As World Confidence Comes Together, Will the UK and EU Break Apart?

- World financial markets appear to be recovering from a “state of shock.” Negative central bank policy surprises left a void that was filled by Chinese currency fears, “petrol dollar” asset sales and related financial risks at the start of the year. This drove a highly unusual rise in correlation between asset prices and crude oil not seen since 2008/2009. Effectively, this left world asset market expectations poised for a deep economic contraction. We see markets recovering as the expected shocks have not materialized and economies are not contracting away from the petroleum sector and related industries.

- However, as market views of downside growth risks diminish, unusual political risks loom in the background. Away from the gradually-emerging clarity over the coming U.S. presidential election, the U.K.’s June 23 vote to remain in or leave the European Union could prove a potential driver of volatility. U.K. assets could become strongly correlated with polling data in the months to come, particularly if the polling results look inconclusive.

- The issue is non-trivial for the U.K. economy. The E.U. accounts for half of U.K. goods and services exports and 13% of U.K. GDP. Brexit uncertainty may already be stalling business investment, which was the pattern of activity around the Scottish independence referendum of 2014 and the U.K.’s general election uncertainty of 2015.

- The near-term impact of Brexit uncertainty has been felt in Sterling already. This is because the U.K is dependent on foreign direct investment and portfolio flows as it runs a large trade deficit. Brexit risk might even be over-priced in the UK exchange rate currently, particularly if polling data were to turn away from Brexit. However, investors may want to consider managing related asset market and real estate risks that range far wider than a single exchange rate.

- One risk we will watch going forward is the impact of the U.K.’s renegotiation of membership terms on the policy cohesion and political developments of other E.U. members.

World Markets Follow the August/October 2015 Pattern

As discussed in recent bulletins and our latest Quadrant – Oil: Tail that Wags the Dog, we see world financial markets now recovering from a “state of shock.” This was driven by a second, true collapse in crude oil in as many years, so-called “petrol dollar” asset sales, Chinese currency fears, and a vacuum of confidence in central banks. All of this stunned investors in the young new year.

However, like the sudden 12% drop in global share prices in August/September 2015 (which was subsequently reversed), the lurch to expect shocks and economic contraction has to be real, rather than imagined, for bearish market trends to endure.

The sluggish pace of global expansion apparent since 2010 will remain. Yet after a lurch toward expecting a significant economic contraction – as implied by a swift,15% drop in global share prices - we suspect market views
of the world growth outlook (more accurately, the extent of the downside risks) need to be adjusted upward once again (see figure 1).

Figure 1: Purchasing Manager’s Index vs. DM MSCI Index

![Chart showing Purchasing Manager’s Index vs. DM MSCI Index](chart.png)

Sources: Haver as of March 2, 2016. Notes: Last two data points are daily observations. PMI figures above 50 indicate expansion, while below 50 indicates contraction.

We expect monetary policy to play a role in market recovery this month while confidence in such actions has waned. Around the turn of the year, policymakers (the European Central Bank especially, which meets March 10) raised expectations, suggested action was needed, and then failed to act. Importantly, it was inaction rather than views of impotence that significantly dashed investor confidence, while China and OPEC fears filled the void.

Significant risks remain. Yet today, we see “normalizing” markets as the dominant, near-term trend. As discussed in Quadrant, when correlations between most asset markets and the crude oil price have risen to levels not seen since the heart of the 2008/2009 economic collapse, even this year’s slate of U.S. presidential candidates doesn’t seem the most frightening concern. Looking out further, however, what do we face if markets do indeed get a grip? Unfortunately, in that event, we see political issues adding an extra dimension of risk to the near-term.

Brexit: Binary Driver of the U.K Outlook, and with Significant Overspills

It’s often been said that the wider world is “held hostage” by U.S. elections and political decisions. However, this year, Group of 20 leaders decided to specifically cite the U.K.’s coming referendum to remain in- or leave the European Union as one of the risks to the world outlook. When looked at through the prism of short- to medium term economic risks, we have to agree. Part of the reason for this risk assessment is that the U.K.’s renegotiation of its membership terms with the E.U. is likely to further embolden national sovereignty or separatist movements throughout the broader E.U. The Middle-East refugee crisis is exacerbating this political weakness in the region. All of this somewhat counters the confidence building efforts of policymakers.

Our base case expectation is that the U.K. will vote to "remain in" after U.K. Prime Minister Cameron renegotiated some of the terms of the UK’s membership (please see a more detailed discussion here Quadrant – Oil: Tail that Wags the Dog). This view is based in part on public polling data that favors the UK remaining in (see figure 2). Yet the risk of Brexit is non-trivial. The probability of exit could be as high as 40%, particularly after notable members of the ruling Tory party have decided to campaign in favor of Brexit.
Away from the generalized recovery in financial market risk taking that we believe is now underway, for the UK, there will be a period of significant uncertainty ahead until the June 23 vote. This is likely to stall business investment decisions and perhaps portfolio investment flows.

The E.U. accounts for half of U.K. goods and services exports and 13% of U.K. GDP. Stalled investment was the pattern of business investment activity around the Scottish independence referendum of 2014 and general election uncertainty of 2015 (see figure 3).
If a Brexit vote were to occur, current trade arrangements would remain in effect for two years while new arrangements would be negotiated. However, that uncertainty alone is likely to weaken the investment spending that is linked to E.U. trade. If there is a Brexit vote, the impact on U.K. exports (including financial services) could be quite significant and negative over time.

Following the vote, if it is to ‘remain’, then UK assets could have a substantial relief rally across all asset classes. The extent of this rally would depend on the magnitude of any prior weakness. **U.K. assets could become strongly correlated with polling data in the months to come, particularly if the polling results look inconclusive.**

The near-term impact of Brexit uncertainty has been felt in Sterling already. This is because the U.K is dependent on foreign investor direct investment and portfolio flows as shown by the large U.K. external deficit (see figure 4). With near-term GBP implied (expected) volatility priced higher than long-term volatility, the risk of Brexit might even be over-priced in the UK exchange rate currently, particularly if polling data were to turn away from Brexit. However, as we will discuss in coming publications in the months ahead, investors may want to consider managing related asset market and real estate risks that range far wider than a single exchange rate.

One thing we can be nearly certain of is the return of attention to idiosyncratic political risks at some point fairly soon. This was evident in the performance of Spanish asset markets as political uncertainty of late has offset a strong local economic performance. The June 23 vote on Brexit is likely to drive a return to this “local” focus with international market implications. The U.S. presidential election then looms as another issue beyond.

**Figure 4: UK Current Account Deficit, Investment Flows (% GDP)**

Sources: Bank of England as of 3Q’2015.
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