What’s at stake in “Brexit” vote?

Article highlights

- Public opinion polls in advance of the June 23 “Brexit” vote have become too close to call. It’s not clear to what extent last week’s killing of a British MP might influence the outcome.
- A Brexit would put the European Union in uncharted territory, as no country has ever left the EU before.
- Ultimately, we expect U.K. voters to decide there is too much uncertainty associated with a “leave” vote, and will opt to stay.
- We anticipate an increase in short-term market volatility if the leave camp prevails. While we think the possibility of a Brexit has largely been priced into currency markets, the British pound could be vulnerable to further weakening.
- Despite the potential for market turbulence in the wake of the vote, we believe such volatility can create attractive investment opportunities. We encourage investors to remain patient, diversified and focused on the long term.

On June 23, U.K. voters will participate in a public referendum to determine whether Britain should leave or remain in the European Union (EU). A British exit, or “Brexit,” would put Europe in uncharted territory, as no country has ever left the EU before.

The stakes are high, reflecting a tug-of-war between those who believe EU membership confers the benefits of economic strength and free trade against those who favor greater national sovereignty and independence from the EU, particularly in areas such as immigration policy. British Prime Minister David Cameron has led the charge for the “stay” campaign, while the “leave” movement is made up of various factions representing anti-EU sentiment.

Given the economic, political and social concerns involved, much of the debate over the referendum has been emotionally charged. At its most extreme, this intensity led to the June 15 murder of Jo Cox, a Minister of Parliament and strong proponent of the stay campaign, allegedly at the hands of a far-right British nationalist. Whether and how this event will influence the outcome of the vote is unclear. In the days preceding the tragedy, public opinion polls had become statistically too close to call but showed the leave camp gaining some traction. Subsequent polling has indicated a blunting of that momentum. Whichever side wins, it may well be by a razor-thin margin.

How will markets respond?

The prospect of a Brexit and its potential impacts has weighed on financial markets and the U.K. economy to varying degrees since the referendum was announced in February. Uncertainty over the outcome—perhaps as much as fear of a particular result—has contributed to volatility and subdued economic activity along the way. In part, market reaction in the wake of the vote will likely depend on the extent to which a “leave” victory has been priced in. We assess some potential market reactions below.
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- **Currencies.** Investor angst has been most evident in the currency markets. At $1.42, the British pound is testing lows not seen since the financial crisis in 2008. Already down 10.7% versus the dollar in the past year and 4.3% year-to-date, the pound could fall sharply—perhaps by another 5% to 10%—in the aftermath of a leave vote. Longer term, we would expect such a sell-off to abate as the transition path becomes more clear. So far, the euro has strengthened against the dollar this year, but it, too, would be vulnerable to near-term weakening.

The pound has weakened since last summer and could fall further if Brexit occurs

$US/£ spot exchange rate, June 2015 – 2016*

![Graph showing the USD/GBP exchange rate from June 2015 to June 2016. The graph shows a steady decline in the pound's value against the dollar.]

*Through 6/16/2016. Source: Haver Analytics

- **Equities.** Equity markets have experienced heightened volatility over the past month as polls have tightened, suggesting that we may see a “relief rally” if the stay camp carries the day. On the other hand, a decisive vote to leave could send the U.K. and Eurozone stock markets lower in the near term. In our view, however, the possibility of a Brexit has largely been priced into market expectations; this could help mitigate a downward move.

Increased risk aversion could cause some contagion in the U.S. and other global equity markets, but we would view any corrections as potential buying opportunities. Importantly, European equity markets have already declined roughly 8% year-to-date through June 16, as measured by the STOXX Europe 600 Index, and may have further to fall immediately following a Brexit vote. Despite this short-term market uncertainty, corporate fundamentals in Europe are improving, and stocks in many sectors continue to represent long-term buys. After five years of downward revisions, earnings appear to be troughing, while valuations are attractive at 14x earnings, a 20%-25% discount to U.S. equities.
Many economic drivers for Eurozone equities are also supportive, with manufacturing and service-sector activity remaining in expansion mode, regional unemployment at five-year lows, continued quantitative easing by the European Central Bank (ECB), and, since March, an upward trend in the Citigroup Economic Surprise Index. This index gauges the extent to which economic data releases diverge from consensus forecasts; rising index levels indicate more upside surprises. We currently forecast GDP growth of 1.7% for the Eurozone in both 2016 and 2017, versus 1.4% and 1.5%, respectively, for the U.K.

