the election in the first place.

Rest of Europe (ex Spain)

- Perhaps the most surprising non-reaction to Brexit has been the lack of concern about the outlook for the rest of Europe, and the fact that the Euro has not weakened at the same pace as the Sterling. The hostile response from EC Chairman Junker toward the UK has been disconcerting, as one could argue much of the blame for Brexit should be placed in Brussels, not the UK. The lack of any resignations in the EC (which gets to the heart of one of the main points of Brexit – that you cannot remove failed politicians) indicates that Brussels may now 'dig in' rather than offer a conciliatory tone and acknowledge the need for change. Although market reaction has focused on the Sterling, the real economic problems will continue to be in the rest of the EU, which has consistently underperformed the UK in the last six years.
- Existing trade agreements between the European Union (EU) and the UK remain in place for at least two years. Also of note, the EU has stated it will not negotiate with the UK until Article 50 is triggered. There has also been a proposal by German Finance Minister Wolfgang Schäuble, that the UK could be offered a type of Associate membership of the EU.
- The UK runs a $100 billion dollar trade deficit with the EU, so any punitive trade action could hurt the EU more. In an estimate by the Pro-Brexit camp, the UK will save approximately $1.8 billion a month in net contributions to Europe once extricated. This of course will significantly hurt the EU budget, a fact not lost on the Germans.

- European growth will likely be impacted. Tepid signs of recovery were evident in some countries pre-Brexit, but business confidence will now be affected. Greece's financial problems may re-emerge this year, with Greece likely needing a third bailout. The UK is the second most important tourist market for Greece. The fall in Sterling and the inevitable slowdown in the UK will severely affect the Greek economy and could be the factor that drives Greece over the edge. Italy also continues to struggle with its membership of the Eurozone. Italian banks are particularly vulnerable and will certainly need assistance from the European Central Bank. Central banks will be diligent to avoid a run on any European or UK bank.
- The Brexit vote also begs the question regarding ramifications in other parts of the continent. A majority of voters in Italy and France want their own referendum. However, polls currently indicate that less than 50% of voters in each country actually want to leave at this juncture. Interestingly, this was also the case in the UK several months before the Brexit vote. Other countries will also demand their own referenda. The Netherlands, Hungary, Portugal and Finland to name a few. The propensity to want to leave the Eurozone is probably higher than the desire to leave the EU, especially among the southern European states. There are 28 countries in the EU of which 17 are members of the single currency Euro.
- Brexit itself may now embolden the anti-European movement. If the EC decides that the answer to the uncertainties caused by Brexit is more 'Europe' for the remaining members, it is likely that this will quickly be met with opposition, and could fuel the rising popularity of the anti-Europe political movement. Unfortunately for the Eurozone, more Europe is what is needed for it to ever become a successful economic model…therein lies the dichotomy. More Europe means more centralization of budgetary powers in Brussels, more immigration and free movement of labor, more control and more loss of sovereignty to an unelected body.

Concluding thoughts

The key factor that could determine the future course of the markets (and by extension global growth) is what the EU does next. If Brussels and other European leaders offer a more conciliatory tone toward the rest of the EU, including a plan to boost fiscal stimulus and increase transparency in Brussels, then the net result of Brexit could be more democracy and pro-growth economic policies. This could help global confidence. However, if the proposed solution is an accelerated European superstate with increased control from Brussels, then the market tone could be decidedly negative as anti-Euro populism rises.

We expect continued volatility as the market seeks clarity and a new chapter emerges overseas. With increased liquidity injections by the world's central banks, money will seek safe yield. This favors U.S. fixed income markets. Coupled with an anticipated slowdown in world gross domestic product (GDP), and a tepid inflation outlook, yields should stay low globally.