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Brexit update: Will they stay or will they go?

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Less than a week is left before the British electorate will decide whether the United Kingdom should remain a member of the European Union (the Remain scenario) or leave the union, an outcome known as Brexit. Two months ago, when we started covering this event in a series of blogs (see [here](#), [here](#), [here](#) and [here](#)) Brexit seemed unlikely, markets were relatively calm and the political debate in the UK was as civilized as one would expect in one of Europe's most mature democracies. In April and May, the probability of Brexit to happen even dropped, the British pound recovered some of its previous losses, and the Eurozone volatility index (VSTOXX) almost halved.

Since the end of May, however, the situation has massively changed: The likelihood of Brexit has increased again, investors are getting nervous, and the political debate in the UK has turned nasty. What has happened?

Opinion polls and betting odds point to a rising probability of Brexit

Online polls have shown a majority for Brexit for some time, but more recently also the lead of the Remain campaign in telephone polls has been evaporating. Moreover, also in betting markets the probability of Brexit rose temporarily to 40% before falling back to around 30% in response to the public reaction to the murder of a British pro-EU politician last week.

While these developments suggest that the referendum will be a close race, on balance, Remain still seems more likely. Election experts emphasize that typically more than 20% voters make up their mind only days before the actual vote, and that late-deciders tend to vote for the status quo. From previous cases (Quebec, Scotland) it is known that the final swing toward the status quo could be 5-6 percentage points.

One important factor will also be turnout. Since Brexiters supposedly are more committed to their cause, the general view is that turnout needs to be at least 55-60% for the Remain vote having a chance to win.

01

Markets under pressure in June

While currency markets started pricing in Brexit-related risks already in the fourth quarter of 2015, equity and fixed income investors were complacent for a long time. This changed in June. The Euro Stoxx volatility indicator climbed to 40, and British and European stock markets moved sharply down, losing 5-7% in the first half of the month.

Against the backdrop of elevated risk, it also became clear which assets investors consider as safe havens to escape Brexit-risks:

- German, US and UK sovereign yields resumed their descent, with bund yields falling below zero, yields of UK 10 year gilts hitting a multi-decade low and US 10 year treasuries falling to a four-year low.
- The Swiss Franc appreciated 3% against the Euro over the past four weeks, and the Japanese Yen gained more than 5%. Surprisingly the US Dollar, normally also among the safe haven currencies, remained weak, suggesting that the main driver at present is the Fed, not Brexit-risks. However dollar strength will likely return, if and when the Fed resumes its tightening stance.
- Also gold, which had retreated in May, staged a comeback, nearly scratching at the level of USD1,300/oz.

02

... but Brexit is not fully priced in

Given current polls and betting odds, Brexit is certainly not the base case on which the majority of investors operate. Thus, recent market swings clearly have signalled in which direction assets were to move in case Brexit happened, but they are not reflecting the full impact of this event. The FX options market implies that the British Pound will devalue by around 7.5% against the Euro and around 8.3% against the Dollar in case of Brexit (Source: Bloomberg). This would push the cable (GBP/USD) down to just a shade above 1.30, a level not seen since the early 1980s. (The author's own feeling is that the implied devaluation of the Euro against the Dollar of less than one percent may be too benign. It reflects the Fed's current caution on

interest rates, but if Brexit really happened the dollar's attraction could strengthen regardless of the Fed's policy stance.)

03

More importantly, the pressure related to Brexit would certainly not be limited to currency markets. With the jump of the likelihood of Brexit from around 25% (end of May) to 40% (June 15) triggering an increase in the equity volatility in Europe to 40 (VSTOXX), it is not difficult to imagine that the volatility index could easily exceed levels of 50 -55 in case of Brexit – a level that was last time reached in 2011 in the course of the second Greek bailout.

04

Both the Euro Stoxx 600 and the FTSE 350 have already shed some 7% from their recent highs in the second quarter. In case the referendum results in a win for the Brexit campaign, both European and UK stocks will move lower. Given the recent pattern it seems that the event-risk is of the same magnitude both for UK and European equities.

Over the past ten years, a weekly change of ten points in the implied volatility index (e.g. from 20 to 30) was associated, on average, with a drop of 5.8% in the Euro Stoxx 600. Thus, assuming that the implied volatility would spike to 55 from its current 38 (June 17) in case of Brexit – still a conservative assumption in my view – would trigger a fall of the Euro Stoxx 600 by another 10% in the near-term.

05

Asymmetrical risks

Of course, in case Breain prevails we can expect a relieve rally, i.e. a switch into risk-on mode with stocks and other risk assets rebounding, volatility falling and the Euro and the British pound gaining. The latter could easily return to 1.50 versus the dollar, and possibly climb to 1.55 in the weeks following a positive outcome of the referendum.

But it is important to note that, while the event – the referendum itself – is binary, the same is not true for its impact on financial markets. The distribution of expected returns is skewed to the downside.

There are two reasons for this: First, the uncertainty that will unfold in case of Brexit is simply much bigger than the certainty gained in case of Breain. While a decision for Brexit will take the UK and Europe – politicians, the business community, investors and everybody else – deep into uncharted territory related to the long-term risk of a crumbling EU, a decision for Breain will at best restore the status quo ante, which means that global growth concerns, Chinese macro, the Fed and the earnings outlook will regain the control over European markets. Negative developments in any of these areas could quickly end the Breain-relief rally, in case it happened.

Second: A tight outcome, even if it will be in favour of Breain, would not solve the massive ideological split among British conservatives, and could create a government crisis. More importantly, a tight outcome would not fully remove the uncertainties about the future of the EU. It would still not calm the anti-EU movement in the UK and it could encourage secessionist movements in other member states to press for a vote on EU membership.

It seems that times for Europeans continue to be interesting – which, as we learnt from the Chinese, is a curse not a blessing.

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