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Around THE Curve

Response to Brexit Referendum

The British populace has changed history and voted for an exit from the European Union (EU). Now, the messy divorce begins. The fall-out has immediately reverberated through shocked financial markets. The sterling and risk assets, including stocks, corporate credit, and emerging market assets, are under extreme pressure, while safe-haven government bonds are rallying. The long-lasting effects of this volatility will depend on how major central banks decide to reassure markets, and the next steps British Parliament, various political parties in the U.K., and the rest of Europe take to address the departure. Uncertainty will be an overhang for markets, including what will happen after Prime Minister Cameron's departure, the timeframe for invoking Article 50 of the Lisbon Treaty, the legal framework to facilitate the exit, and what the U.K.'s relationship with the union will be like moving forward. More broadly, the U.K.'s departure will likely beg the question of whether other EU members will follow suit, as many developed nations have become swept up in the zeitgeist of nationalism, a trend that is starting to permeate the globe. Therefore, we view the "Brexit" decision as a political event illustrative of rising populism—a phenomenon that seems to elude opinion polling and has clearly taken markets by surprise.

We believe this "referendum contagion" could impact the rest of Europe. Therefore, spreads on peripheral eurozone debt have and will continue to come under pressure. This contagion effect will keep risk assets on edge, or at least until we receive data that signals that better global growth is on the horizon. We expect the risk-off environment to persist over the next several weeks. As of June 24, global financial markets continue to sell off, which we believe will force global central banks to ease more aggressively. In the U.K., we expect rates will remain low for quite some time; however, a weaker sterling and the easier monetary policy from the Bank of England could drive up inflation expectations in the medium-to-longer term.

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