GLOBAL MARKETS UPDATE

24th Feb. 2016

CAPITAL ECONOMICS

How big is the Brexit premium?

- **We estimate that sterling would rebound from \$1.39 to \$1.50 against the dollar if the UK voted today to remain a member of the EU. But if a similar move occurs in response to a vote to stay in the club in four months' time, we suspect it will be short-lived given the prospects for monetary policy in the UK and the US. And if the vote is to leave, we think the exchange rate could fall swiftly to \$1.20**.
- Quantifying the current size of the Brexit premium is more of an art than a science. Nonetheless, it is quite clear that the possibility of the UK leaving the EU has had a substantial effect on the value of the UK's currency in particular over the last few months – since it peaked on 19th November, sterling has slumped by about 9% on a trade-weighted basis and by 8% or so against the US dollar.
- Sterling's slide has against the dollar has occurred despite the fact that there has been no significant change in the gap between expected interest rates in the UK and the US, movements in which had previously been highly-correlated with movements in the exchange rate. (See Chart 1 on page 2.) So it is reasonable to assume that cable would have stayed close to \$1.50 had fears of a Brexit not grown.
- Once the dust has settled, though, we suspect that sterling will fall further against the dollar even if the UK votes to stay in the EU (our end-2016 forecast is \$1.30). This is largely because we think the contrast between the monetary policies of the Bank of England and the Fed will be starker than anticipated by the average investor. If we are right, a renewed shift in interest rate expectations in favour of the US is likely to take another toll on sterling, which would be justified by the UK's large current account deficit and something that her monetary policymakers might be keen to preserve.
- While sterling could get a short-term lift if the UK votes to remain in the EU, how far might it fall if the result is different? Bookmakers' odds currently imply that the probability of the UK staying in is around two thirds. So if sterling has already tumbled by 8% against the dollar on the basis that there is only a one in three chance of the UK voting to leave, it is not inconceivable that it could drop by three times as much in total (i.e. 20% or thereabouts), to say \$1.20, if that were the actual outcome.
- **There is less evidence of a Brexit premium in the Gilt market**. Admittedly, the cost of insuring against a default by the UK government, which might lose its top-notch credit rating in the event of a Brexit, has shot up since 19th November – the 5-year CDS premium has virtually doubled, to more than 30bp. The gap between the 10-year Gilt yield and the 10-year sterling overnight indexed swap (OIS) rate – which captures the effect on the former of all factors other than expectations for, and uncertainty surrounding, the outlook for UK monetary policy – has also grown a bit. But while the cost of insuring against a default by the US government has barely increased (see Chart 2), the gap between the 10-year government bond yield and OIS rate has risen slightly more in the US than in the UK. (See Chart 3.)
- Some would argue that there is in fact a Brexit *discount* in the Gilt market, since the possibility of the UK leaving the EU has prompted investors to scale back their expectations for future tightening by the Bank of England. But while OIS rates have tumbled in the UK this year, they have fallen by similar amounts in the US. (See Charts 4 & 5.) This suggests that other factors, such as concerns about the global economy, have been the main driver of the reassessment of the outlook for UK monetary policy.
- **It is also difficult to discern any Brexit effect in the UK stock market**. Indeed, it has only fallen by about 6% since 19th November, whereas the US stock market, for example, is down about 8%. (See Chart 6.) One reason is the higher weighting of commodity-producing companies in the UK stock market, which has benefited as commodity prices have stabilised. But even if we strip out the oil and gas and basic materials sectors, the stock market has not fallen as far in the UK as in the US. (See Chart 7.)
- **Much of this can be explained by the weakness of sterling tied to fears of a Brexit**. (See Chart 8.) After all, a cheaper currency not only boosts the prospects for UK exports but also the sterling value of the earnings of the foreign subsidiaries of UK multinationals.
- **Any boost to sterling from a vote to stay in the EU would therefore probably cap the upside for the multinational-heavy FTSE 100, while a fall in the currency in the event of a vote to leave could cushion the downside if the index reeled amid concerns about the effect of a Brexit on the UK economy**.

