The referendum and market reaction

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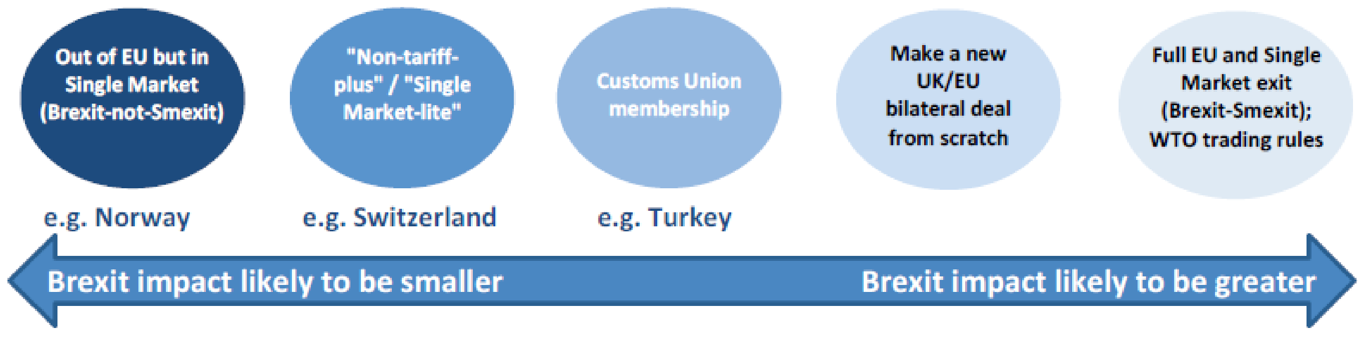
The lead-up to this referendum has been particularly tortuous so thank goodness it's nearly over. The political mud-slinging has been less than edifying and there can be little doubt that, as it was 20 years ago, the Conservative party will end up deeply and publicly divided whichever way the vote goes. It's unlikely that David Cameron can hang on as party leader if we vote to leave. But a vote to remain will also lead to Tory blood-letting given how personal the issue has become. Who knows, this may even take some pressure off Jeremy Corbyn – for a week or so.

My personal experience is that the standard of debate has been far higher outside of the political arena than inside. I just feel sorry for anyone who is still undecided on the issue. They must be crying out for informed argument as most of what they've been served up has been scare-mongering and blatant untruths from both sides.

However, the beauty of a referendum is that we can ignore our elected representatives when we enter the voting booth. Unlike a General Election, we don't have to hold our noses and put a cross next to the least bad option. And each and every vote counts equally.

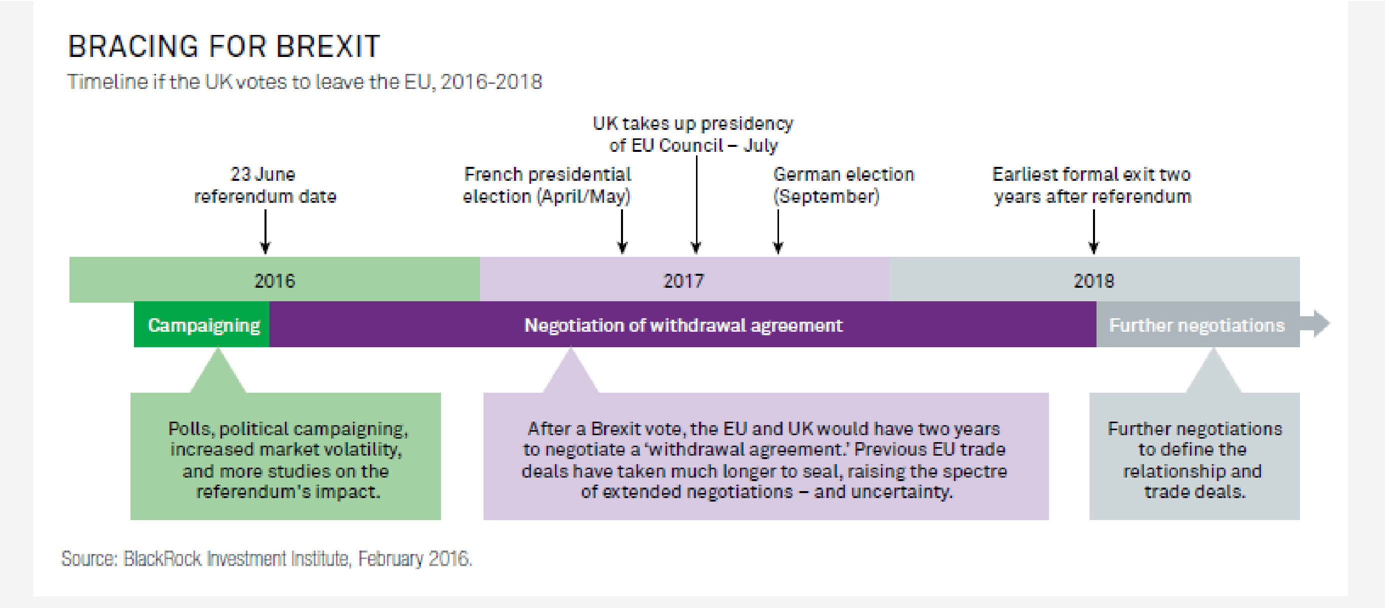
The analysis now is how the markets react to (in the absence of an unlikely dead heat) a pure binary decision. A vote to remain seems, on the face of it, a vote for the status quo. But what is that? For a start, given Mr Cameron's "new settlement" we'll be looking at a two-tier European Union, not just a 28 member union and a 19 member Euro zone. How long will it be before other countries demand opt-outs and concessions as a reward for staying in? This may not be the seismic shift that a Brexit would be but such shifts create their own uncertainty and put additional strains on the EU. Also, can the UK really sit on the side-lines of a single currency bloc that needs to become a fiscal union to survive?

