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The Investment Engineers

Brexit unlikely, but what if…?

Lukas Daalder
CIO Investment Solutions

- **We currently put the odds of a Brexit at 25%**
- **The overall impact for the UK and financial markets is closely linked to the fate of the pound**
- **For Europe, the biggest risk is potential speculation on a further disintegration**

What are the odds that the UK will leave Europe on 23 June? And if this occurs what impact will it have? We asked Lukas Daalder, CIO Investment Solutions.

Let me start by saying that we do not expect the British majority to vote in favor of the UK leaving the EU on 23 June. Neither the deal secured by Cameron, nor the fact that the mayor of London Boris Johnson has joined the Brexit camp can be seen as decisive elements that will determine the outcome of the vote. Many British citizens feel limited affection for the EU, but faced with the greater uncertainties surrounding a Brexit, when push comes to shove, we expect the majority to choose to maintain the status quo. As such, we currently put the odds of a Brexit at 25%.

But what if? What if the Brexit camp does manage to secure a majority, how will that impact the UK and European economies and what will the impact be on the financial markets? Interestingly, the first part of this question (on the economic impact) is irrevocably tied up with the second part: much will depend on how the financial markets deal with the additional uncertainties for what is already a fragile market environment.

It will depend on the overall volatility in the months prior to 23 June: if things have more or less stabilized in the intervening months, the impact will probably be much more muted than if a 'no' vote were to take place today. There is some risk of escalation, but we don't think it's very likely.

To be clear: even if there is an exit majority on 23 June, it will still be rather unclear to all parties involved what the direct implications will be. David Cameron's resignation is pretty likely, the replacement of Boris Johnson plausible, but beyond that, there are a lot of uncertainties. Trade deals need to be renegotiated (within a two-year time frame), which probably poses bigger risks for service-oriented sectors as they do generally not fall under WTO rules. No one knows how lenient the Eurozone countries are going to be during these negotiations, so it is impossible to assess what the outcome will be.

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Crucial uncertainties include:
1. How the British pound will react to the 'no' vote (in light of the external funding of the twin deficits)
2. Foreign direct investment flows out of the UK

3. Impact on the status of London as Europe's financial center (will it move to Frankfurt, will the UK still be allowed to handle euro-clearing?)

And on a broader level for Europe:

4. Will it trigger a potential renewed wave of XXexit worries (fill in XX with the country of choice)?
5. Potential weakening of Europe's global political power

UK growth will be hit, inflation will reappear

As for the economic impact on the UK, there are three elements that will directly affect growth. The first is the impact on sentiment and the increased uncertainty, which will hit foreign investment. The second is the effect on financial asset prices in the UK (housing sector), as the influx of wealthy foreigners will stall (with longer term implications for underlying labor market growth as well). Potentially the biggest and most direct impact will be what happens to sterling, however. In the event of a strong slide (>25% versus EUR and USD) the impact on inflation will be significant, possibly pushing it up to as much as 5%.

The big question in such a scenario will be whether the Bank of England is willing to let this run its course, or will they feel the need to hike rates. Higher interest rates might also be needed to keep the pound from depreciating too much and to attract capital to finance the twin deficits. A 25% slide may seem big (it does to us as well), but it should be seen in the context of an overvalued starting point (from a BIS REER perspective) and the somewhat ominous twin deficits (current account, government budget).

