

# Brexit: What has happened since our last update<sup>1</sup>?

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The EU Council meeting to discuss the UK's proposed reforms to membership of the European Union (EU) concluded on 20 February 2016. The settlement improved on terms proposed to the UK in a draft proposal on 2 February, and are described in the table below, with our assessment of the degree of success achieved relative to the UK's demands:

Change	UK demand	EU settlement	Success?
<b>Immigration</b>	Four-year period of residence before EU migrants can claim in-work benefits	Child benefit payments to EU migrants to be paid at home country rates. Will apply only to new claimants before being broadly applied from 2020.	✗ Conservative Party manifesto committed to a total ban on child benefit payments and four-year ban on in-work payments (without approval by EU Council).
		'Emergency brake' (decided by the EU Council) on in-work benefits for EU migrants would last for seven years.	
<b>Economic governance</b>	Guarantees that euro currency nations cannot impose changes for all EU members.	Exclusion from incurring budgetary responsibility for future euro area financial stability measures.	✓
	Recognition of currencies other than the euro and no discrimination for business on the basis of currency.	EU member states that do not use the euro to be protected from discrimination.	
	Tax-payers in non-euro area countries should be excluded from financial liabilities in relation to supporting the euro as a currency.		
<b>Sovereignty</b>	Formal and legally binding UK opt-out from the commitment to 'ever closer union'.	UK will not be committed to further integration.	✓
	Enhance the role of national parliaments.		
<b>Competitiveness</b>	Reduce burden of excessive regulation and extend the single market.	Safeguards for the UK financial sector against regulations from the euro area.	✓

<sup>1</sup>Please see 'Brexit: Risks and Implications'

Despite making significant progress on securing concessions on the bulk of proposals, critics continue to point to the deal on migrant benefits as too significant a compromise. Our previous piece viewed the UK's demands on immigration as the most challenging, and our baseline view was that these were unlikely to pass without some amendments.

Prime Minister Cameron subsequently announced that the referendum date for the UK's membership in the EU based on the newly agreed terms would be set for Thursday 23 June. Soon after, London mayor Boris Johnson threw his backing behind the 'Leave' campaign.

### What is the probability of Brexit?

The latest poll of polls (six-poll average) indicates that the vote to remain is in the lead, at 52% (excluding don't knows). Since polling began in September 2015, this has ranged between 48%-64%, although the range has been a lot tighter since the referendum date was announced, between 48%-57%. For a brief period this year, phone versus online polls showed a consistent divergence, with the former placing the vote to remain in a clear lead, whilst the latter showed even splits. But this has not lasted, with the latest two phone polls showing a swing towards the vote to leave.

In January, odds on betting exchanges implied a 34% probability of Brexit. This drifted lower to around 30% in the middle of March before the tragic events in Brussels saw market implied Brexit probabilities jump to 35% currently. Some market participants opt to place greater weight on market implied probabilities over polls, however it is not clear that markets are materially more accurate on average than polls. We prefer to use both survey and market-based measures as signalling tools.

### What is and is not being priced into financial markets?

#### Foreign exchange

Foreign exchange (FX) markets have been the favoured method for those wishing to express a view, or hedge a Brexit. Currency weakness has been driven by more than interest rate differentials, which we attribute to Brexit risk premia. We expect sterling weakness to continue in the run up to the referendum, and believe that corporates have only just started to implement currency hedging programmes.

FX implied volatilities on sterling have risen sharply since the start of the year and are at early 2009 levels. Particularly notable has been the surge in three-month implied volatility on GBPUSD on 23 March, with the three-month window covering the referendum date.

EURUSD implied volatilities have not reacted to Brexit fears, and could potentially be a cheap option to own should a Brexit spark fears of other countries (for example Finland) leaving and the stability of the European project.

#### Rates

The deterioration in global risk sentiment since the start of the year has seen a flight to quality to core government bond markets. However, UK rates markets have outperformed those of the US and Germany despite economic data surprises being somewhat similar, signalling concerns about Brexit. Indeed the front end of the UK rates curve is currently pricing in approximately 25% probability of rate cuts towards the end of the year, and the first rate hike is not priced until early 2019.

Some market participants have expressed the view that in the event of a Brexit, the resulting depreciation in sterling would serve to boost UK inflation, and force the Bank of England to hike rates in response. We strongly disagree, and would expect the negative growth implications and deterioration in risk sentiment to more than offset upside risks to inflation. In our opinion, the Bank of England would respond quickly to a Brexit by providing liquidity and credit easing via a range of measures. Monetary policy easing could take place with a lag, after weighing up the trade-off between currency related inflationary effects and a substantially weaker growth outlook.

Gilt asset swap spreads encompass sovereign credit risk premia<sup>2</sup>. Investors concerned about UK credit risk may choose to replace their gilt exposure with UK swaps, in effect putting on swap spread narrowers (selling gilts, receiving in swaps). Since the start of the year until the referendum date was announced, UK swap spreads had already narrowed by 15 basis points (bps), far exceeding the tightening observed in other markets. After Boris Johnson declared support for the leave campaign, we observed a further collapse in long end swap spreads of close to 15bps over a week, before bouncing back. Swap spreads in the 10-year sector are back to levels seen at the beginning of the year, whilst longer dated swap spreads are narrower. If investors are considering selling swap spreads to hedge against Brexit, our view is that selling 10-year spreads offers less downside than selling long end spreads should a vote to remain win.

Euro area sovereign debt markets have so far been supported by the European Central Bank's (ECB) public sector purchase programme (PSSP). Economic growth and commitment to reforms in most countries within the Euro area has also contributed to a compression of country spreads to German yields. But a Brexit would impact European economic and political developments, and could result in some spread widening from current locally tight levels. We believe any material spread widening would be kept in check by a forceful ECB response.

#### Sovereign CDS

UK sovereign credit default swaps (CDS) spreads have doubled from the start of the year, but still remain at low levels historically at just 40bps running a year. Similar to asset swap narrowers, the rationale is that the negative economic effects of Brexit and the decline in foreign sponsorship will cause a deterioration in the credit worthiness of the UK.

<sup>2</sup> In addition to funding rates available in the repo market.

## Causes for concern?

Not yet. However, once a date was set for the referendum, we began to consider all possible scenarios. We consistently stress test our portfolios for our expectation of likely moves in each outcome and in conjunction with our fundamental forecasts over the medium term. And despite some markets having not yet reflected higher risk premia for Brexit as described above, the next three months encompass numerous economic data releases and central bank actions, which makes establishing a position now solely for the UK referendum much more difficult.

Sujay is a fund manager in our global rates team. Before joining BMO Global Asset Management, Sujay worked at Goldman Sachs prior to which he spent 7 years at the Bank of England in a range of positions including senior portfolio manager on the Reserves Management Team. Sujay has an MSc in Finance and Economics from the London School of Economics and has completed all three levels of the CFA exams.

## Also available

Brexit: risks and implications - January 2016



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