Notes from the Trading Desk - Europe: Brexit Special

June 24, 2016

admin

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Franklin Templeton's Notes from the Trading Desk offers a weekly overview of what our professional traders and analysts are watching in the markets. The European desk is manned by eight professionals based in Edinburgh, Scotland, with an average of 15 years of experience whose job it is to monitor the markets around the world. Their views are theirs alone and are not intended to be construed as investment advice.

Friday, June 24, 2016

In a result that confounded bookmakers' odds, the United Kingdom voted to leave the European Union (EU) on Thursday (June 23) by 52% to 48%, with a high voter turnout of 71%. The leave campaign won the majority of votes in England and Wales, while London and every Scottish region saw remain majorities. In reality, it was the scale of the vote for leave across England that swung the vote where many traditional Labour voters backed a leave.

On the back of this result, UK Prime Minister David Cameron resigned this morning and will stand down once the Conservative Party appoints a new leader—a process that is likely to take around three months.

The Digest

Predictably, European equity markets opened significantly lower on a huge volume, but markets quickly recovered a little ground. The financial sector—banks and insurers—led markets lower while support for health care and staples seemed to reflect a flight to safety.

That said, it is important to look at these moves in the context of what has happened over the week. Markets had climbed sharply ahead of this vote on the expectation of a remain outcome, so broader markets are essentially back at last week's lows.

In currency markets, the sterling fell to lows not seen since 1985, trading as low as -11% against the US dollar, when the result first emerged. It has recovered somewhat since then. Meanwhile, traditional safe havens like the Japanese yen and Swiss franc surged higher. The Swiss National Bank (SNB) stated it has intervened to stabilise the Swiss franc. The euro also lost ground over fears of a "domino effect" as other European nations consider their future in the EU.

In bond markets, German Bunds hit all-time lows, whilst the gap for peripheral government bonds has grown wider.

What's Next? For the United Kingdom to begin the process of leaving the EU its government must trigger Article 50 of the Lisbon Treaty, launching a two-year negotiation period, which can be extended if parties agree. Brexit, therefore, is likely to be a drawn-out process.

It is worth noting that the Brexit vote is not legally binding, so there are a few ways it could theoretically be blocked or overturned. However, we think it extremely unlikely that a government would go against the will of the majority of voters.

We think one difficulty for UK negotiators is that EU leaders may not be in a forgiving mood after a British vote to leave. Many European countries have domestic Eurosceptic movements of their own, and European leaders may be worried that a successful British exit could embolden them. So the EU may refuse to give the United Kingdom a favourable deal as a warning to other countries thinking about exiting the EU.

> "If the UK—the fifth-largest economy in the world—doesn't want to remain in the EU, can we expect other member states to start asking questions about their continued membership? People are likely to question whether the EU will be able to continue to exist in its current form." David Zahn, 24 June 2016.

The Ripple Effect

United Kingdom:

- British Prime Minister David Cameron has already resigned in what will effectively be a "staged exit" with a new prime minister by next October. One candidate to take over the ruling Conservative Party and become the new prime minister is a key figure of the leave campaign, Boris Johnson.
- Given the demographic split of the EU referendum vote, the prospect of a second referendum in Scotland is now also higher. Additionally, Northern Ireland's Deputy First Minister Martin McGuinness has called for a poll on a united Ireland, as support for the EU is considerably higher in Northern Ireland than the rest of the United Kingdom.
- From an economic perspective, it is anticipated that the United Kingdom will likely see a hit to growth in the short- and medium-term, with an increased risk of a technical recession, not helped by the profound uncertainty as to the prospects of this political contagion.

EU Politics and Reaction:

- A number of European leaders have given statements: The heads of governments and EU institutions are already scheduled to meet early next week to discuss viable options. The president of the EU, Donald Tusk, has already started to propose "a wider reflection on the future of our [European] Union" should take place.
- Although it seems very unlikely, a conciliatory EU could offer a compromise in exchange for the United Kingdom to hold a second referendum on the issue.

Central Bank Reaction:

A number of global banks sought to calm fears as soon as the result emerged, while the European Central Bank was notably absent from central bank rhetoric.

- **Bank of England (BOE):** Bank of England Governor Mark Carney has stated that the central bank is monitoring developments closely, has undertaken extensive contingency planning, and will take all necessary steps to meet its responsibilities for monetary and financial stability. He added that "substantial capital and huge liquidity" allows them to continue to lend to businesses and households, ready to provide an extra £250 billion of support.
- **Bank of Japan (BOJ):** Bank of Japan Governor Haruhiko Kuroda said the BOJ stands ready to provide sufficient liquidity, including using existing swap arrangements with other central banks to ensure market stability.
- **Swiss National Bank (SNB):** At this stage the only major central bank to announce intervention is the

SNB, which said that it had intervened in the foreign exchange market to stabilise the situation and will remain active in that market.

Views You Can Use

Insight from Our Investment Professionals

In The Know: The UK Votes to Leave the EU

David Zahn

On Thursday, June 23, 2016, UK voters confounded expectations and the dire warnings of many politicians, business leaders and international non-governmental economic organisations by choosing to leave the European Union. Here, David Zahn, head of European Fixed Income, Franklin Templeton Fixed Income Group, shares his initial thoughts on how markets may respond, and the challenges and potential opportunities he sees ahead. Read More.

Zahn says that anyone hoping that the result of the vote to remain in or leave the European Union will bring an end to the uncertainty and volatility is likely to be disappointed. Here, he explains why he believes the political fallout of this vote will likely continue to influence investment markets for months or possibly years, and not just in the United Kingdom but across Europe. Read More.

On Brexit, Banks and Bargains

Philippe Brugère-Trélat

Will they stay or will they go? UK voters will answer that question on June 23 when they decide whether their country will retain its membership in the European Union or strike out on its own. Philippe Brugere-Trelat, portfolio manager, Franklin Mutual Series, offers his opinion on whether “Brexit” will come to pass and its potential effects on UK companies. He also provides an overview of economic conditions elsewhere in Europe, with a focus on the region’s beleaguered banks. Read More.

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