Yet it is a Brexit which would have more serious market consequences. We may end up with a more dynamic economy with independent trade deals with countries that have real growth potential. But we have little idea what a future UK/EU relationship would look like if we voted to leave. We don't know which UK/EU trade model we're looking at or how long that will take to achieve. Here's a graphic from RBC Capital Markets which shows some of the possible post-Brexit UK/EU trade deals.



Source: RBC Capital Markets

And here's one from BlackRock Investment Institute showing the likely timeline for negotiations. As you can see, these look likely to extend well beyond the earliest formal exit date.



Markets will have to reset whatever the outcome of the vote on Thursday. It's accepted by both sides that a vote to leave will impact on the economies of the UK and those of EU member states. But whereas the Remain campaign are saying that these will be devastating and long-lasting, the Brexiteers claim that any disruption will be short-lived and a price well worth paying.

I'd have to be a complete madman to claim to know how financial markets will react. Nevertheless it's worth attempting to second-guess what could happen to a few key ones.

A vote to remain should see risk assets rally and hedges unwind. Sterling should bounce and equity markets get a lift – at least in the short-term. By the same thinking precious metals look likely to pull back from recent highs and, after an initial flourish, volatility should decline until we are once again forced to face up to the underlying realities of global economic weakness and ineffective actions from central bankers and policymakers as they continue to struggle with the fall-out from the financial crisis eight years ago.

FX

The clearest signals of how markets may react to the vote have come from FX. Considering sterling, it rallied when the polls favoured “remain” and fell when the polls turned and trended higher for “leave”. (I’ll focus on the GBPUSD rather than the EURGBP due to the implications the vote has for the euro as well).

If we think back to when the Brexit “risk” started getting priced in we’re probably looking at December last year. Investors began to consider the impact of a vote to leave the EU well before a date for the referendum had been confirmed. This was when the GBPUSD fell through 1.5000 on its way to a brief break of 1.4000 in early March.

So what happens to cable once the result is in? Well there’s been a pile of analysis on this and my takeaway is the following: the consensus seems to be that the GBPUSD could fall to anywhere between 1.1000 and 1.3000 should we vote to leave. Let’s call it 1.2000 and let’s assume cable is trading around 1.4000 ahead of the vote. That implies a decline of around 14%. To put that into context here’s a long-term chart of GBPUSD:

In the mid 1980's the GBPUSD fell sharply and briefly broke below 1.0500, but as we can see it recovered relatively quickly back to 1.5000. I'm not trying to suggest that history will repeat as we're dealing with very different situations. I just want to show with this chart that (mid-80's notwithstanding) cable hasn't broken below 1.4000 very often, and when it has it hasn't held there for very long. Maybe the prospect of drawn-out trade negotiations means it will be different this time. But we shouldn't forget that there's the immediate knee-jerk reaction and there's what comes after it.

So what about a vote to remain? Again, there's likely to be the initial reaction and then what comes after. On the upside some analysts expect cable to rally quickly to 1.5000 or so which seems reasonable if it's correct that Brexit fears began to get priced in around this level in mid-December. It would also suggest that the risks are asymmetric. If we again use 1.4000 as our pre-vote starting point, we're looking at 1.2000 on the downside and maybe 1.5000 to the up. So cable loses 14% or gains 7%.

