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Brexit: Breakin' up is hard to do – Part IV

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Stock markets not impressed – so far

While the debate about Brexit is getting more intense (just a day ago the UK Treasury released its warnings) and the Pound Sterling is trading near historical lows as the referendum is approaching, the UK equity market has not shown any signs of stress. Its valuation premium to the Euro Stoxx 600 (in terms of the forward P/E) has not narrowed and its discount to US equities is lower than any time in recent years, as we pointed out in our previous blog.

Year-to-date the FTSE 100, the main equity index, gained 1.6% in local currency (to mid-April), broadly in line with the Dow-Jones Industrial (+2.7%), but clearly outperforming the Euro Stoxx 50, which dropped 6.5% over the same period. Moreover, the market's implied volatility has moved closely in line with the VIX, which suggests that UK stocks have been moved by the same global factors rather than idiosyncratic UK risks.

FTSE 100 (implied volatility) vs. VIX

Difficult to make a directional call

At present investors are undecided in terms of making a directional call on UK equities relative to other markets. This can be seen, for example, in Barclay's regular investor survey (see the chart in our previous blog). It shows that the shares of investors, which are expecting UK stocks to outperform vs. those expecting an underperformance, are almost the same. The reason for this uncertainty is that Brexit would trigger various opposing effects. The fall in the UK's GDP, rising uncertainty and a trade-linked productivity slowdown would weigh on UK-stocks, whereas further currency weakness would support earnings. In addition, longer-term deregulation would reduce the costs of red tape and supposedly increase flexibility in the corporate sector, although this effect should not be overestimated. The net effect is uncertain, although contrary to the investors polled by Barclays, we believe that downside risks linked to Brexit are outweighing upside risks.

While any directional call is subject to substantial uncertainty, there is a better chance, we believe, of predicting the performance on a sector level in case of Brexit. Sectors with mostly domestic exposure will be affected differently from those with international exposure. The FTSE 100 contains a number of companies, particularly in the energy and commodity space, which are operating globally. The fallout from Brexit on the UK economy – weaker consumption and investment – will particularly hurt sectors and companies with a domestic focus, while companies operating in global markets should be relatively immune. The table below summarizes, on a qualitative basis, how we believe domestic and global sectors and companies will be impacted through various channels.

Brexit-impact on ‘domestic’ and ‘local’ stocks

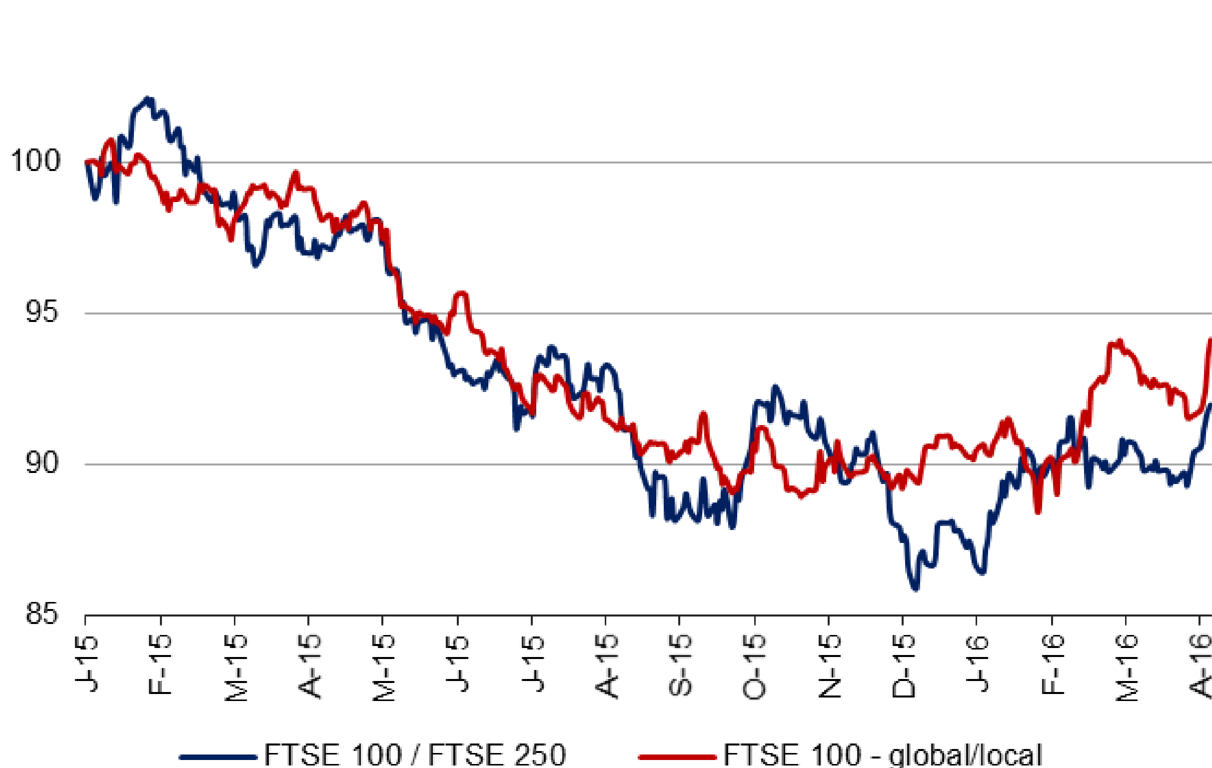
	GROWTH	CURRENCY	INT'L TRADE	LABOR SUPPLY	REGULA-TION
Assumption:	Temporary economic slump	Devaluation	Trade barriers between UK/EU	Lower labor supply	Lighter regulatory touch
Sectors					
Domestic	⇩	?	⬀	⬂	⬀
Global	⇔	⬀/⇔	⇔	⇔/⬂	⇔/⬀

