The Leave campaign has claimed victory in the UK referendum, winning 52% of the vote on an estimated voter turnout level of 72%.

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What happens now is a political rather than a legal question. Under Article 50 of the European Union (EU) Lisbon Treaty, the British government “may decide to withdraw from the European Union in accordance with its own constitutional requirements.” Ironically the sovereignty of the British government and its constitutional requirements now stand between it and the UK’s formal departure of the EU. The constitutional requirement undoubtedly will require an Act of Parliament. It is not a foregone conclusion that the House of Commons, in its current form, would pass such an Act. The current House of Commons is estimated to be 70% in favor of Remain, 20% Leave and 10% Undecided.

The Lisbon Treaty allows for a fixed period of two years for the negotiation of the UK's exit and can only be extended with unanimous agreement of the other 27 EU members. Therefore the timing of this notification is significant.

Prime Minister David Cameron has committed to notify the EU immediately if the referendum resulted in a victory for the Leave campaign. The notification may take place at the European summit meeting due to be held in Brussels on June 28 and 29. However comments during the campaign indicated that formal notification of the EU could be delayed for a number of years.

This likely delayed notification will usher in a prolonged period of uncertainty. It is unclear what form of arrangement the UK will adopt with the EU or what the EU will accept. The UK could remain very closely tied to the EU, in a similar relationship to Norway where the country adopts much of the EU legislation and even contributes to the EU budget. At the other end of the spectrum, the UK may become a completely independent entity, relying on WTO trade agreements to govern international trade, in which case the shape of UK trade will change significantly.

The ambiguity during this negotiation period is likely to result in a slowing of UK growth, as businesses defer investment decisions until the future economic landscape is clearer. Some international businesses with significant UK bases may activate plans to move at least part of their operations to other EU countries to ensure uninterrupted access to that market.

Political upheaval in the UK also appears likely in the near term. Prime Minister Cameron offered the referendum as an opportunity to unify the Conservative party and silence its vocal Eurosceptics. His strategy has gone horribly wrong. Many of the most vocal...
proponents of the Leave campaign were also from the Conservative party, and it was difficult to see Cameron retaining leadership of the party. Other far right parties such as UKIP (UK Independence Party) are also likely to gain further influence given its vociferous anti-immigration views.

Due to the Scottish National Party’s (SNP) overwhelming support for remain, the coming weeks are also likely to see calls for a second referendum for the independence of Scotland. The EU has tended to benefit from considerably greater support in Scotland than other parts of the UK. One of the key campaign planks for the remain camp in that referendum in 2014 was that an independent Scotland would not be a member of the EU.

The result in the Scottish referendum was not a landslide, with 55.3% voting to remain part of the UK, and 44.7% voting to leave, on an 84.59% turnout level.

FINANCIAL MARKET IMPACTS

During this period of uncertainty, we anticipate some significant implications for financial markets.

1. UK equity markets will likely lose ground due to the assumed higher cost of doing business outside the UK that will be borne by UK based businesses. Even though many of the companies listed on the FTSE index are multinationals, they typically have significant UK presences, and so would likely be impacted by the anticipated higher costs.

2. Sterling will likely weaken due to the assumed negative impact on UK GDP (Gross Domestic Product). The recent low in GBP/USD (Great British pound/U.S. dollar) was just above 1.35 which was reached in January 2009. If this low is breached, the exchange rate could easily fall to 1.30 or 1.25 given the psychological importance of the 1.35 level.

3. UK gilts can be expected to be buffeted by a number of factors. A weaker pound would lead to imported inflation, which would drive gilt yields higher. However, weaker economic growth would lead to continued accommodative policy from the Bank of England, which could lead to gilt yields moving lower.

4. UK property markets may be negatively impacted as UK property is less attractive to foreign investors.

5. There are also potentially significant implications for assets outside the UK.

a. As a result of the referendum, membership of the EU has become non-permanent. While the UK was not a member of the Eurozone, the path they follow to exit the EU potentially outlines a framework that other countries could follow, and with additional steps, exit the Eurozone. Yields on peripheral government bonds may move higher in the short term on perceived increased risk. During the next wave of bailout discussions or crises that occur in individual member states, it is likely that market participants view the potential for an EU or euro exit as considerably higher.

b. The euro will likely weaken as market participants take account of the new order where the EU may be bereft of the UK’s contribution to the EU budget, in addition to the perceived increased risk of the EU bloc as a whole.

c. Given the fragility of global markets and slow recovery since the financial crisis, the UK vote will likely increase risk aversion among investors at least temporarily, and increase demand for safe haven assets such as government bonds, the Swiss Franc and the Japanese Yen.
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