Now there's been some chatter about how the Swiss franc (CHF) could see a buyers' rush if the UK votes to leave. This seems a reasonable assumption. If we think back a few years, the CHF rallied on Grexit fears and all the troubles with the peripherals, or PIIGS (Portugal, Ireland, Italy, Greece and Spain). The Swiss National Bank (SNB) even put in a floor of 1.2000 on the EURCHF in an effort to stem the Swiss franc's rally. That cost Swiss taxpayers billions. Then complete chaos ensued when SNB head Thomas Jordan did a reverse-ferret by demolishing the floor's foundations on 15th January 2015 – despite promising to maintain it the week before. Note to all traders: Never EVER trust a central banker, and consequently, be wary of putting too much faith in the Swiss franc.

It's far from clear how euro-related currency pairs will perform in the aftermath of the vote. It could be viewed that the Euro zone has more to lose from a Brexit than the UK. Especially if problems with Greece resurface and the Italian banking sector comes under further scrutiny. Further down the line Brexit could be seen as positive for the European Union. After all, the EU will no longer have to deal with the UK being part of the Union while refusing to join the single currency. Without the UK whining from the side-lines the EU will be freer to work towards closer European integration and ultimately achieve its goal of a full currency, banking and fiscal union.

As we get closer to the vote, volatility has picked up sharply in FX and particularly in sterling-related currency pairs. This volatility, together with the likelihood that liquidity will dry up ahead of the referendum, will mean big swings and price gaps. But this won't be isolated to sterling and sterling-related financial instruments. So many markets are correlated these days. Yet it's quite possible that many of these correlations will break down on the lead-up to and then directly after the referendum result. For example, usually we expect to see gold fall as the dollar rises. But what if there's a vote to leave and everyone rushes for "safe havens"? That could lead to a surge in demand for both gold and the dollar.

Indices

Considering the FTSE100, the general feeling is that the index will sell off on a leave vote and rally on a vote to remain. That well may be the initial market reaction. But of course there will be individual winners and losers and ultimately the overall effect on the FTSE100 could be limited due to its constituents having a heavy international (around 70%) exposure. The share prices of big multinationals that derive a significant proportion of their revenues and earnings from countries outside the EU are likely to benefit from a leave vote. Quite simply, money will flow from stocks with direct exposure to Europe to those more internationally facing. Consequently, pharmaceuticals (such as AstraZeneca, GlaxoSmithKline and Shire), oil majors and miners are likely to benefit as could companies with low exposure to the EU such as Centrica and Prudential. But airlines and tour operators may suffer selling first with questions asked later. Those at risk include EasyJet and Carnival. In addition, companies with a purely domestic focus are also likely to suffer. This is because it's widely thought that UK economic activity will slow on the back of a vote to leave. This list would include housebuilders, property companies and domestic banks such as Lloyds.

Overall, the damage to the FTSE100 as a whole may be limited. Not only due to its weighting towards internationally-facing corporations, but also because any weakness in sterling will make these companies more competitive and thereby boost earnings. In addition, their stock will become increasingly attractive for foreign investors. In contrast, smaller cap UK-centric stocks should suffer disproportionately. These won't be helped by a drop in sterling, and they're also likely to get sold on prospect of weaker UK growth. It's worth remembering that European stocks have been under pressure for over a year now. In contrast to the major US indices which are trading back close to all-time highs, the euro-Stoxx 600 index (the main barometer of European stock market health) has repeatedly failed to bounce back convincingly following last August's China-catalysed sell-off and a pull-back which ran from early December to mid-February this year. European stocks should get a lift if the UK votes to stay in the European Union. However, this may not last for long. Technically the chart doesn't look particularly encouraging. The broad index has repeatedly failed to break back above its 200-day moving average.