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Charts

Chart 1: UK Less US Interest Rate Expectations & Dollar/Sterling Exchange Rate

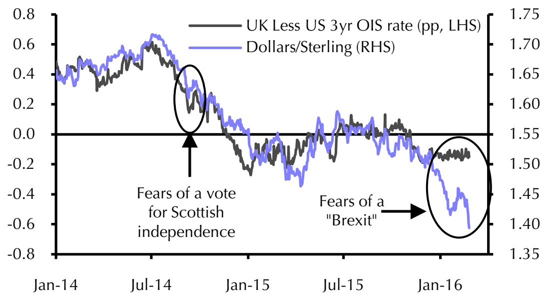


Chart 2: 5-Year Sovereign Credit Default Swap Premiums (UK versus US) (bp)

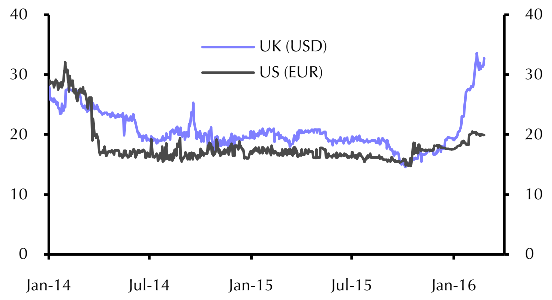


Chart 3: 10-Year Government Bond Yield Less OIS Rate (UK versus US) (bp)

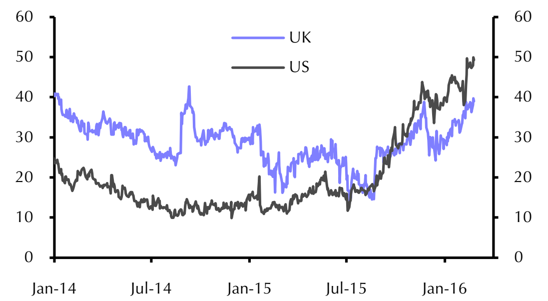


Chart 4: 3-Year Overnight Indexed Swap Rates (UK versus US) (%)

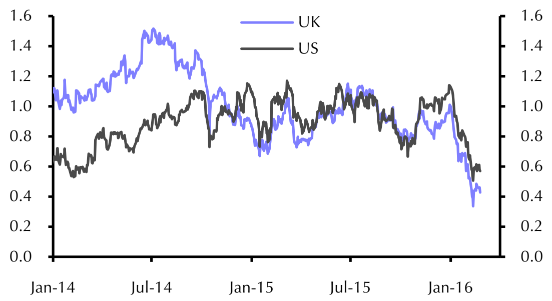


Chart 5: 10-Year Overnight Indexed Swap Rates (UK versus US) (%)

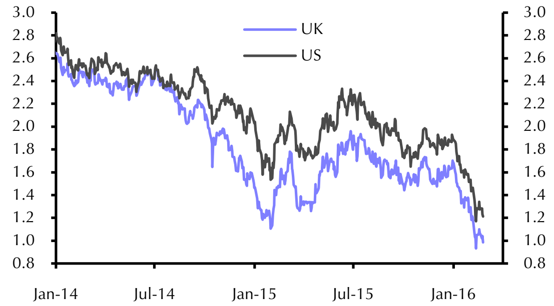


Chart 6: UK & US Stock Markets (19th November 2015 = 100)

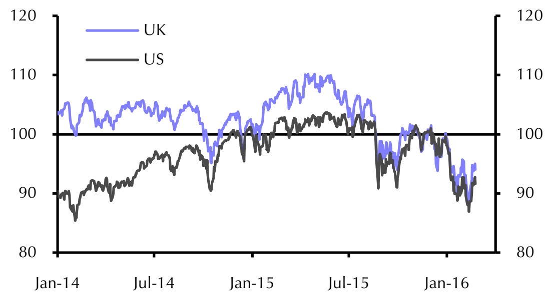


Chart 7: UK & US Stock Markets Excluding Commodities* (19th November 2015 = 100)

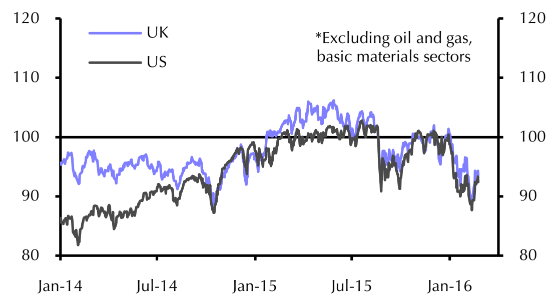
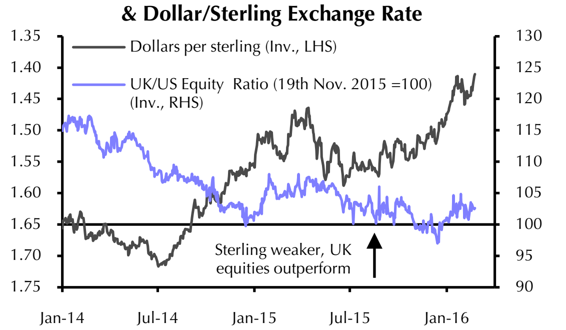


Chart 8: Relative Performance Of The UK & US Stock Markets & Dollar/Sterling Exchange Rate



Sources – Thomson Datastream, Bloomberg, Capital Economics

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