GENERALI INVESTMENTS

Focal Point

Brexit: The fallout on Europe

June 10, 2016

GI Research

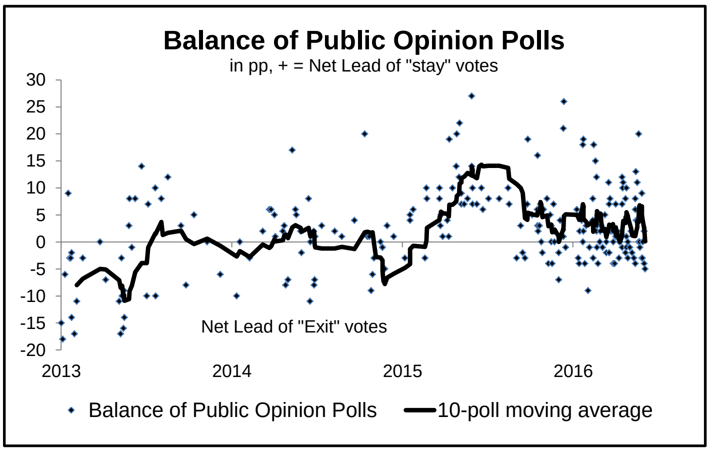
- With polls inconclusive about the EU referendum outcome, British voters may decide to leave the EU on June 23.
- In case of a ‘Leave’ vote, economic growth in the UK, and to a lesser extent in the euro area, would suffer. The ultimate fallout depends, however, on less predictable sentiment effects and the response by political stakeholders.
- On financial markets, the immediate reaction would be the British pound falling visibly. Yields on 10-year Bunds would turn negative, euro area equities would fall sharply and spreads on peripheral bonds would rise. Euro-denominated corporate bonds would track this move, but to a lesser degree. The EUR/USD could temporarily benefit, but should ultimately weaken.
- In a moderate scenario, this can be followed by a slight market recovery. Strong political initiatives to underpin the irreversibility of the EU would be needed. In a somewhat less likely stress case, disintegration forces in the EU will gain momentum, paving the way for a prolonged risk-off mode, including a further fall of equities and core bond yields.

On June 23, British voters will decide in a referendum whether to stay or to leave the EU. Current polls are inconclusive and suggest a neck-and-neck race. The uncertainties around this event have already started to negatively impact sentiment in the UK. In this note, we assess what would be the likely macro and financial market implications for Europe if British voters decide to leave the EU, adding to an earlier Brexit assessment for the UK (Focal Point - Brexit: What is at stake? March 7, 2016). Apart from a moderately harmful Brexit scenario, we also shed some light on an even stronger stress case, which could emerge as a result of a negative feedback loop between confidence and market reactions if disintegration forces in the EU were to gain momentum.

UK growth to suffer

In the UK, a Brexit would elicit strong political and economic uncertainties. On the political side, PM David Cameron has invested his political capital into preventing this outcome and thus would be very likely to step down. Further out, Scotland could also press for another independence referendum, threatening the unity of the UK.

Economically, leaving the EU means giving up access to the free European Single Market with its basic four tenets of free flow of goods, services, capital and labor. According to the Lisbon Treaty, the Brexit decision would be followed by a negotiation period with the EU of up to two years, during which the current legal backdrop remains unchanged. This amounts to an important short-term macroeconomic backstop.



However, the Brexit decision would raise uncertainty already in the very short-term. We would expect the strongest negative impact on investment while private consumption could be less affected. In a moderate scenario, we see a cumulative loss in growth until end of 2017 of 1.5 pp compared to the ‘Remain’ case, with UK growth around 1% instead of 2.1% in 2017. In a somewhat less likely stress case, characterized by a shap drop in investment sentiment and tense exit negotiations amid mounting separatist forces in the rest of Europe, the cumulative loss could amount to 2.5 pp. A strong depreciation of the pound will push up inflation, putting the BoE into a stagflation dilemma, which limits its room for maneuver. However, the BoE has already announced that it will provide extra liquidity around the referendum date by three additional indexed long-term repo operations.

