



## PH&N Update

# Britain's Vote to Exit EU Membership

This publication provides some broad commentary on the U.K.'s decision to leave the European Union (EU), which we believe is an important event that is likely to have significant implications for financial markets, political structures and economic growth over time.

## Initial Reactions in Financial Markets

### **Canada**

The initial market reaction in Canada has been meaningful but – perhaps surprisingly – muted. The Government of Canada 10-year bond yield is now at 1.16%, which represents a decrease of 13 basis points overnight, and returns the 10-year yield to where it was about 2 weeks ago. The credit markets are also weaker since yesterday: the 30-year Province of Ontario spread (to Canada bonds) is around 5 basis points higher; and corporate spreads are approximately 5 - 10 basis points wider, with higher risk names widening even further. In general, high yield names were down roughly 1%.

The S&P/TSX Composite Index finished the day down 1.7%, with the Financials and Energy among the worst performers, and Gold stocks up significantly. These are important moves, but not particularly large and certainly not of the magnitude seen in 2011 and in the 2008/09 crisis. That being said, we note that many currency and equity markets in Europe have been hit much harder. In particular, the stock markets were down more than 10% in some weaker economies such as Italy and Spain.

### **Overseas**

After the shock and near-panic in currency markets as the outcome of the U.K. vote became apparent, global financial markets (so far) have responded in a relatively calm and orderly manner. Nonetheless, the market price action was dramatic during the early hours of the market-open today: the German 10-year bund yield fell 27 basis points to -17 basis points; Italian Treasury Bond (BTP) spreads widened 40 basis points; and the iTraxx Crossover Corporate Credit Derivative Index (XO) jumped almost 100 basis points higher. Following the initial shock, however, around one-third of the overall market impact was then unwound, and cash bonds as well as more liquid derivative and index instruments transacted in an orderly manner.

European stocks today fell more than 5%, with the hardest hit sector being European (and U.K.) Financials. The greater the distance from Europe in terms of economic and financial linkages, the less direct the impact of the Brexit vote. Asset prices in the emerging markets of Eastern Europe have experienced some contagion, but will be supported by European Central Bank policy action, and Brexit

should have limited implications for their economic and credit fundamentals. Our current scenario analysis indicates that the economic and financial impact of Brexit is likely to be modest for emerging markets.

## **Portfolio Positioning**

### ***Fixed Income***

Our actively managed fixed income portfolios have been positioned with relatively little risk, and so we did not expect any “above normal” changes in valuation today, either in absolute or relative terms. We have deliberately left room to add credit (in Corporates and Provincials), and so if we find value over the coming days/weeks we won’t hesitate to add. The current duration positioning is also relatively small, leaving us ample room to manoeuvre as yields change. We have not responded to the drop in Government of Canada yields by increasing the risk budget allocated to interest rate strategies. The risk budget for interest rate strategies has been set at conservative levels for some time.

### ***Equities***

Performance in our broad market Global Equity strategies has been in line with the market today, while our Canadian portfolios are generally slightly behind the market due to an underweight position in gold stocks, which performed strongly during the day. In all of these strategies we have ample room in risk budgets to take advantage of opportunities that may present themselves in the coming days.

Our low volatility equity portfolios were down, though they outperformed their respective markets meaningfully, as expected in this type of trading context. The decline in the Canadian dollar relative to the U.S. dollar has offset somewhat the losses in non-Canadian equities.

### ***Alternatives***

Broadly speaking, our alternatives teams had been reducing risk going into the vote, and we expect performance in our public market alternatives strategies to be modestly down today but somewhat muted in relation to the sell-off that we have seen in the broader markets. Overall, we have been cautious of the risk introduced by the referendum and we positioned portfolios accordingly. Within private markets, we expect the near-term impact to be limited as the majority of the current portfolio companies tend to be national players acting in non-cyclical industries, and should not be materially affected by either the direct or indirect consequences of Brexit.

## **Medium-Term Implications**

We will consider carefully the precise nature and size of these impacts over the coming days, weeks and months. It is important to recognize that there will be both positive and negative impacts, and that the expected increase in volatility should provide many opportunities for us, as active managers, to add value for our clients’ portfolios.

Some of the key “big picture” messages to keep in mind are the following:

First, there is no question that Brexit adds uncertainty to the world of investing and that this uncertainty is unlikely to dissipate any time soon. This will provide a headwind for risk assets, although it may also result in more attractive investment opportunities from a valuation perspective.

