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MARKET FLASH | 24 June 2016

"Brexit" Is Here. What's Next for Markets?

The unexpected has come to pass with Britain voting to leave the European Union (EU). Investors, most of which were positioned for the alternate outcome, are now wondering what could happen next. Here are the four main consequences they can expect.

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Heightened volatility

First, we expect markets to be hit with an immediate volatility shock. Markets have never dealt with an event like this before, so analysts have no framework to evaluate it. Moreover, most investors were positioned for the opposite outcome: that the "remain" camp would win. So the shock will be global, similar to the way the localized Chinese equity crash last year quickly spread around the world.

Both UK and eurozone assets are likely to sell off sharply, raising the likelihood of relatively swift intervention from the Bank of England (BOE) and the European Central Bank (ECB). The BOE will likely cut rates and restart its quantitative easing (QE) program. The ECB has few additional options left, yet it could announce more targeted purchases of peripheral sovereign bonds in the case investors start betting against the euro again.

Drawn-out negotiations

Second, there will be no immediate change in the relationship between the UK and the EU. It will be the start of a two-year negotiation period to reach a deal for the UK to leave its current institutional arrangement. British businesses will continue to have access to EU markets, and EU citizens will continue to be able to travel, live, and work in Britain. No foreign investor will move out of the UK immediately. We could, however, see some early announcements of cancelled future investment projects.

One of the first issues to watch out for would be the names of the negotiation teams. However, it will take a while before the scope of the negotiations becomes clear. Initially, the EU may play hardball. But over the course of the next six to 12 months it will become clear that both sides are interested in a deal.

A "refidemic"

Third is the risk of EU referendum contagion. Since British voters got an opportunity to decide whether an "ever-closer union" is what they want, others may demand a similar vote. Referendum movements could spring up in countries like the Netherlands, Finland, or Denmark – all of which have growing Eurosceptic populations. Even France and Italy are not immune to EU and eurozone membership challenges.

In any case, Brexit threatens to undermine the EU and the euro in a much larger way than merely through the questions of Britain's continued EU membership.

More elections

The fourth issue is the likelihood of snap elections in the UK. Prime Minister Cameron may be forced to resign given the outcome of the vote. New elections could bring in an even more conservative and, thus, even more business-friendly government. That prospect and the growing instability of the EU could change the way investors look at the UK and the remaining EU.

Initially, UK assets will likely bear the brunt of the market selloff. However, it should become clear that the impact on the UK economy is not imminent, whereas further challenges to the EU or eurozone are likely to focus investor attention fairly quickly on markets there.