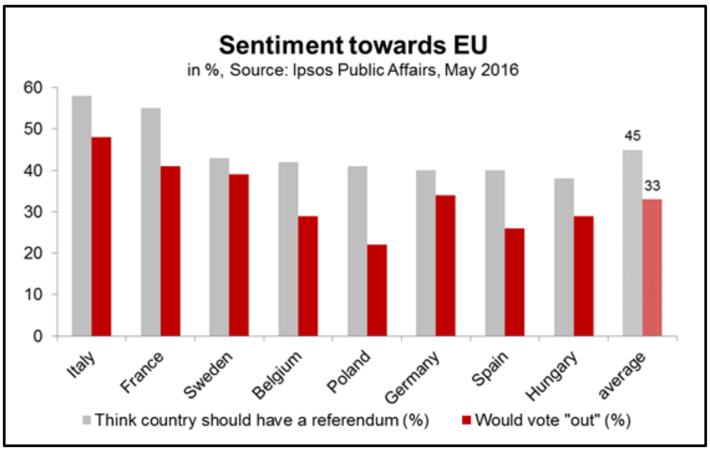
Euro area: Confidence shock and political fallout

In 2015, euro area exports to the UK amounted to 2.6% of nominal GDP and the trade surplus was 1.1% of GDP. Belgium, Ireland, the Netherlands and Germany would be most affected by the weakening UK economy via the trade channel. While undoubtedly negative, lower exports would alter the growth outlook only slightly.

More important, but much harder to assess, is the impact on activity via a deterioration in confidence. Uncertainty about the future relations with the UK, the effect on specific businesses, and concerns that this might be only the first step in a process of disintegration of the EU will dampen investment activity in the first place. That said, the ECB stands ready to take firefighting measures (e.g. emergency tenders, swap lines with other central banks) in order to prevent a sharp deterioration of financial conditions and to tame a possible spike in financial market volatility. In case a Brexit significantly deteriorates the growth and inflation outlook for the euro area, we expect the ECB to enlarge and extend QE beyond the current end of March 2017. Likewise, the Fed would restrain from hiking rates for a prolonged period.

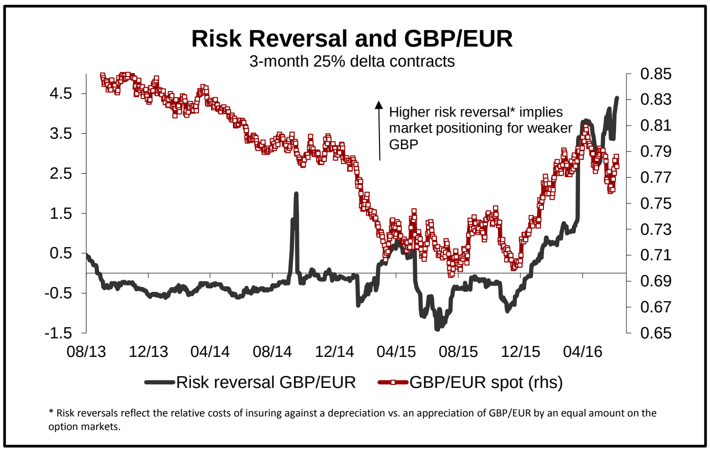
In case of a moderate Brexit fallout, we deem it likely that the remaining EU countries will intensify integration initiatives, to strengthen ties and reinforce the irreversibility of the Union. In this scenario, we deem a cumulated output loss of 0.6% until end 2017 likely compared to a non-Brexit.

