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

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What financial markets are telling us about Brexit

The UK's exit from the European Union – known as "Brexit" – would be a major economic and political event for the UK, Europa and the wider world. While Brexit is not the most likely outcome (see the first blog in this series), it is a real possibility, raising questions, how financial markets will respond. In this column we present some evidence on how Brexit fears have affected markets so far and our thoughts what we can expect going forward.

Which assets will be affected by Brexit?

The simple answer is: all – at various degrees. First in line are British assets, of course, followed by European assets, and then by the rest.

A regularly updated survey conducted by Barclays, a British bank, shows that the British Pound is the only asset that a massive majority (over 50%) of investors expects to suffer in case of Brexit. A smaller majority expects European risky assets to underperform, whereas the views on UK equity and corporate credit are broadly balanced.

The key (relative) winner is government debt, particularly in the form of German bunds, which traditionally enjoys safe haven status in a European context, but investors also believe that UK gilts will offer protection.

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However, it is almost certain that should Brexit happen, investors' concerns about Europe in general will rise and they will look beyond European assets in their investment decisions. Against a backdrop of elevated uncertainty, US dollar assets, like the currency itself, and US treasuries will likely outperform their European counterparts.

What are markets telling us?

So far, most of the action has taken place in currency markets. The British pound has lost more than 10% since mid-2015 against the US dollar and has been the weakest European currency year-to-date.

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That the GBP performance is mainly event-driven by investors' concerns about the outcome of the referendum can be clearly seen in the delta risk reversal of GBP/USD for various maturities. (The risk reversal is defined as the implied volatility for out-of-the-money call options minus the implied volatility for out-of-the-money put options on the base currency with the same delta, i.e. with the same sensitivity to the underlying spot rate).

Risk reversals across all maturities except those at the very short end gradually started moving further into negative territory in Q4 2015, as the Brexit-debate moved to the forefront. In February, when the June-date for the referendum was set, the decline of the six month maturity (which at this point already extended beyond this date) accelerated, whereas the one month and three month maturities remained stable. The latter dropped sharply on March 23, when it also became subject to the event-risk of a negative outcome of the referendum.

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In contrast, neither gilts nor equity markets have so far shown a strong reaction. While Pound Sterling has clearly reached crisis territory, the yield spread (ten years) of gilts to US treasuries has been negative, well below the historical average and lower than any time since 2006. Spreads to German bunds are above the long-term average, but the rise took place before the Brexit debate started. Since the second half of 2014, the spread remained fairly stable and have only widened moderately in recent weeks.

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Also UK equities have not shown any real weakness relative to their peers. In recent weeks, UK indices lost relative to US equities, but at the same time they posted gains relative to continental European indices. The valuation discount of UK equities has been narrowing over the past 18 months, and relative to European peers they are even trading at a premium right now.

5

Bottom line: Investors seem to be hedging against the referendum outcome – or are taking a bet on it – via the currency market, but they seem surprisingly relaxed with regard to the longer-term impact of Brexit.

The downside of the British pound in case of Brexit

Following months of weakness, the Pound Sterling is now trading against the dollar at levels that occurred only three times in the past 25 years. The downside against the low in the mid-80s (c.1.05), however, is still 25%.

6

Also looking at the real exchange rate suggests that there is more downside. The current level is about 8% below its long-term average, but only 4% below its trend value. Relative to its lows during the past financial crisis, however, there is still a downside of 12-15%

7

Another approach to the currency issue is viewing the current Pound rate as the weighted average of what the market believes the rate will be in case of Brexit and in case of Bremain. An immediate implication of this approach is that, assuming that the rate will strongly rebound in case of the UK will stay in the EU, the current rate implies a significant downside in case of Brexit. How massive is difficult to say, since we are dealing with an equation in four variables (current rate, rates in case of Brexit and Bremain, and the probability of Brexit) of which only one is known – which leaves a lot of room for speculative projections. Nevertheless, the relation helps to get a feeling for the Pound's sensitivities.

Assuming, for example, that the market believed that in case "stay in the EU" is winning, the Pound is climbing back to its long-term average rate of 1.65 to the dollar, and also assuming a Brexit-probability of 40% (somewhere in the middle between what polls and what betting odds are saying), implies that the Pound would drop to below 1.07 in case of Brexit. However, it is worth pointing out – following Anatole Kaletsky, who recently performed a similar analysis ("The Case For Sterling", Gavekal Research, April 4) – that below 1.10 to the US dollar, Pound Sterling would be the world's cheapest currency and "also significantly cheaper than at any time since the breakup of Bretton Woods".

8

To sum it up: There is strong evidence that the performance of the British currency in recent months has been mostly driven by fears related to the outcome of the referendum. The weakness of the Pound Sterling at a time when Brexit is still just a remote possibility implies that in case it turned into reality, we would see a further significant correction. Against this backdrop, the muted response of equity markets is a bit puzzling. It would be surprising if the volatility of UK and European stock markets would not increase in the run-up to the referendum – which is the topic of our next and last blog in this series.

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