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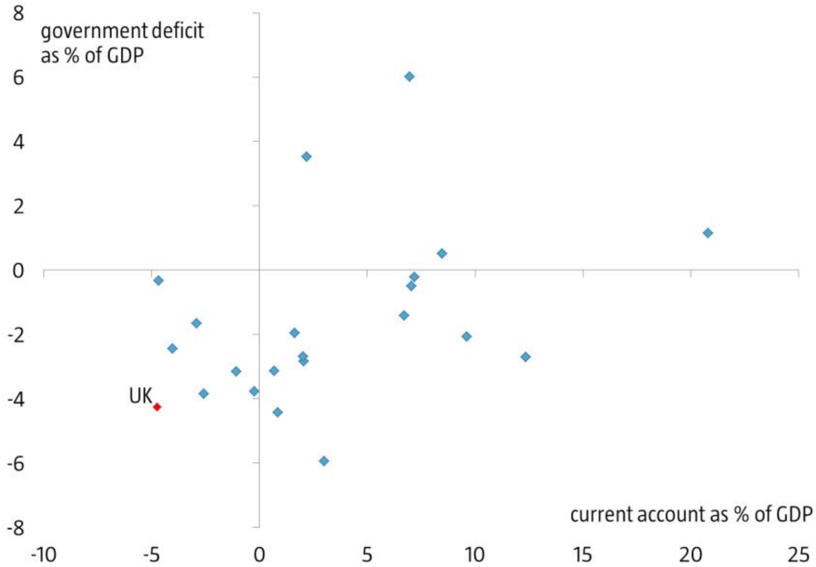
The UK needs external funding and this will be at risk once we get into a Brexit scenario. Additionally, UK stocks will enter a pretty volatile trading environment, with the financial sector as the most likely victim. This is the short-term outcome, with the pound as the main variable to keep an eye on: the more muted the response in the FX markets, the less extreme the ripple effect on the economy and other financial markets. The longer term impact depends on the outcome of the negotiations, which – as said – are impossible to evaluate at this point in time. It is clear though that a no-vote poses clear risks to the position of the UK as the financial center of Europe.



Source: IMF, Robeco

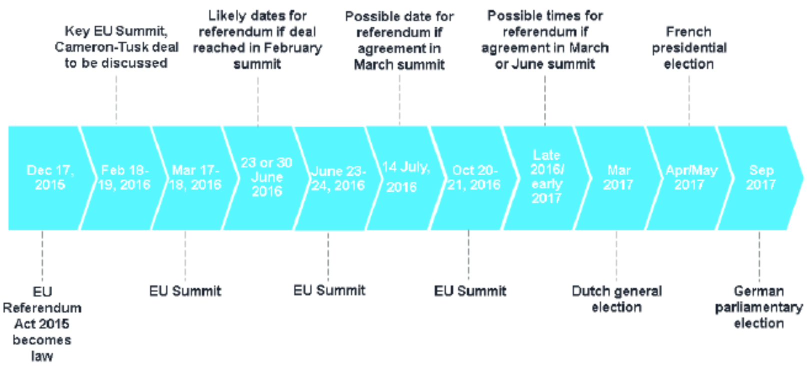
Cost of Brexit for Europe

As for Europe, the cost of Brexit will also be mostly linked to the way financial markets are able to cope with the uncertainties. Although we would expect the euro to strengthen versus the pound (or rather, the other way round), the euro is certainly going to weaken versus the dollar (and other currencies), which means that the impact will be evened out. Investments will be hit (uncertainty), although EU countries (Ireland?) and sectors (financials) will get a boost from the diverted foreign direct investment.

'For Europe the biggest uncertainty is linked to potential speculation on the further disintegration of the Eurozone itself'

For Europe the biggest uncertainty is linked to potential speculation on the further disintegration of the Eurozone itself. Peripheral bond spreads could widen once again, forcing the ECB to step up to the plate again to keep things from escalating out of control. The real test will be to see how a Brexit will impact the various parliamentary elections that will take place in 2017 (Dutch, French and German).

Figure 2. Key Dates Influencing the UK EU Referendum, 2016-17



Source: Citi Research

Market impact

As stated previously, we feel that the pound is the crucial variable that will determine the extent of the shockwaves that hit the system. With a limited drop in the pound's value (<10%), the direct impact for inflation will be manageable and not trigger any central bank policy change. In that scenario, the focus will be more on the longer term effects, with negative consequences for UK stocks (lower growth) and positive ones for UK bonds (lower growth, flight to safety). If the correction in the FX markets is more pronounced, this will compound the market stress and add the inflation element to the mix. Short rates may have to move up, while the outlook for bonds will become less certain (inflation up, growth down) and credit spreads will widen.

The developments in the UK markets will be mimicked outside the UK as well, but will become less extreme, the further away we move geographically. In other words, the impact will be felt in the European stock market more strongly than in the US and even less so in Asia. Volatility in the markets will undoubtedly once again lead to speculation on the safety of the European financial sector. There is a fair amount of uncertainty on how and if the financial system could be 'unbundled' in an orderly fashion. Despite their ultra-low yields, bonds would be likely to profit from a flight to safety yet again, although credit spreads are likely to widen.

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