Second, on balance this is likely to be negative for economic growth, particularly in Europe, although how negative remains to be determined.

Third, in the medium term, this event may make it more difficult for Europe to stay together – populations such as the Spanish and Greeks may exert greater pressure to leave Europe or at least renegotiate the EU conditions. How the EU reacts to these demands will be critical.

Lastly, the Brexit result supports the case for a “lower for longer” yield environment, and delays any move by interest rates to “more normal” levels.

We understand that clients may have many concerns and questions as a result of this unusual and important event. Please do not hesitate to contact your Institutional Portfolio Manager if you would like to discuss this in greater detail. In the meantime, we have also provided some insights from our Chief Economist, Eric Lascelles.

## Bringing Home Brexit

By Eric Lascelles, RBC GAM Chief Economist

In a surprising and highly consequential turn, British voters have now opted to end their membership in the European Union (EU). However, we stop short of deploying the words “shocking” or “devastating”, as we had long maintained that the risk of Brexit was in the realm of 35% to 40%, and the long-term economic and financial market consequences – while significant – are not as outsized as some imagine.

The immediate financial market response has been quite large, with the pound down by as much as 15%, the British stock market down by as much as 9% and the British 10-year yield lower by as many as 36 basis points. But these moves have already been partially unwound. We suspect the long-term market effect will ultimately prove smaller than these initial moves.

While there are very real economic and financial market consequences that emerge from this decision – mainly, the extent to which financial conditions tighten – the most important developments and risks are political in nature. While consequential, this does not appear to be a “Lehman moment.”

### Parsing the Results

A slim 51.8% majority of Britons voted to leave the EU. This was within the margin of error for recent polls, but deviated significantly from the market’s expectation as past referendums have had a strong tendency to favour the status quo, and indeed both the 1995 Quebec and 2014 Scottish referendums experienced a large six percentage point swing toward the status-quo from the final polls to the actual vote. This clearly did not occur today.

Anticipating the outcome correctly was always going to be a challenge. British pollsters have struggled lately even to predict run-of-the-mill election outcomes, let alone one-off events such as this without a good understanding for the variable willingness of the voters on each side of the issue to reveal their preference.

From an accounting perspective, a number of explanations have been thrust forward for this surprising outcome. Weather in the heavily pro-EU southeast of England was quite poor, potentially damaging voter turnout. But turnout was similarly uninspiring in the pro-EU bastion of Scotland. Meanwhile, the “leave” camp enjoyed a greater fraction of the vote than anticipated in areas generally expected to lean their way. In the end, it is simply the case that “leave” managed more votes than “remain.”

Why have British voters opted out? At the considerable risk of playing armchair psychiatrist, there are a number of plausible explanations.

The “leave” camp has tended to focus on the allure of greater national sovereignty and the advantage of escaping the serial crises that have plagued the EU. These are legitimate reasons, even if the economy and financial markets are somewhat damaged by the decision.

To the extent that there has been a worldwide shift in sentiment – as also demonstrated by the U.S. presidential election and a host of other political developments globally – it may also have to do with the feeling that globalization has not been all it was made out to be, and that many have been left behind in an increasingly winner-take-all world. This naturally manifests in a desire to up-end the status-quo.

## Economic Implications

The economic effects of Brexit can be broken into ongoing, short-term and long-term consequences:

The ongoing effect is that high policy uncertainty surrounding Brexit has already interfered with U.K. business investment over the last few quarters, undermining the rate of economic growth. This had been a key factor in our previously downgraded U.K. 2016 growth forecast from 2.5% to 2.0%.

The short-term effect is that the U.K. is now at serious risk of a temporary recession (with a roughly 60% probability) as the recent abrupt financial market declines combined with increased risk aversion stall economic growth in the short run. Business investment should remain poor and the large U.K. current account may prove somewhat more difficult to finance. In response to the referendum result, we are now tracking British GDP growth of just 1.25% across 2016 (including a mild recession in the third and fourth quarters) and then roughly similar growth in 2017. Note that the U.K. will not actually leave the EU for several years, so this drag is not due to higher tariffs or diminished immigration but rather represents an anticipatory effect by businesses and households.

