The UK referendum premium

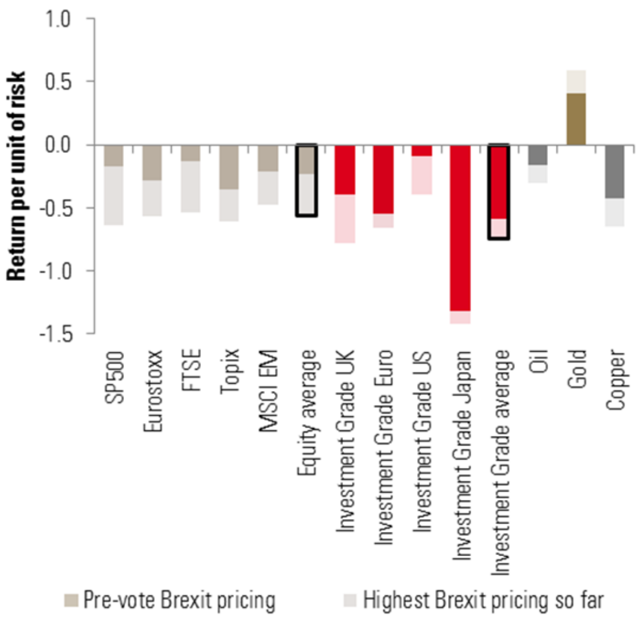
June 2016

Florian Ielpo, Head of Macroeconomic Research within the Cross Asset Solutions and **Jeremy Gatto**, Vice President, Trader within the Equities team

On the 23rd of June, the British citizens expressed their willingness to leave the European Union, after an intense political campaign. The "Brexit premium" that emerged over the past few weeks is likely to remain at the centre of markets' attention in the near future. We think that (1) this premium will intensify in the near term but (2) will eventually retreat and that (3) the previous weeks of market performance is a reliable guide: European and Japanese risky assets will suffer from the rising market stress environment; British markets will see the formation of a recession premium, with the pound, gilts and UK credit reflecting this the strongest. The scale of the recession premium will depend on the intensity of recession fears and the likelihood of such. We think the likelihood of a Brexit-driven sequence of a couple of negative growth quarters is low. A close-to-zero to negative quarter of economic growth for Q3 is, however, a likely possibility.

A Brexit premium emerged over the past few weeks, as poll surveys conveyed uncertainty around the likely result. This market-stress episode led to risk-adjusted performance that should show the global direction of markets ahead, as displayed in Charts 1 and 2. In terms of asset classes, credit has shown the strongest sensitivity to Brexit speculations. In terms of geographic exposures, European and Japanese equities showed the largest correlation to this surge in market stress. Gilts and the pound have also been quite sensitive to the changes in the probability of Brexit.

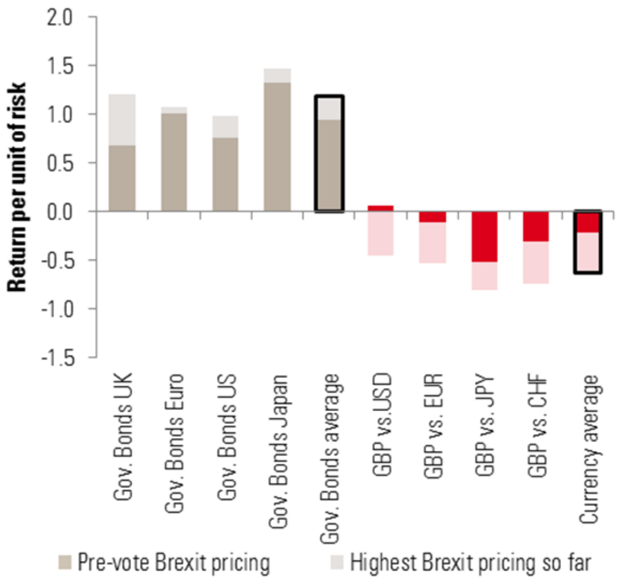
Chart 1: Brexit premium priced in equities, credit and commodities



Source: Bloomberg, Unigestion's calculations.

The chart shows the risk-adjusted performance for different financial assets, from peak to trough (trough to peak for gold) over the past 4 weeks. A negative (positive) ratio indicates investors suffered (profited) from being long the asset.

Chart 2: Brexit premium priced in government bonds and currencies



Source: Bloomberg, Unigestion's calculations.

The chart shows the risk-adjusted performance for different financial assets, from peak to trough (trough to peak for government bonds) over the past 4 weeks. A negative (positive) ratio indicates investors suffered (profited) from being long the asset.

These performance maps give us the direction. The scale of the moves will depend on the intensity of the impact of Brexit on the UK and European economies. It is likely that the odds of a recession risk will grow along with increasing market stress. In the long run we believe Brexit will not heavily disturb the commercial relationships between the European Union and the UK[1], but it may have a temporary impact on UK GDP, as market stress will weigh on investment and production expectations. A quarter of negative GDP growth is a possibility, but we do not foresee the UK moving into an actual recession. A recession premium should emerge over the medium term, until the dust settles. This premium should negatively affect equities, credit, the pound and the euro. It should support gold, the US dollar and government bonds broadly. UK assets should show the strongest reflection of these evolutions, but European assets are likely to be strongly affected too.

Once the dust settles, the market's attention is likely to shift focus towards the UK's "divorce" terms, which will have to be negotiated with the EU's leaders over the next two years. We expect those negotiations to be another source of market stress because of the renewed uncertainty involved.

[1] See Brexit: a stress-test for the EU?.

Important Information