The UK is to leave the European Union (EU). So what does this mean for markets and asset classes?
Here managers from a number of BNY Mellon Investment Management boutiques outline what we may expect.

Victory for the exit campaign has sparked new fears of a damaging run on sterling and a slump in equity markets, with some predicting its political impact could upset gilt markets, weaken the euro currency and trigger the departure of other countries from the EU.

Looking ahead, UK equity markets may lose ground due to the assumed higher future cost of doing business with the EU that will be borne by UK based businesses, says Sinead Colton, head of investment strategy at Mellon Capital. “Even though many of the companies listed on the FTSE 100 are multinationals, they typically have significant UK presences.”

Newton Investment fixed income portfolio manager Howard Cunningham believes the leave outcome may result in another two to five years of uncertainty, some deferral of inward investment and probably lower growth for the UK economy. Insight Investment’s multi-asset team echoes this belief, noting the likelihood of a period of volatility for sterling assets as the UK enters a two-year exit negotiation. “Short-term costs will be inevitable, but longer term, the consequences of a Brexit are far less clear.”

**GILTS & FIXED INCOME**

Commenting on specific impacts on fixed income markets, Cunningham notes the leave result is likely supportive of shorter dated gilts as activity slows and the prospect of interest rate increases recedes even further into the future. “The gilt curve may steepen as investors demand more compensation for the longer term uncertainties but overall yields should not necessarily be higher.” Colton agrees UK gilts will be buffeted by a number of factors. She notes a weaker pound would lead to imported inflation, which would drive gilt yields higher. Like Cunningham, she believes weaker economic growth will lead to continued accommodative policy from the Bank of England, which could lead to gilt yields moving lower.

Newton’s fixed income manager goes on to speculate that index-linked gilts could also perform well with expectations pushed up in spite of lower economic activity. “It is worth bearing in mind that, to the extent investors initially view the leave vote negatively and want to dump sterling assets we doubt gilts will be top of their sell lists. Sterling corporate bonds face conflicting forces and greater uncertainty may ultimately lead to higher risk premia, i.e. higher credit spreads (particularly for UK domiciled issuers).”
However, Cunningham points out that with yields on euro denominated bonds already low (with the potential to move lower when the European Central Bank starts buying corporate bonds towards the end of the quarter), sterling corporate bond yields might look more attractive. “Particularly,” he adds, “if, as we expect, ECB intervention has unintended negative effects on liquidity in the euro corporate bond market.”

**STERLING**

Insight’s currency manager Paul Lambert says, “This historic outcome is likely to have a lasting impact on sterling. In our immediate line of sight, we expect it will bear the brunt of what are likely to be less favorable relationships with some of the UK’s most important trading partners. In addition, and over the longer term, it will need to adjust to what is likely to be a significant and negative growth shock as businesses and consumers defer spending activity until there is greater clarity on the direction on the terms of the exit. Overall, in this environment, we would expect sterling to depreciate significantly.” Mellon Capital’s Colton points out the pound may not be the only one affected. The euro is also likely to weaken following the leave result as market participants take account of the new order where the EU may be bereft of the UK’s contribution to the EU budget, she says.

Commenting on the impact of the vote on currency markets, Alcentra’s chief investment officer Paul Hatfield adds: “We expect concerns over the future of the euro to be highlighted by Britain leaving and other countries following suit.

“The net result is therefore likely to be continued relative strength of the dollar against these two currencies and more volatility in FX on the back of news flow. Sterling bonds and loans may come under pressure but haven’t done so markedly yet. But with the massive degree of uncertainty we are experiencing at the moment, it’s hard for the market to analyse this and price it in accurately.”

**POLITICAL FALLOUT**

British Prime Minister David Cameron—who campaigned to remain in the EU during an often bitter contest—was among the early casualties of the UK’s EU exit vote, with only hazy details on renegotiation terms available at this stage, according to Rowena MacFarlane, Standish sovereign analyst in London.

“In the political space, domestically we expected the resignation of David Cameron while Scotland is likely to hold another referendum on its independence within the next two years. Externally, the focus will be on the timeline for negotiations with the EU about our future relationship.

“While EU treaties allow a time frame of two years for these negotiations—given that there are French and German elections in summer 2017—we suspect Angela Merkel will want to speed these talks up. Our base case remains for a European Economic Area (EEA) style relationship between the UK and its EU partners, but this is not guaranteed.

“In the eurozone, the referendum outcome presents downside risks to our macro forecasts and we expect the ECB to reconfirm its already dovish monetary policy stance. There is also likely to be political momentum to reduce the risk of similar votes being held in other eurozone countries experiencing populist political movements,” she says.

Newton strategist Brendan Mulhern says opposition towards the EU has been rising across member states for some time and in his opinion, reflected in the rise of right wing parties and the emergence of new parties. These have contributed to the increasingly fractionalised nature of national politics, he says. “The discontent with traditional politics that has underpinned this changing of political
landscape is itself a symptom of the challenged economic backdrop. Since the financial crisis economic growth has proved lacklustre; insufficient to resolve problems such as the stubbornly high unemployment that afflicts many countries.

Mulhern says leading parties in the UK remain splintered and post its EU decision, UK political risk has gone even higher as a result of the underlying discontent of voters. “It is likely a case of when, not if, some other nation calls for a referendum on EU membership, or a region calls for a vote on whether to secede from a national union, such as Scotland’s vote on continued membership of the UK in 2014. Meanwhile Catalanian calls for independence are complicating Spanish politics like never before.”

FURTHER UNCERTAINTY

Mark Bogar, European smaller companies manager at the Boston Company Asset Management (TBCAM) echoed fears the UK vote to leave the EU could trigger new uncertainty in Europe, with other countries tempted to follow UK’s lead in moves that could destabilise the eurozone.

Commenting he says: “Follow-on risk is now a major factor. Separatist movements in countries such as Scotland and Spain could well be emboldened by the UK’s vote to leave and we have to think about potential knock-on effects; for example, other countries voting on their membership of the EU.

“If this leads to an unravelling of the EU the hit to economic activity over the immediate term will be significant. I like to think over the longer term countries will figure it out – and will continue to trade with one another – but it could take up to three years to iron out the ‘new order’ and in the meantime economic activity and GDP growth in European countries will feel the impact. In my opinion the eurozone will go into recession again during that time.”

Raj Shant, portfolio manager, global equities at Newton is less fazed about the immediate impact of the vote but shares concern other countries might be tempted to follow the UK towards an EU exit.

“First order impact will not be that great; sterling had already weakened in the run up to the vote. But we are now preparing for second order impacts, which concern us more. Namely, we are worried about the effect on the eurozone if other countries start petitioning for their own referendums. There are several countries where the sentiment in the population is pretty 50/50 towards EU sentiment.”

TRADE & VOLATILITY

While specialist investment manager Alcentra sees a negative short-term outcome from an EU exit it is more optimistic on the longer term outlook for renegotiating trade treaties.

According to Hatfield: “We think the short-term impact will definitely be negative for the UK economy, with the uncertainty delaying investment decisions and stalling spending all round.

“Longer term, it is possible the UK can renegotiate a good outcome with the EU but it hasn’t said how or on what basis. You could see the other EU countries making life difficult for the UK after Brexit, partly out of pique and partly to deter other countries from doing the same.”

Looking ahead, Mellon Capital’s Colton believes renewed volatility triggered by the referendum outcome could ultimately lead many investors to become more risk averse.

“Given the fragility of global markets and uncertainty about global growth, the vote is likely to increase risk aversion among investors at least temporarily leading to declines in risk-seeking assets globally and increased demand for safe haven assets,” she says.