In a stress scenario, sentiment could be affected much more strongly, potentially including consumption spending. Moreover, polls suggest that in core European countries EU skepticism is already high. In case of a Brexit it might gain momentum, resulting in referenda also in other member states and fuelling doubts about the long-term stability of the EU. Adding to the strains, a compensation for the UK's current net budget contribution of € 5 bn per year would need to be found. Amid rising worries about the EU, the euro area might temporarily experience negative growth rates and the output loss compared to the 'Remain' case might sum up to above 1% of GDP by end 2017.



Strong impact on sterling

A 'Leave' vote would strongly affect the UK exchange rate, with a plunge in sterling the most likely market reaction. The UK ran a current account deficit of 5.2% of GDP in 2015, which requires a continued stream of capital inflows. A complete stop of inflows may lead to a 20% weaker exchange rate, if sensitivities by the IMF are applied. In the stress scenario, sterling could fall to 0.95 GBP/EUR, close to the historical lows seen in early 2009. Markets seem to agree. GBP/EUR has been strongly driven by opinion polls over the past weeks, while the costs for insuring against GBP weakness are at record highs.



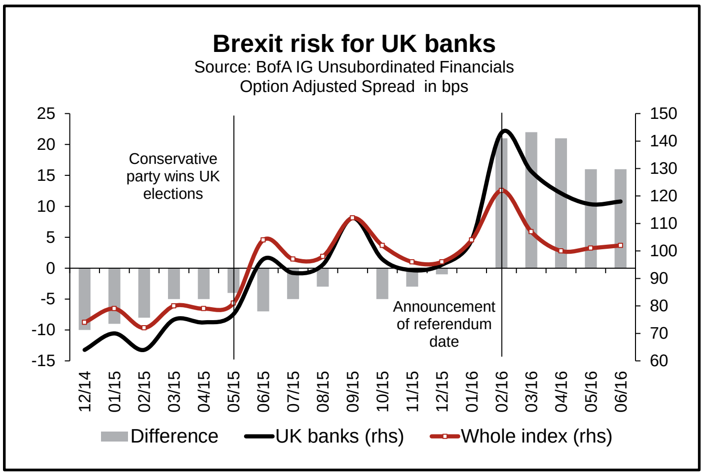
For the moderate scenario, a full drain of capital inflows need not materialize and the persistent drag on sterling could be more moderate. Moreover, part of the adjustment of the C/A balance would be triggered by weaker demand for imports. Still, short term a temporary overshoot in the exchange rate will likely be required in any case to compensate investors for the higher risk premium.

The impact on the EUR/USD is more uncertain. Medium term, the euro will likely weaken due to a higher risk premium on doubts about the stability of the EU. Short-term, however, the EUR/USD may even strengthen. For one, the euro has turned into a global funding currency which tends to strengthen also against the US dollar amid rising risk aversion. Moreover, while the ECB will stand ready to inject liquidity, US rate expectations will decrease. The resulting tighter transatlantic yield spread may additionally underpin the EUR/USD short term.

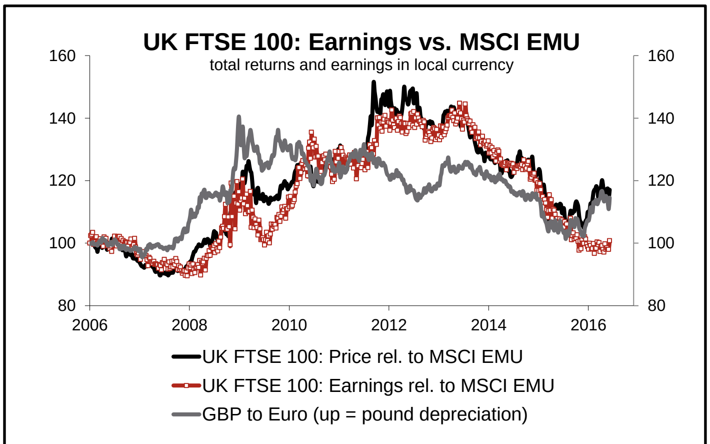
Long-dated Bund yields to slide into the negative

In case of a 'Leave' vote, the safe-haven effect in combination with the deteriorating growth outlook will dominate and will drive down core euro area bond yields. In a knee-jerk reaction, long-dated Bund yields will mark new historical lows and 10-year yields will fall into negative territory. Thereafter, depending on the prevailing scenario, long-dated Bund yields will either creep upwards towards current levels until the end of 2016 or fall further – even below Japanese levels. The case is less clear for UK gilts. Notwithstanding high volatility, the net impact on gilts is likely to be moderate given the offsetting effects of slower growth and less foreign demand.