The long-term effect is only moderate, but not insignificant. The central tendency for economic models when modelling Brexit is that the British economy will be roughly two percentage points smaller than otherwise within a decade. Some models claim much more problematic consequences, but a handful argue that the impact could even be slightly beneficial. Overall, the impact should be somewhat negative due to higher tariffs, less immigration and the slight diminishment of London as a financial hub. This means that Brexit hardly prophecies economic stagnation for the U.K., though it does unhappily shave as much as a quarter percentage point off growth annually over the coming decade. Potential savings on transfers to Brussels and greater regulatory sovereignty are attractive, but do not constitute complete offsets. But the precise effect depends enormously on what sort of subsequent relationship the U.K. negotiates with the EU.

## Markets in the Short Run

The financial market response has been within the realm of our expectations. We continue to operate on the assumption that markets will first overreact, and then reclaim some of their losses. Arguably this is already happening in most markets, though it is not entirely clear whether markets could again suffer lower lows before sustaining a more enduring rebound. Either way, there are certainly investment opportunities to be captured as all of this plays out.

The pound fell by as much as 15% versus the U.S. dollar but has since reclaimed four percentage points of that decline. It is nevertheless lower than at any other point in the past thirty years. And in contrast to some of the other financial variables, it would not be surprising if the pound shed some further ground over the next year.

The British FTSE 100 fell by 9% but has since reclaimed 4.5 percentage points of that drop. We had identified a potential short-term response of as much as -10% to -13%.

The U.K. 10-year yield fell by as much as 36 basis points, but has since bounced by 6bps since then. Given understandable risk aversion paired with growing expectations that the Bank of England will cut rates by as much as 50 basis points, this is arguably within the range of a normal initial response as well.

It is important to recognize what Brexit is not: it should not trigger opaque, cascading losses on the order of the 2008-2009 financial crisis. There is certainly room for significant losses and who is to say what investors may be found offside on the large pound swing in particular. But banks do not appear set to be undermined, and the Bank of England is offering additional liquidity to ensure that this is avoided. Similarly, the scope for global contagion – while material – is not as dramatic as during the financial crisis.

## Markets in the Long Run

It is important to distinguish short-term from long-term effects. Over the long run, the impact on the stock market and bond market should be considerably less.

We figure that a two percentage point hit to the level of British GDP over the long run should roughly map onto a two percentage point hit to the present value of future corporate earnings. This is a fancy way of saying that the British stock market should logically only be around 2% weaker than pre-Brexit once the dust eventually settles.

For the bond market, higher uncertainty and a more dovish central bank promise to keep yields lower for some time, but in the end it is not obvious that yields will be permanently lower. After all, a weaker pound may trigger higher inflation, and slower growth likely maps onto higher public debt levels.

## International Markets

International markets are reacting, but only moderately.

The U.S. dollar is up just over 2% versus a broader set of trading partners. This, along with the additional uncertainty surrounding the implications of Brexit, is likely to strengthen the Fed's conviction to remain on the sidelines for some time. Reflecting this and greater risk aversion, the U.S. 10-year yield is now 23 basis points lower on the day, if still higher than the all-time lows reached in 2012.

U.S. stock markets opened roughly 3% lower, and remain volatile. The Canadian dollar is roughly 1.5% softer versus the U.S. dollar – a notable but not overly consequential move. Unsurprisingly, gold prices are 5% higher due to greater global uncertainty.

## Political Implications

Let us start with the domestic U.K. political implications.

As widely expected, Prime Minister Cameron has responded to the Brexit vote by announcing his resignation by the early October Conservative Party convention. This was inevitable both because he has wound up on the losing side of the outcome and also because he was the one who promised a referendum to voters. It would have been difficult for the U.K. to undertake subsequent negotiations with the EU led by an anti-Brexiter.

Former London mayor and prominent Brexiter Boris Johnson has been pegged as an early leader in the battle to become the next Conservative leader (and Prime Minister), though he is said to be unpopular internally with Conservative MPs.

While the other side of the aisle normally makes hay when a political crisis like this erupts, that isn't exactly the case today. This is because Labour leader Jeremy Corbyn is also under threat, with a vote of confidence scheduled regarding his leadership. He had also campaigned for "remain" despite personal misgivings.

Given the closeness of the vote (just 51.8% for Brexit) and the opposition of Brexit by the two dominant parties and the majority of British MPs, it is conceivable that an election will be necessary somewhere along the way. We do not present this as our base case, but it is a substantial risk.

