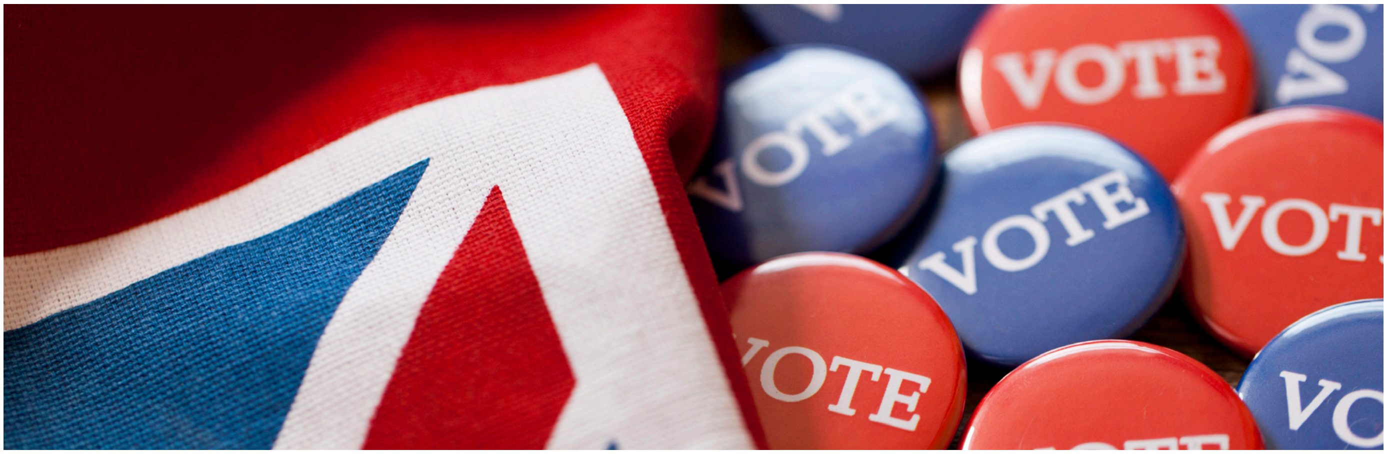
Analysis of the United Kingdom Referendum Results



On Thursday, the United Kingdom (U.K.) held a referendum on continued membership within the European Union (EU). In the run-up to the referendum, surveys indicated that the vote would be close, but in the last few days, the 'remain' vote started gathering momentum. With the surprise outcome for 'leave' (52% to 48%), the process of a British exit from the EU will begin. Rules for an exit are outlined in Article 50 of the Treaty on European Union and negotiations will now take place to determine terms of exit.

Initial Market Movements

As an unexpected, risk-off event, there was an initial knee-jerk reaction to the news. In the days leading up to the referendum, capital markets and odds makers increasingly reflected a high probability of the U.K. voting to remain in the EU. Lower bond yields and equity prices since the 'leave' result reflect an uncertainty premium related to the exit.

Equities have sold off globally with European stocks seeing some of the most severe losses. Canadian stocks are outperforming as expected given the outsized exposure to gold stocks in the TSX Composite (gold prices have moved 5% at the time this was written). Volatility as measured by the CBOE Volatility Index (VIX) has elevated but does not currently reflect a market panic.

Bond yields moved significantly lower on the announcement but have settled at levels higher than the initial reaction. Canadian bond yields were 13 basis points (bps) lower and U.S. yields 19 bps lower. Interestingly, this takes them back to levels similar to the beginning of this week. On the currency side, the U.S. dollar and Japanese yen are the winners with, as expected, the British pound and euro the losers. With a stronger U.S. dollar and risk-off environment, most commodities are lower with oil prices down 4% at the time of writing.

The European Central Bank (ECB) and the Bank of England (BoE) have both pledged liquidity support and, at this moment, asset movements are not reflecting a liquidity event. As we will highlight, the situation remains fluid with a large number of unknowns, which could change the outlook.

Greystone's Exposure

Greystone's direct exposure lies within the global and international equity funds. Leading up to the vote, the global equity team assessed uncertainty with the ultimate outcome and reduced the U.K. weighting to 7.3% within the Greystone Global Equity Fund and 19.6% within the Greystone International Equity Fund, broadly in line with the weighting of MSCI indices (prior to the referendum).

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What will this mean for the U.K. and the EU going forward?

Politically, a lot of uncertainty. Already, the U.K. Prime Minister David Cameron has announced his resignation effective in October and the political landscape in the U.K. will remain clouded. For Europe, there are concerns that other countries may also want to exercise their right to have a say on their membership and upcoming elections in some countries will be the platform for this voice.

From an economic perspective, one likely outcome is for lower capital investments in the U.K. as businesses are unwilling to invest without visibility of what might happen during negotiations with the EU. This will lead to lower GDP growth for the U.K. and possibly a mild recession. Additionally, the U.K. will see higher prices for imports driven by a weaker currency. This may put pressure on U.K. inflation at a time when the BoE is also expected to be more accommodative in terms of monetary policy.

For Europe, there will likely be more concern about some peripheral countries. For example, we have witnessed higher credit spreads for Italian sovereign bonds (as of writing Italian 10-year bond yields are up 12 bps versus benchmark German Bunds, which are trading 14 bps lower). We are also seeing pressure on European banks as this event adds further risk to an already fragile EU banking system.

It should be noted that we do not expect an immediate impact to trade or a seizure of liquidity in the financial system. It will be business as usual for Europe and the U.K. with an eye on what the new rules of engagement are after the U.K.'s exit.

What are broader long-term implications?

Globally, there is likely to be an impact to GDP growth although it is difficult to quantify the exact magnitude until we gain greater clarity on the terms of a U.K. exit.

This event is unprecedented and therefore does not allow for accurate modelling of outcomes. Terms of the U.K. exit can range from many similarities to the status quo, to punitive and acrimonious.

Our primary focus in the coming weeks will be the reaction of stocks, bonds and currency markets, which can range from a one-time repricing to a continued risk-off move. Currency markets are of a particular note in safe haven markets. Further appreciation of the Japanese yen and the U.S. dollar risks tightening financial conditions and impacting economic growth. Japan, in particular, may feel pressure on corporate profitability and business investment with any sustained appreciation of the yen.

Bottom Line

Markets have understandably priced in future uncertainty with the U.K.'s decision to exit the EU. At this moment it doesn't appear that panic is widespread, but the situation remains fragile. We believe it is prudent to wait before fully assessing the longer term outlook as key information on the terms of the outlook are not yet known.

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