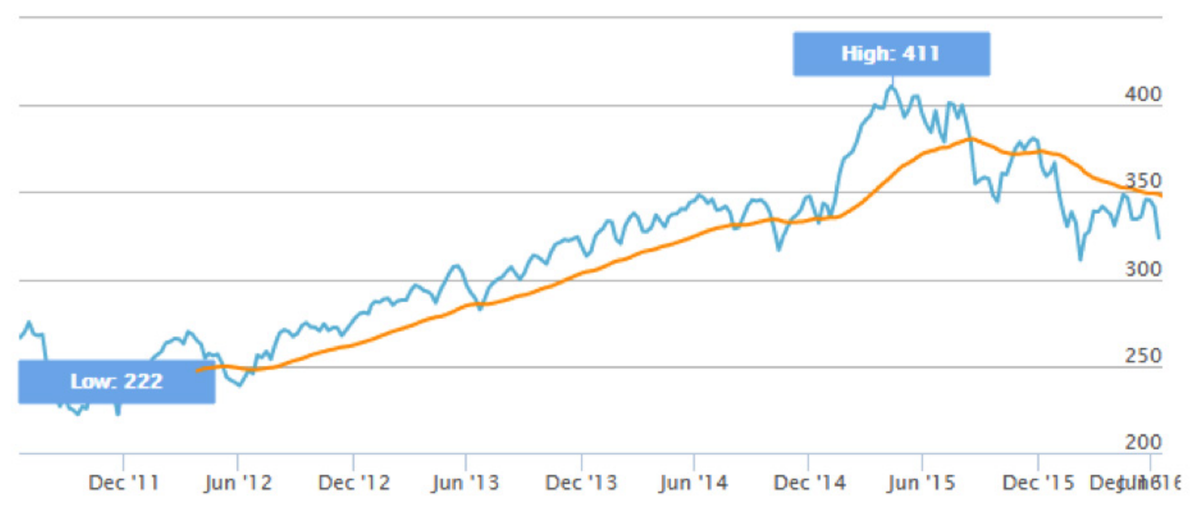
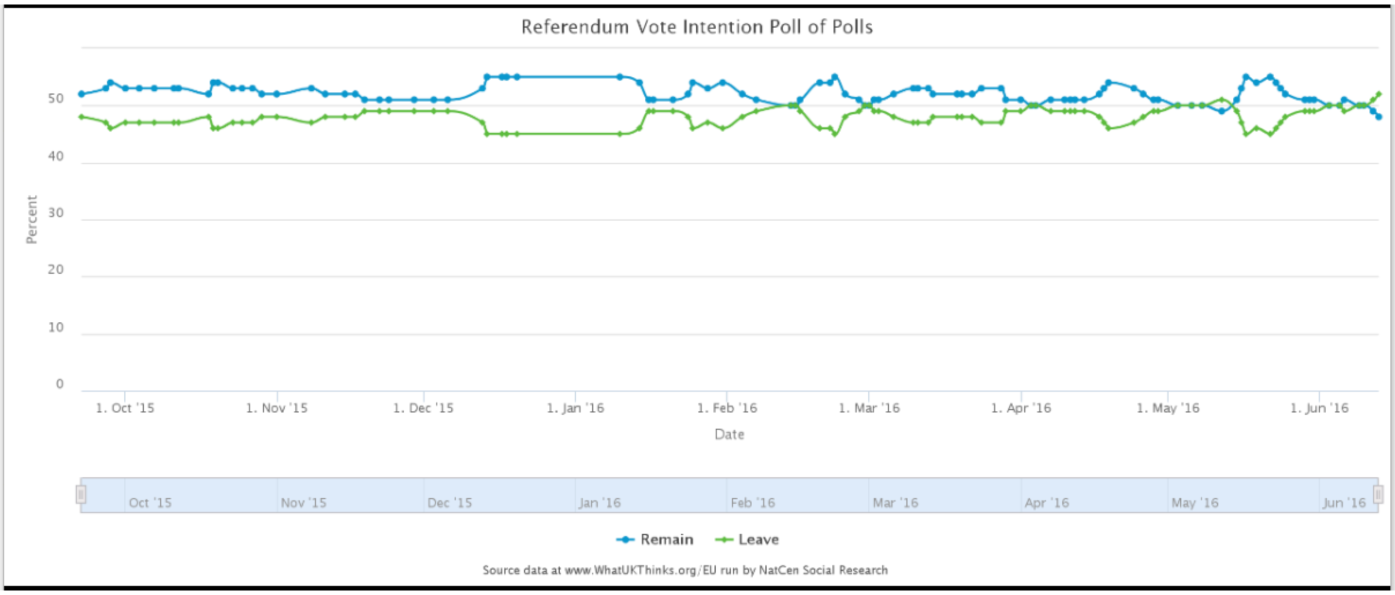


Chart courtesy of www.stoxx.com

Predicting the outcome



Here's a chart from NatCen Social Research showing voting intentions via a poll of polls up to Monday 13th June. What it shows quite clearly is that the "Leave" vote has pulled ahead and appears to be building momentum. (As a caveat, there are still plenty of potential voters who are undecided and turnout will be a big factor). Yet opinion polls have come in for a lot of stick in recent years and as far as the bookies are concerned, the "Remain" vote is likely to hold up and win on the day.