- **Fixed income.** In a Brexit scenario, yields on U.S. Treasuries and Japanese government bonds may fall further from already low levels amid increasing demand for safe-haven assets. (Yield and price move in opposite directions.) Yields on German government bonds, or bunds, have also declined, turning negative for the first time on June 14, 2016. Meanwhile, yields in peripheral Eurozone bond markets (e.g., Italy and Spain) could potentially move higher as investors demand greater compensation for the amount of risk they’re assuming.

  That said, bond markets—like their equity counterparts—appear to have largely priced in the possibility of a Brexit. Moreover, ongoing ECB stimulus should help keep a lid on European yields should debt markets become more volatile, and we don’t foresee the kind of yield increases that occurred during the worst of the Greek-driven euro crisis in 2011-2012. In the U.K., yields on government bonds, or gilts, could decline as the market prices in expected rate cuts and even the possibility of quantitative easing by the Bank of England.

- **Real estate.** As investors in European and U.K. commercial real estate, TIAA is prepared for multiple potential outcomes. Europe’s recent recovery has caused us to upgrade our forecasts, but a Brexit could reverse or temper these trends in the short term. In a leave scenario, both rents and demand for commercial space would likely fall. Longer term, the upside potential for Europe remains appealing. The number of well-capitalized domestic and overseas buyers of U.K. property should provide a floor for prices, particularly given the weakness of the pound. If markets appear to overreact to a leave vote, we may look for buying opportunities.

**Other potential after-effects**

Given the history of interdependence between the U.K. and the rest of Europe under the EU framework, Britain’s departure from the union would create other challenges. One example is the U.K. banking system. London has long been the undisputed banking capital of the region, and the U.K. has been a first stop for foreign enterprises to domicile before entering markets on the continent. Moreover, the financial services sector accounts for 10% of British GDP, and London alone stands to lose important segments of its workforce. Indeed, London’s largest banks have already announced planned layoffs in the event of a Brexit.

That’s not to say there’d be a single, clear alternative to London elsewhere. While Parisian officials have positioned their city as a finance hub for Europe, big banks are indicating they are likely to spread their London operations among several European cities, including Frankfurt, Dublin, Paris, Warsaw and Lisbon. This would take time, meaning London would not lose its global-financial-center status overnight. In addition, though U.K. banks would certainly feel some short-term pain from a Brexit, overall they are well-capitalized and globally competitive.
Another post-Brexit challenge would be heightened political uncertainty. There are factions in other European countries—notably Spain, where a June 26 general election is scheduled—that want to leave the EU and would seek to capitalize on any “leave” momentum from a Brexit. While not necessarily poised for major victories, a growing chorus of “Eurosceptics” has prompted core EU members such as France to consider closer integration of the union as a defense mechanism. France has also vowed to impose harsh terms on the U.K. should it choose to leave the EU, thereby creating a disincentive for other potential defectors.

Bottom line

The June 23 referendum remains a toss-up. However, we believe that when push comes to shove, voters will decide there is too much uncertainty associated with a leave vote, and will opt to stay. While the U.K.’s regulatory burden would be lighter under a fully independent system, the path to get there would be neither short nor simple. Nearly 1,300 regulations and hundreds of thousands of pages of laws would need to be reviewed and renegotiated to effect Britain’s transition to independence. Throughout this process, the U.K. would still be subject to the EU’s jurisdiction.

TIAA does not anticipate material adverse impacts on participants and clients resulting from a possible Brexit. While markets may be volatile in the short term following a leave vote, we believe such volatility can create attractive investment opportunities. Meanwhile, a vote to stay has the potential to spark a substantial upside move, as the uncertainty that has weighed on markets and constrained economic activity would be removed. Regardless of the outcome, we encourage investors to remain patient, diversified and focused on the long term.