To be or not to be...part of the EU

As we draw closer to the EU referendum, opinion polls show an almost equal likelihood for either outcome. If we do see the UK exit "Brexit" the EU, a key question for us is how it will impact our investments? We felt it was important to address these concerns as investors have become very nervous which has been reflected in the recent volatility within the markets.

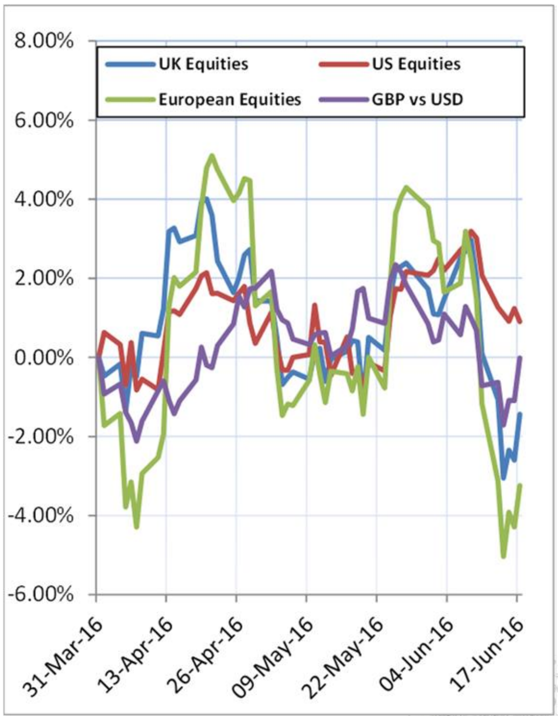
How will Brexit impact the UK economy?

Before we analyse the impact of an EU exit, we should note that even if the UK votes to leave, it will continue to be part of the EU for at least another two years and business is expected to continue as usual. We could definitely see new investments slow down and the initial impact of a Brexit would be a selloff in UK and EU stock markets, along with depreciation of Pound Sterling. The UK and EU should have enough time on their hands to ink a new trade agreement to ensure trade flows continue to be smooth and seamless, but this is not guaranteed.

What about the global economy?

The largest threat to the global economy from a Brexit decision is that other member states from the EU will start to follow suit, ultimately resulting in dissolution of the EU. An ultimate dissolution feels less likely but we could very well see a few EU members such as Greece push to leave the union. This would definitely slow down the recovery in the Eurozone, undermining all efforts by the ECB to stimulate the economy.

How will the markets behave in the short and longer-term?



One certainty is that we would continue to see a trend in volatility going into the vote and most likely for another week afterwards. But soon, the markets will look to move to focus on other global issues such as a slowdown in China and the mixed macro-economic data from the US.

In the last two weeks, a number of polls suggest the 'leave' camp is gaining ground, raising a greater possibility of a Brexit. We can see from the chart on the right, UK and European markets along with GBP tumbled as markets adjusted to an increased Brexit probability. If we do see a Brexit, we could very well see this trend continue as Pound Sterling would depreciate against all major currencies along with a selloff in global equity markets in the short-term. Hedge funds and short-term traders are bound to squeeze the markets in one direction but this trend is expected to be short-lived. If we do see a sharp drop in investments, we could even see the Bank of England cut interest rates to stimulate the economy. Nonetheless, we do expect performance from the UK and EU markets to remain subdued till a new trade agreement is reached. In the longer-term, the markets will stabilise and behave more in tune with global events rather than continuing to focus on the UK.

To be or not to be…part of the EU continued

On the flip side, if we choose to remain, the recent losses in the equity and currency markets are set to reverse. The reversal may overshoot previous neutral levels on short covering by traders and hedge funds but are likely to stabilise in a week after the referendum.

We'll be keeping a close eye on our Copia portfolios and the algorithm for signs that we are ready to realign our portfolios accordingly when the appropriate opportunity and signals arise.

Hoshang Daroga – Quantitative Investment Manager

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