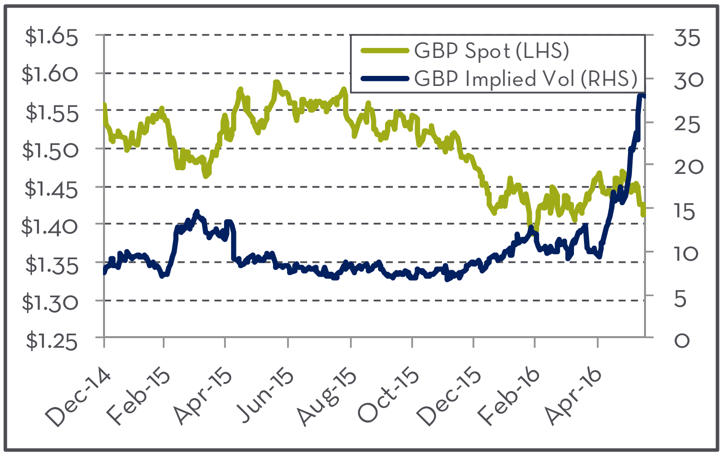
MARKET CHATTER: IMPLICATIONS OF BREXIT

NEPC Research

On June 23rd, the United Kingdom (UK) will hold a nationwide referendum to decide whether to remain or leave the European Union (EU). Cleverly labeled 'Brexit', the upcoming vote is of increased interest for global financial markets as recent opinion polls in the UK show a dead heat. Considered a remote possibility only several months ago, the prospect of the UK leaving the EU appears to be filtering into financial markets and pressuring the value of British pound while pushing volatility expectations higher (*Exhibit 1*). **While we cannot predict the outcome of the upcoming vote, we believe a long-term perspective remains important and any short-term market moves may present buying opportunities for investors.**

Exhibit 1: British Pound Spot Price and Implied Volatility



Source: Bloomberg

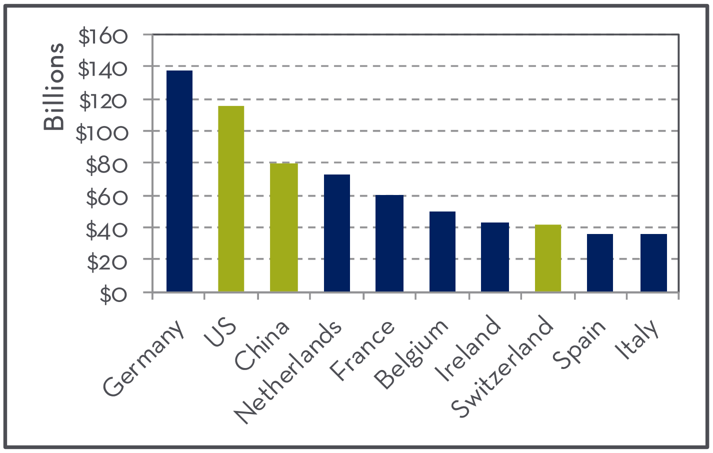
The EU referendum vote is a simple choice, 'Remain' or 'Leave', but the arguments in support for either side are multi-faceted and cover a spectrum of longstanding socioeconomic issues in the UK. The 'Remain' campaign is largely supported by the UK government and Prime Minister, the corporate sector, and financial institutions operating in the UK. They have warned of increased economic uncertainty, currency depreciation, and disruptions in trade agreements harming economic growth. The 'Leave' campaign has been critical of these warnings, arguing such pronouncements are a coordinated campaign to scare UK voters and maintain a flawed status quo dominated by a narrow group of special interests.

The leave EU platform argues the cost of EU membership outweighs its benefits and EU governance encroaches on the sovereignty of the UK. The leave campaign believes EU membership hinders business growth due to the overreach of EU regulations and inhibits the development of UK industry. According to supporters, exiting the EU would allow the UK to take back control of local politics, borders, and reduce the financial burden of supporting less developed EU nations.

The remain campaign argues the UK receives significant economic benefits from membership in the EU. Similarly, prominent independent global institutions have criticized the idea of Brexit with the OECD and IMF publishing papers outlining projections of the negative economic consequences. The Bank of England has struck a parallel tone, remarking that a departure from the EU would be a serious risk to financial stability and harm financial markets.

While a thousand words are insufficient to detail the political and economic membership structure of the European Union, the simple statement is the UK operates in a special arrangement within the EU. Most notably, the UK has not adopted the euro and maintains independent monetary policy. In addition, the UK is afforded flexibility in welfare benefits for EU migrants and special protections for its financial sector. The UK is able to fully participate in the 'Single Market', which treats member countries as one economic area allowing the free movement of goods, services, and capital. The single market represents a portal to the EU for both UK companies and foreign subsidiaries based in the UK, offering businesses unfettered access to the European market. For example, a US financial services company will use its UK subsidiary to access customers in the EU market. As a result of its unique status, the UK is the financial capital of Europe and the launchpad for global financial companies to offer services in the EU. Losing access to this single market would have far-reaching effects for the UK due to the high volume of trade with the EU (*Exhibit 2*) and the large contribution from the services and finance sectors to the UK economy. Of primary dispute for the remain and leave camps are the potential economic effects of a Brexit and the ease of process to renegotiate trade agreements to maintain commercial access to European markets.

Exhibit 2: UK Top 10 Trading Partners (Imports and Exports)



Source: Bloomberg

The effect of the UK leaving the EU is broad but also difficult to quantify. A central argument for the remain camp is the loss of access to the single market, even if only temporarily or in a renegotiated form, would cause a contraction in UK-EU trade. The belief is the UK would either be unable to negotiate an equally favorable trade agreement with the EU and/or that such negotiations would take significant time and effort which itself would cause a drag on the economy. In contrast, the leave camp is optimistic a unique bilateral trade pact can be negotiated with the EU that differs from others. It is difficult to speculate on the details of such an arrangement, but critics of the leave movement have noted that negotiations between other countries and the EU have typically been lengthy and the UK would likely be in a poor negotiating position. Besides these potential difficulties, many contend the unknowns associated with Brexit are likely to fuel economic uncertainty in the UK. The accompanying influence on consumer and business confidence could have a negative effect, suppressing both domestic investment and employment gains. One area of common thought shared by the remain and leave supporters is the likelihood of increased volatility in the British pound and financial markets in the coming days as the referendum nears on June 23rd.

While we acknowledge the potential disruption of the United Kingdom leaving the European Union and the heightened volatility that may result, we also recognize the investment repercussions of such a binary outcome are difficult to forecast. Irrespective of the outcome on June 23rd, the growth of political movements in the developed world looking to reverse longstanding trade and economic linkages are likely additive to the volatility of financial markets. This represents both a challenge and possibly an opportunity for investors. As events like Brexit arise, we encourage investors to be contrarian and look past the short-term noise with a focus on long-term fundamentals. Furthermore, should a more significant sell off occur we encourage investors to rebalance and look to increase risk exposure to exploit new buying opportunities across global markets.

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