Britain Will Leave the European Union: Now What?

Update

Surprise, then Tumult

Up until mid-June few thought the so-called "Brexit" referendum, on whether Britain should exit or remain in the European Union, would have consequences beyond fluctuations in the pound. That changed, however, as momentum shifted toward the "leave" vote. Recent weeks have seen a broad flight to safety, with slumping stock prices, increasing currency volatility, rising gold prices and new-low bond yields. The Federal Reserve cited Brexit uncertainty as one of the factors influencing its decision not to hike interest rates in June.

Brexit came true last night as the U.K. voted to leave the EU. Most observers thought the "remain" vote would prevail and many investors bet that Britain would stay; those expectations were dashed overnight as the vote to leave came in loud and clear. Prime Minister Cameron has resigned, which will likely throw U.K. politics into a season of turmoil along with the economic and financial market disruptions.

The "remain" camp's chief point was that leaving the EU would hurt the British economy. Proponents of Brexit rejected that argument, insisting that quitting the bloc would make Britain richer, by allowing freer trade with other regions of the world and by reducing regulatory burdens on businesses. In the end, however, the vote seems to have been more about immigration than economic issues.

Economists warned that a vote to quit the EU would be likely to trigger a downturn, perhaps even a recession, in the U.K. and more broadly in Europe. The International Monetary Fund said a "leave" vote would lead to slower economic growth and higher unemployment in coming years. In its annual review of the U.K. economy, the IMF predicted that leaving the EU would hurt Britain's financial system and harm numerous other countries, particularly Belgium, Ireland and The Netherlands.

Overnight indicators seem to bear out the dire warnings: Standard & Poor's has already said that the U.K. will lose its AAA credit rating. The pound has fallen to its lowest level against the U.S. dollar since 1985; stocks in Asia and Europe have retrenched to their lows of February. Liquidity became an issue this morning and there was talk of coordinated monetary easing from a number of central banks. EU banks and U.K. housing stocks were both suffering double-digit losses.

Traders were bracing for a tough day ahead of Friday's open in New York — S&P futures were down almost 4% overnight, and expectations were that circuit breakers would halt trading if U.S. stocks followed Asia and Europe down. With the markets in "risk-off" mode, so-called "safe haven" investments were rallying early; the ten-year U.S. Treasury yield had fallen to 1.47% and gold was up more than 8%.

What Happens Next?

In recent years, the U.K. has been among the stronger economic performers in the EU. Since it accounts for almost 18% of EU GDP, Britain's departure will have painful consequences for the rest of Europe as well as for itself. The extent of the damage will depend on the terms of separation, which now must be negotiated; the separation could take more than two years to complete.

Clearly, the Brexit vote is a blow to the goals of European integration. Now that Britain has chosen to leave, other disaffected EU nations may attempt to follow it out of the EU. A recent Pew Research Center survey showed that many other EU nations think even less of the Union than does the U.K. Levels of EU disapproval ran as high as 61% in France, 49% in Spain, 48% in Germany and 46% in the Netherlands. Anti-immigration forces are likely to draw strength from Brexit, further deepening political divides across the EU.

Implications for Investors

From a multi-asset strategy viewpoint, we believe that after the "leave" vote, uncertainty will prevail and risk assets will move lower, with asset markets closest to the U.K. and Europe feeling most of the pain. Assets seen as safe havens, such as U.S. Treasurys, gold, the Swiss franc and Japanese yen, will continue to be sought by global investors. It is in these higher moments of fear that volatility rises dramatically, and once it does it can take quite some time to recede — especially in these instances where there is no historical context against which to measure the event. It is our view that the Bank of England (BoE) and European Central Bank (ECB) will have to make statements and take actions to keep liquidity lines open and prevent the credit markets from becoming unhinged. Eventually, the Fed may have to step in to provide liquidity as well. The ramifications of political uncertainty can still cause a worrisome outcome, and the European Union's member countries will need decisive action to quell other constituents that have voiced similar concerns to those of the U.K. The longer term effects may be a slow process that raises the equity risk premium globally and keeps bond yields suppressed. It will bear close watching of consumer and business confidence indicators for signs of spillover into economic transmissions. We would expect increased volatility as we move toward the U.S. elections in November, and the German and French elections in 2017. In our multi-asset universe it is too early to buy European equities on the initial carnage. Currently, we are slightly overweight U.S. equities and selected credit-related fixed income.

The U.K. economy is headed toward negative growth, and the markets will price in recession. Near-term uncertainties include an unknown timing and outcome for the new government. The Tories have a slim majority but they may not all agree with a new proposal for the Prime Minister. A hung government is a possibility. A second Scottish independence referendum is now on the table, and the leader of the Irish Nationalist Sinn Fein party has called for a referendum on a united Ireland. As for timing, Cameron stated there will be no decision on invoking the process to begin negotiations for at least three months. The negotiating process itself to extricate from the EU may take up to two years.

