

5 THINGS TO NOTE ABOUT BREXIT JITTERS

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Core European bond yields have been negative for some time, as the European Central Bank has been aggressively buying bonds as part of its quantitative easing policy. While most of the German yield curve has been negative, German 10-year bond yields turned negative for the first time last night, reflecting uncertainty over the implications of the Brexit vote. The move was brief and 10-year bund yields are now back around zero.

The 'leave' campaign for Britain to exit the European Union (EU) – focusing on the emotive topic of immigration – has clearly been doing a good job with polls showing a slight lead over 'remain' campaign.

Key points regarding the referendum and its implications are as follows:

- > First, even if there is a victory for Britain to leave the EU, it could be two years or so before the terms of the exit are agreed.
- > Second, a victory for a leave outcome would be seen as a negative for the UK given the threat it would pose to its free trade access to EU markets, its financial sector and labour mobility. The size of this impact would depend on what sort of exit is negotiated with the EU but has been estimated at somewhere around -2% of UK Gross Domestic Product (GDP). This would adversely affect UK assets including the pound. Britain could in time agree a trade deal with the EU (like Norway has) but Britain would have to agree to EU rules with no say in setting them. The implications of a hit to the UK economy on Australia would be small as the UK takes just 2.7% of our exports.
- > Third, the real issue amongst global investors is around the perceived impact on the Eurozone as a Leave victory could

lead to renewed concerns about the durability of the Euro. The Leave campaign may be seen as encouraging moves within Eurozone countries to exit the EU and Eurozone. This in turn could reignite concerns about the credit worthiness of debt issued by peripheral countries, leading to a flight to safety out of the Euro into the \$US and possibly contributing to renewed pressure on emerging market currencies, the Renminbi and commodity prices. Ultimately, the hurdle for Eurozone countries to leave the EU and Eurozone is much higher and a Brexit may actually trigger more pressure for integration in the Eurozone, not less. Albeit, markets won't know that initially.

- > Fourth, a Leave victory may be seen as reinforcing the anti-globalisation forces already evident globally. This is negative for long term growth potential and hence long term investment returns.
- > Finally, in the last few weeks markets have already moved to partially discount a Leave victory with the British pound down 4% or so, Eurozone shares down 7% and global shares down generally with safe haven assets like the \$US, Yen, sovereign bonds in major countries and gold up. German bond yields falling below zero are part of this. Of course, if Leave wins then there could be more to go in the short term but this could prove to be a buying opportunity as Europe may simply hang together (as it has through its sovereign debt crisis) and the negative impact on the UK will take years to become apparent. Of course, if Remain wins then these recent moves will reverse – the British pound and Eurozone shares could bounce sharply and bond yields will bounce back up.

**DR SHANE OLIVER**

Head of Investment Strategy and Economics and Chief Economist at AMP Capital

ABOUT THE AUTHOR

Dr Shane Oliver is responsible for AMP Capital's diversified investment funds. He also provides economic forecasts and analysis of key variables and issues affecting, or likely to affect, all asset markets.

WILL BRITAIN LEAVE OR REMAIN?

The polls have a slight edge in favour of Britain leaving the EU, but I still lean to a remain outcome. That's because undecided voters (assuming they actually vote) are likely favour the status quo and telephone polls – which were more accurate during the UK election last year – still favour a remain outcome. But it's a low conviction call.

It's important to note that underlying global economic conditions haven't changed, and that having largely ignored Brexit risks until last week, markets are most likely overreacting. Expect market jitters to persist ahead of the vote.

The Brexit vote is upon us in the week ahead and is contributing to market jitters