Peripheral bond spreads are expected to rise strongly initially. The weighted average of 10-year Irish, Italian, Portuguese, and Spanish spreads is seen to increase at least to levels prevailing in February 2016 (around 165 bps). This means a widening of more than 20 bps at first. In case politicians are able to soothe markets and the extraordinary monetary measures succeed in calming the situation, sovereign spreads are likely to re-tighten in H2 2016 again. However, if separatist movements and eurosceptical parties will gain momentum and EU break-up fears will arise again, a further spread widening until the end of 2016 is likely. In this stress scenario, sovereign spreads may increase to levels above 200 bps – a level last seen at the start of 2014.



Euro denominated corporate bonds are likely to track the development of peripheral bonds, but to a lesser degree. Given the tighter linkages of financial corporates to sovereigns, we anticipate financials to underperform non-financials. UK banks are obviously the most exposed to the Brexit risk. Their relative performance has already been disappointing, with a widening in the relative spread vs non-UK peers of nearly 20 bps year-to-date, but the latter are likely to suffer as well. While ECB and BoE's liquidity will ease funding pressures in the short-term, the prolonged negotiating phase will contribute to an upward shift in risk premia for financials. In contrast, non-financials are better positioned to weather the turbulent times rather well. Given the euro area's relatively sound fundamentals and the support by the ECB's purchase program, we expect non-financial spreads to resume the tightening trend in the course of the year.



Impact on equities

In case of a Brexit, the MSCI EMU could plunge by 10%, underperforming the S&P. With such a decline the market would approach the previous February lows. A decline of 10% is consistent with a spike in the risk premium similar in magnitude to the one experienced twice in 2015: during the Greek crises and the Chinese woes (summer 2015). Currently, the equity risk premium in the euro area as well in the UK looks too low if compared to the level of the policy uncertainty index (indicating that the market is vulnerable to political shocks). So in the case of a Brexit, a market setback would happen quite quickly.

Sectors like financials (UK banks in particular), industrials, auto and UK domestic discretionary should underperform the most in case of a Brexit. Given the accommodating action by the main central banks, we expect markets to recover at least some of the initial losses in the moderate scenario. In local currency, the US and SMI indices should outperform the euro area in the aftermath of a 'Leave' vote as they are more defensive in nature (sector composition) and feature a lower beta. For the UK in particular, the bigger caps would enjoy a weaker pound which in time would sustain the earnings momentum (through stronger exports and translation gains), as happened in 2007-08. On that occasion the FTSE 100 was able to anticipate the profit upturn and overperformed the MSCI EMU index (indices in local currency). However, due to its current weaker earnings momentum the UK would underperform the MSCI EMU in case the 'Remain' camp prevails.

Conclusions

A 'Leave' vote would have a strong adverse impact on financial markets. The size of the fallout will on the one hand depend on hardly predictable responses in sentiment (investors, businesses and households). On the other hand, the political response in the rest of the EU will be key. For the fallout to prove moderate and for financial assets to recover from an initial fall, EU policy makers will need to push ahead swiftly with fresh and credible initiatives towards further integration. Moreover, while EU countries will pursue tough negotiations with Britain to deter other countries from following suit, preserving the links to the UK will be vital for limiting the fallout. The political reaction to a 'Leave' vote will be a key issue to watch for deciding whether a Brexit will provide buying opportunities or it is just the start of a prolonged decline in risky assets and core yields alike.

Imprint

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