Britain Will Leave the European Union: Now What?

U.K. yields have plunged 30 basis points (bp), more than any G10 economy overnight. This is highly comparable to the U.S. downgrade in 2011. The 2011 downgrade caused yields to fall by 30 bp in two days, and another 20 bp over the subsequent week. So the 30 bp rally we have seen in the U.K. thus far is in our judgment the first response. We expect to see G10 yields decline further.

The BoE said it stands ready to pump at least 250 billion pounds into the financial system, which is 20% of the economy's GDP. We expect the BoE to cut its policy rate by a full 50 bp to zero and to put quantitative easing on the table to mitigate the economic impact from the uncertainty shock. As we know, central banks are increasingly near-term data driven given the small room for error to the downside.

In our analysis, the U.K. will experience negative GDP in the third quarter and close to zero growth in Q4. This is reinforced by what is an already slowing economy. Therefore, the market will price in a recessionary scenario.

Based on our empirical frameworks, a recession should trigger a further depreciation of the pound. But we should expect an undershoot from sterling due to 1) the BoE's desire for the currency adjustment to cushion the economic blow, 2) the confidence shock which will reverberate with secondary effects, 3) a rebalancing from the currency for the current account deficit that is near historic wide levels, 4) political upheaval near term and medium term and 5) poor positioning: yesterday's trading volumes were low but there was a feverish attempt to go overweight risk in an effort to offset poor monthly performance from hedge fund and currency funds. We should see a positioning whipsaw.

The long-run consequences should be constructive for the U.K. There are several different existing models among other nations on the continent (Norway, Switzerland, the WTO model), which Britain might choose to establish trade relationships. And the U.K.'s policies will be reflective of its domestic interests.

This referendum result comes at an awkward time for the European Central Bank, whose officials up to now have signaled they have probably done enough to drive inflation back to 2%. There are other risks in Europe from the Spain election and Italy referendum. But the question is whether those events will lead to pricing redenomination risk. The behavior of the euro suggests the answer is no. The political commitment of the Eurozone to preserve the currency and central bank backstop are strong, while leverage in the system is low. These are very different characteristics from the 2008 or 2010 European crises.

With regard to the fixed income markets, the immediate impact will be to have an increase in risk premium across asset classes. In itself, the uncertainty tied to the British exit from the euro zone is not enough to cause a meaningful and sustainable increase in risk premiums. The size and persistence of the current risk premium increase will depend upon the likelihood of the Brexit vote leading to increased levels of political uncertainty for the broader euro zone. In the immediate term, the move lower in government bond yields is likely to be met with a continuation of the hunt for yield that has been ongoing in the current low rate environment. With the near-term outlook for global growth becoming incrementally uncertain on the back of this British vote, we anticipate that higher quality spread assets such as agency mortgage-backed securities, highly rated corporate bonds and senior positions with securitized instruments — such as commercial mortgage-backed securities and asset-backed securities — will prove resilient.

From an equity market perspective, we believe it is important to understand the macroeconomic environment in which we are investing and to construct portfolios that are likely to perform well in the overall environment. Voya's equity strategies are firmly rooted in bottom-up fundamental research and managed to a philosophy and approach that maximizes the impact from stock selection and minimizes the impact of such macro events. As investors, our focus remains on being fully aware of all exposures in our portfolios. We believe our exposure to the Brexit event is relatively balanced with no meaningful impact from either outcome. While we recognize certain industries may be more vulnerable — or even benefit from a "Brexit" scenario — we do not maintain any significant exposures that influence our investment decisions. We intend to adhere to our investing discipline.

Voya's senior loan strategy has little direct U.K./sterling loan exposure and minimal cross-over loan exposure. Barring a dramatic and persistent "risk-off" trade, we don't believe the "leave" vote will materially impact on our loan portfolios. In the event of a major global equity markets correction, volatility within the loan market would likely increase, but we would expect loans to maintain their relatively low level of correlation to broad equity markets.

Disclaimer

This commentary has been prepared by Voya Investment Management for informational purposes. Nothing contained herein should be construed as (i) an offer to sell or solicitation of an offer to buy any security or (ii) a recommendation as to the advisability of investing in, purchasing or selling any security. Any opinions expressed herein reflect our judgment and are subject to change. Certain of the statements contained herein are statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (1) general economic conditions, (2) performance of financial markets, (3) interest rate levels, (4) increasing levels of loan defaults (5) changes in laws and regulations and (6) changes in the policies of governments and/or regulatory authorities. Past performance is no guarantee of future returns.

The opinions, views and information expressed in this commentary regarding holdings are subject to change without notice. The information provided regarding holdings is not a recommendation to buy or sell any security. Fund holdings are fluid and are subject to daily change based on market conditions and other factors.

©2016 Voya Investments Distributor, LLC • 230 Park Ave, New York, NY 10169 • All rights reserved.

BREXIT 062416 • IM0624-25581-0617