Polls versus bookies

This referendum has few precedents. Being a binary event where everyone's vote carries equal weight, there's just no point in using last year's General Election as a guide to how accurate opinion polls may prove to be now. But we can look back to September 2014 and the Scottish referendum to see if there's anything worth taking away from that. In that referendum the bookies did better than the polls in predicting the eventual outcome. Could that be the case this time round? I'm not so sure.

Back then the bookmakers consistently showed that Scotland would vote to remain in the UK. Meanwhile the polls were close and indecisive. Then, what proved to be a rogue poll just before the referendum showed a big majority for "Leave." The "Remain" campaign went into overdrive and the rest is history - a thumping win to keep the Union together. Of course, this is what the punters had been backing all along. Follow the money.

But in this referendum it looks as if the money is following the polls rather than acting independent of them. The "Remain" lead with bookmakers has shrunk to its lowest level since the polls turned in favour of a Brexit. One week before the referendum Betfair said the probability of vote to remain was around 55%. This was down from 78% just seven days earlier. Could it be that the punters are just as clueless as everyone else this time round – following the news rather than leading it?

Referendum night

It looks as if there will be no official exit polls once the booths close at 10:00 pm on Thursday night. But private polls are being carried out, so it may be that we see markets move before actual results or information on voter turnout is released. This could be misleading. As said before, the first market reaction may be short-lived, especially if the data used is misinterpreted.

Professor Curtice, whose exit poll following the 2015 general election proved to be accurate when other polls hadn't, said that taking an exit poll in a referendum was a "very difficult exercise". So traders should not only be very cautious ahead of the referendum but straight after it as well.

Of the 400-odd electoral regions announcing results, the vast chunk will come in between 2am - 5am. The results will be announced town-by-town and region-by-region, and the final nationwide result is expected to be confirmed in time for the European open on Friday 24th June. There is no minimum turnout requirement—the referendum will be decided by whichever side has secured a straightforward majority of votes.

Conclusion

If we vote to leave then it seems likely that a "worst case scenario" will get priced into markets pretty quickly. That is, further uncertainty as we argue over what kind of relationship we want with the EU, and them with us. Then there will be a long period of negotiation. However, one would hope that the focus of most parties' efforts will be to make the transition as smooth and positive as possible. We may experience some unpleasantness from some of our old European partners. After all, no matter how strong the resolve for an amicable divorce, there are always outbreaks of nastiness leading up to, and often beyond, the final separation. But self-interest should ultimately prevail. Politically, no matter what senior Tories have said about David Cameron remaining as leader of Conservative Party and Prime Minister, can his position really be tenable if we vote to leave, or even to remain by a small margin? Given his view about how leavers are like turkeys voting for Christmas (in other words forgetting his previous comments suggesting that the UK could thrive outside the EU) how can he take charge of Brexit negotiations, whatever form they take?

The Bank of England has said it may have to look at additional monetary stimulus if the UK votes to leave. The ECB may also do the same. If that happens (and bear in mind we've had some mixed messages from the Bank and the UK Treasury over what they may or may not do in the event of a Brexit) then equities could bounce quite sharply. In this situation we can expect sterling to continue to come under pressure, but that should help the Bank with its inflation target and boost UK exports.

A vote to remain should see sterling jump and equity markets rally, initially at least. There will be a general feeling of relief as all the uncertainty surrounding the referendum evaporates. But then it's time to refocus on the economic outlook, both for the UK and globally. The "Remain" campaign has repeatedly warned that a recession will follow a vote to leave. But we're well overdue one in any case. There really is no such thing as an end to boom and bust, even if we haven't had much of a boom since 2009. Then there's Europe itself. Economically the Euro zone still has to deal with sclerotic growth and deflationary pressures. We can expect the problems in the peripheral countries to come back into focus. The status quo is maintained, but it is a troubling one with some major issues that require solutions. But in the lead-up and immediate aftermath of the vote one thing is for sure: volatility will spike higher while liquidity in some financial instruments could vanish. We'll have some mad swings with the likelihood of prices gapping in both directions and this will be exacerbated by algorithmic trading. That is, programme-driven trades without human intervention. So expect considerable market turbulence, and not just in markets most obviously affected by the referendum. The British pound and euro may react most violently, but other markets have the potential to move sharply too. Wild swings in currencies have knock-on effects and correlations can break down more abruptly than they took to establish. It's a good time to be cautious.

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