Source: Erste Asset Management

To capture these effects, we split the FTSE 100 into two segments – one comprising companies mostly exposed to the domestic economy, the other containing companies with strong international operations – and then calculated the performance of local and global stocks relative to their sectors. In case investors start to be more concerned about ‘Brexit’ we would expect the latter segment – global stocks – to outperform the domestic segment of the market.

A similar approach is to compare the relative performance of the FTSE 100 (dominated by global companies) to the FTSE 250, which consists mostly of mid-caps with domestic operations.

Both indicators signal that in recent months a sector rotation has taken place in the UK equity market, away from stocks mostly exposed to the domestic economy. This could be evidence that investors started to become concerned about the UK’s exit from the European Union, and it suggests that the shift out of domestic stocks will likely accelerate in case Brexit actually happened.



Source: Bloomberg; Erste Asset Management. Rebased Jan 2015

European equities: Calm before the storm?

Europe's equity markets have had a weak start into 2016, underperforming the average of developed markets by almost seven percentage points (Euro Stoxx 600 vs. MSCI Developed Markets). However, Brexit has probably played a negligible role in this dismal performance. A poor reporting season together with a subdued earnings outlook, tensions in the EU linked to the migration issue and deteriorating macroeconomic data at the beginning of the year have been the main culprits. More recently (since mid-February) European stocks rebounded in line with global markets and the (implied) volatility index dropped to 20.

However, should Brexit-risks increase in the run-up to the referendum we can expect a replay of the performance a year ago during the Greek crisis, with surging volatility and the Euro Stoxx 600 underperforming its peers. A year ago, when Grexit was a much-debated possibility, the index of implied volatility exceeded 30 and the Euro Stoxx 600 underperformed global markets by more than 5%. It would be a surprise, if the market reaction would not be more pronounced this time around, given the much more widespread impact of Brexit relative to Grexit.

Main takeaways

This is the last of four blogs, where we attempted a summary of what is known about Brexit and what we could expect in the run-up to the referendum. The situation remains fluid. Developments both in Europe (e.g. the migration issue) and in the UK (domestic political and economic issues) may move the pendulum in either direction. Still, the vast amount of empirical evidence, commentary and research allows drawing some preliminary conclusions:

- Brexit is not the most likely outcome, and the likelihood of it to happen has only increased moderately in recent months. However, it cannot be excluded and, therefore, it remains a serious tail-risk for global financial markets.
- The majority of available research suggests that the implications for the British economy will be negative. Hopes that an amicable exit from the EU will limit the downside (particularly negative trade effects) seem a bit starry-eyed. A divorce is often a messy affair, particularly when complex economic issues are involved.
- Europe will suffer too, economically but more importantly politically as a number of columnists recently emphasized in the Financial Times. While some EU politicians might hope that in a European Union without Britain it will be easier to deepen integration and to speed up institutional reform, this appears to be wishful thinking. The main fault lines in recent years on issues like austerity, negative interest rates, dealing with Greece, migration and others were not between Britain and the rest of Europe.
- Financial markets, outside currency markets, have so far not really reacted to the risk of Brexit. Any signs of a rising probability of Brexit will likely increase stock volatility and trigger a switch towards a risk-off-mode in financial markets.

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