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Brexit fears are hitting the markets

With just over a week to go to Britain's EU referendum, the Leave camp has again taken the lead in some opinion polls. These latest numbers appear to be forcing markets to reassess their hitherto rather optimistic view of the outcome of the referendum. Until the first days of June, the FTSE100 was higher than in February 2016, when the date for the referendum was set. Also the pound, after some ups and downs, was trading close to its February levels. But this has changed as the most recent polls are now weighing heavily on British currency and stock market while pushing "safe" gilts to record highs. The fear about Brexit also has strong international implications, e.g. pushing Bund yields into negative territory.

Heightened volatility in the run up to the referendum is both unsurprising and justified. Looking at long-run average poll numbers, the outcome was always going to be tight. Therefore, the rather benign view about Brexit risk that had prevailed on financial markets appeared rather odd. By now, it must have become clearer that a potential Brexit would cause significant economic damage. The economic and political uncertainty before the decision and after, in case of a Leave vote, is substantial and it causes a wait and see mode of investors and dampens economic activity in Britain. The uncertainty concerns future trade relations with the EU as well as globally, potential policy changes once EU law stops applying in the UK, a likely rekindling of the independence movement in Scotland (and possibly Wales), and, importantly, instability and a possible split of the ruling Conservative party.

These concerns are confirmed by the fact that investment in the UK has already started to stall, that business sentiment has been heading south and discussions about the need of new QE measures is beginning. In the long run, once a deal is done (in 2019?), investors will learn to live with the new regime, uncertainties will vanish and economic activity will improve again. But it seems highly implausible that the new relationship with the EU could be any better for the UK economy than the situation today. If Great Britain insists on more sovereignty and independence from the EU, it will have to pay an economic price. The most recent repricing of Brexit risk has two implications.

The first is that it could ultimately play into the hands of the Remain camp. The outcome of the referendum will crucially depend on turnout, since eurosceptic voters are highly motivated to vote while many other Britons are pragmatically pro-European but not deeply committed. Financial market volatility helps to illustrate how much is at stake for the country and might thus help to increase turnout among those who would otherwise not bother to vote. It might also help sway those 15-20% of Britons who say they have not yet made up their minds on how to vote. Financial markets are not always good predictors,

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but in the complex pre-referendum environment, their signals will not be overlooked.

The second implication could be a positive one for investors. With the now low valuations of British stocks and sterling, a decision by the British people to remain in the EU has substantial upside potential. We still believe that the remain vote will succeed, if possibly only by a very small margin. If that were to happen there would be a sigh of relief pushing up British and European stocks and lifting the pound especially vis-a-vis the US dollar. It would most probably also put an end, to negative yields on German 10-year Bunds, which are not least a reflection of the risk aversion combined with Brexit.

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