Given Scotland's clear preference for the EU and the ongoing fermentation of secessionist sentiment, another Scottish referendum must now be above a 50% probability, with a strong possibility that – like Russian nesting dolls – the U.K. is itself then dissected. The equivalent risk for Northern Ireland is smaller, but not trivial.

## International Consequences

The consequences for the remaining EU members are large.

Economically, much depends on how frightened markets become and whether they start to price in a further breakup of the EU. Presuming these fears are contained, the economic impact is probably about one-quarter as large, meaning perhaps 0.25ppt less growth in each of 2016 and 2017, and ultimately around a 0.5ppt loss in economic output over the next decade.

Politically, this is an enormous development for the EU. Not only does the EU lose an important centrist voice at the table, but the risk of an eventual EU breakup is surely much higher than it was before the British referendum. It is some consolation that the core of the EU – the Eurozone – is still unbroken, but a bad precedent has nevertheless been set. Given the number of far right, far left and populist parties balking at EU oversight, this may not be the last such referendum. And polls suggest that a worryingly large fraction of voters are fed up with the EU in other nations, too. If the U.K. – a country that avoided the worst of the financial crisis and largely sidestepped subsequent European debt crises – is opting out, it is quite easy to imagine others being highly tempted to follow. Spain has an election this weekend, Italy has a (non-sovereignty) referendum in the fall and both France and Germany have major elections next year. Austria just recently avoided electing a far right government.

Outside of Europe, the Brexit vote is another reminder that voters are no longer content with the status quo. This has implications for the U.S. presidential election and beyond.

## Next Steps for the U.K.

Britain's exit from the EU is hardly complete. There is much left to be done.

To exit, the U.K. must first legislate this action in parliament and then invoke Article 50 of the Lisbon Treaty. All of this should be delayed until after the October Conservative Party convention when a new Conservative leader has been selected.

The legislation itself should be reasonably straight-forward, but one cannot completely rule out the possibility that MPs either vote for their personal preference (with the majority against Brexit) or view a 51.8% win as demonstrating insufficient conviction to warrant breaking the union. One way or another an

exit should still be pursued, but there is the risk of an election along the way should the situation become messy.

Once Article 50 of the Lisbon Treaty has been invoked, there will be a two year period of negotiations regarding the terms of exit and any subsequent relationship between the U.K. and EU. This can theoretically be extended, though it is also possible negotiations could be wrapped up quickly. We do not put much likelihood on the latter outcome, as the EU is unlikely to offer favourable terms to the U.K. This would be partly out of spite, partly because of the need to dissuade other members from exiting, and partly because the U.K. just doesn't matter to the EU as much as the EU matters to the U.K. (exports to one another are 3% versus 13% of GDP, respectively). Already, the EU has indicated that a set of favourable concessions delivered to the U.K. in early 2016 are no longer valid and that no informal negotiations will begin until the U.K. has formally invoked Article 50.

The U.K. desire for a made-to-measure deal that provides free trade in goods and services, limited immigration, complete autonomy over regulations and no financial transfers to Brussels would be a guaranteed non-starter. No other associated country enjoys this combination of features. This suggests quite long negotiations. Additionally, the U.K. will have to negotiate new trade deals with all of the countries that the EU has relationships with. This presents a particular challenge for the U.K. as its government no longer possesses considerable depth in this area given that the EU has long handled these matters.

When negotiations with the EU are finally done – perhaps in the fall of 2018 – all 27 remaining EU nations plus the U.K. will have to legislate the change, and each will require a parliamentary majority. This will be tough sledding.

## Conclusion

This Brexit vote constitutes a significant surprise, though not an utter shock. We have long talked of high policy uncertainty and geopolitical risks constituting challenges to economic growth. It appears these challenges have intensified somewhat, and it highlights that voters today are willing to take risks that they normally wouldn't entertain. We must watch Europe even more closely for evidence of other countries beginning to push their way out of Europe. This is probably a multi-year monitoring process given the glacial rate at which these sorts of things progress.

All the same, Brexit does not constitute the end of the world. This is a country pursuing slightly less close relations with the rest of the world. While the initial market reaction has been quite large, the long-term effects should be somewhat smaller. Similarly, while the British economic outlook is now materially diminished, the immediate hit to Europe is considerably smaller and the effect elsewhere in the world should be quite limited unless global financial conditions deteriorate in an outsized way in response to the vote.

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