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

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The likelihood of Brexit

On June 23, 2016 the UK will hold a referendum. Voters will decide whether the country should remain a member of the European Union (the "Bremain"-scenario), or whether it should leave the EU (the "Brexit"-scenario). Arguably, Brexit marks the most significant tail-risk for European and global asset markets in 2016.

The formal process for the current referendum started less than a year ago, when the Referendum Bill was introduced to the UK parliament. However, the frequency of Google-searches for the term "Brexit" suggests, that the wider population both in the UK and on the continent only started to develop an interest in the issue at the beginning of 2016.

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This blog is the first in a series of columns focusing on Brexit. It deals with what polls and betting odds are saying about the likelihood of the UK voting to leave the European Union. In the next blog (scheduled for Friday, April 15), we will focus on what is known about the economic consequences of Brexit, while the third and fourth installments will deal with questions related to the impact on financial markets.

We attempt to address the key questions, which we at Erste Asset Management believe to be relevant for investors. We are aware though – using ex-defense secretary Donald Rumsfeld's famous approach to uncertainty – that the "known unknowns" massively outnumber the "known knowns" and we may even come across some "unknown unknowns" in case Brexit really happened.

What are the chances that Brexit will happen?

This, of course, is the key question. There are three sources available to assess the probability of the UK's leaving the European Union: opinion polls, betting odds, and financial markets. Unfortunately, those three sources are delivering contradictory messages.

According to polls in recent months, it will be a close race. Most of the time remain-votes exceeded the 50% threshold, but there was non-negligible number of polls where the Brexit-vote dominated. From September 2015 to April 8, 2016, in total the results of 85 polls were released (see [this link](#) for details), of which exactly two thirds showed a majority for the 'remain'-vote and 26% for the 'leave'-vote, with the remaining 7% pointing to a draw.

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However, there has been a moderate but noticeable mood shift, reflected in a slightly falling trend in the share of remain-votes over time (see chart above). In the last four months of 2015, the 'leave'-vote won in only 20% of the polls, whereas in 2016 so far, this share climbed to 31%. Simultaneously, the share of polls indicating a majority for Bremain dropped from 75% in 2015 to 60% this year.

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Betting odds suggest Brexit will not happen

In contrast to opinion polls, betting odds, which are more readily available than polls, point to a comfortable win of the remain-faction. Presently the odds of 20 UK bookmakers for the "remain"-vote to win vary between 4/9 and 4/11, implying a probability of 69.2% to 73.3%. In contrast, the odds for Brexit range from 2/1 to 13/8, implying a probability of 33.3% to 38.1%.

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Financial markets, which we cover in more detail in the third and fourth parts of this blog, are not directly delivering probabilities. So far, reactions in various market segments have been contradictory. While there has been pressure in the currency market on the Pound Sterling, fixed income and equity markets have responded relatively calmly. This suggests that the majority of debt and equity investors hold one of two views: either a) that the likelihood of Brexit is low (maybe just requiring some currency hedge against the referendum-linked volatility), or b) that the consequences of Brexit, even if it happened, would be minor.

However, all three sources are laden with problems: polls are notoriously unreliable due to methodological issues (as we could see last year, for example, in the context of the parliamentary elections in the UK). Betting markets are biased because participants are probably not representative of the entire demographics (e.g. they tend to be younger). And financial markets are not only affected by Brexit fears but also by other developments that are of concern to investors such as China, the Fed, global growth concerns, Eurozone woes not related to Brexit, and so on. Therefore, any signals from financial markets tend to be confusing, sometimes even misleading.

Bottom-line: Brexit is not the most likely event. However it is a real possibility – which is reason enough to take a closer look at its economic implications. This is what we will do in the next part of this blog.

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After his research work at WIFO (Austrian Institute of Economic Research) from 1978 to 1990, he worked as a securities specialist in various management functions at internationally renowned investment banks. During this time he held the position of Head of Research at such institutions as Creditanstalt Investmentbank, UniCredit Bank Austria, Robert Fleming Securities, and at Bank Sal. Oppenheim.

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