

# Global Brexit Impact: Lost In Translation?

March 2016

**Mellon  
Capital**

So far, the U.S. has not paid much attention to a potential UK exit from the European Union (EU) — known as a Brexit — or its repercussions. But as the UK nears polling day will global markets shift to red alert? Here Mellon Capital Management<sup>1</sup> outlines potential impact of the referendum.

With three months to go up to the UK/European referendum on June 23, 2016, European press will report each and every element of the ‘yes’ and ‘no’ campaigns. Outside the European Union, coverage is likely to be sparser but that is not necessarily commensurate with the impact a potential Brexit could have on global markets, says Sinead Colton, head of investment strategy at Mellon Capital, a BNY Mellon company.

“In the U.S. there has not been much coverage of the twists and turns seen since the referendum announcement. People do not automatically recognize the significance of certain personalities — such as Boris Johnson (London’s mayor) joining the pro-Brexit movement — and have not necessarily processed the fact that close to half of Conservative Members of Parliament have come out on the side of leaving,” says Colton.

In the event of a Brexit, Colton believes the global knock-on effect would depend largely on the overriding market environment at the time. “If markets are going through a period similar to the start of 2016, with risk aversion and volatility at the forefront of investors’ minds then adding a UK exit decision into the mix could feed a greater amount of uncertainty and broader negativity across the globe.”

If, on the other hand, market sentiment is more sanguine and the backdrop is reasonably constructive, she expects the impact to be more isolated to European markets.

## Currency Contagion

From a currency point of view there has been a great deal of talk about depreciation in sterling but Colton believes not enough attention has been paid to how the euro will fare if the British public vote to leave the European Union.

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While the depreciation of sterling might not be negative for all elements of the UK economy, it could present the Bank of England (BoE) with a headache, Colton adds, particularly if it spawns a period of higher inflation.

“We believe it would be negative because the UK is the second largest net contributor to the EU budget and that contribution could be in jeopardy depending on the type of UK exit that unfolds. Additionally, a departure from the European Union would put in place a precedent for voluntary exit of the supranational institution and likely dent confidence in the euro,” she explains.

While the depreciation of sterling might not be negative for all elements of the UK economy, it could present the Bank of England (BoE) with a headache, Colton adds, particularly if it spawns a period of higher inflation. “Some central banks appear to be covertly attempting to devalue their currencies at the moment because it typically boosts exports. However, the offset to this is that imports become more expensive, spurring inflation. In the case of the UK, this could potentially lead to a situation where the Bank of England has to raise rates sooner than expected to combat this effect.”

The speed with which the weakness of sterling develops will be an important factor, Colton explains. Over the past year sterling has been weaker against the US dollar because of the divergence in interest rate expectations. But following the announcement of the referendum, sterling versus the US dollar (also known as cable) reached a level not seen since 2009. On February 24, four days after confirmation of the referendum, sterling fell as much as 0.9% against the dollar, dropping below \$1.39 for the first time since February 2009.

“If it dips below \$1.3504, which was the low reached in early 2009 during the financial crisis, there could be significant additional depreciation, with the next psychologically significant level at 1.30,” says Colton. “The BoE and governor Mark Carney will have to communicate policy intentions very clearly if sterling depreciates rapidly and inflation filters into the economy.”

### Guilty As Charged

UK government bond yields will likely move higher if inflation increases, assuming there are no contradictory pressures in the broader global sphere, says Colton. But if the implications of a Brexit created slower growth in the UK economy then lower rates for longer would bring Gilt yields back down. “It would likely be a very dynamic situation for the BoE Monetary Policy Committee to navigate when it comes to policy response and a lot could depend on the timelines that emerge in the event of a vote to leave.”

This is an area that requires more clarification, not least because a member leaving the EU has never happened before, says Colton: “There needs to be more explanation of what the next steps would be if the UK public votes to exit. Potentially, the UK could follow the same model as Norway, which contributes to EU budgets and implements most EU regulations. Alternatively, there could be a complete exit, where the UK would rely on WTO agreements to govern trade with the EU. Part of the challenge of this discussion is that it is unclear which option would likely be pursued, what the process to effect that would be, and how long it is expected to take. While it may seem obvious to people in the UK that David Cameron would probably have to step down as prime minister if the UK votes to leave the EU this may not be so immediately apparent to people outside Europe.”

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Indeed, if the UK votes to leave the EU, it is likely to trigger a second Scottish referendum on leaving the UK, as support for the EU in Scotland has tended to be significantly higher than in the rest of the country, she adds.

### Learning From The Past

Finally, Colton points to the experience gained from the Scottish referendum in 2014 as a blueprint for how market behavior could turn. Indeed, if the UK votes to leave the EU, it is likely to trigger a second Scottish referendum on leaving the UK, as support for the EU in Scotland has tended to be significantly higher than in the rest of the country, she adds.

“Polling ahead of general elections has experienced significant challenges of late. If the polling companies assume a similar turnout for the UK referendum as for an election they will likely underestimate it, as happened in the Scottish referendum, which provides a very interesting precedent. The lack of coverage of the Scottish referendum up until two weeks ahead of polling day shows how many people outside the country concerned did not give it much credence when ultimately it was a closely-run contest and one that could have had global ramifications,” she concludes.

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