The Reaction to Brexit: The Market's Failure of Imagination

The news the U.K. has voted to leave the EU has caused surprise in the media, and concern in the markets. While it's too early to say what will happen in the long term we thought it would be useful to outline a number of key points to put recent market moves in context.

– What has happened?

The U.K. has voted to leave the European Union in a referendum. Prime Minister David Cameron has announced he will step down later this year, and the negotiations about leaving will be led by the new Prime Minister. The Conservative Party will now run a leadership election to determine the new Prime Minister. Markets have opened down significantly, although as at the time of writing some of the initial losses have been pared back, with U.S. equity markets down a little more than 2%, European equity markets down around 5% and the pound still down below the $1.40 level.

– What does the law say about how this might all happen?

The provision in the treaty that allows for a country to leave is called "Article 50." Invoking that Article begins a two year period of negotiation which can only be extended by unanimous agreement. Prime Minister Cameron has said the triggering of that Article should be left to the new Prime Minister, to allow the situation to stabilize, as invoking it starts a two-year stopwatch to the final moment of leaving. That implies a final leave date where the U.K. would be fully outside the EU no earlier than October 2018.

– When will things start to change? Will there be an immediate impact?

This is important to understand when looking at the market reaction. As outlined above there is a long time between today and the moment when the U.K. actually leaves the EU. During this period little or nothing will change in terms of how business is done. While there will be uncertainty, our view for most businesses and individuals is nothing will change today, little will change in the next couple of years, and any change will most likely be gradual, rather than sudden. This was emphasized by the Prime Minister in

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his speech, and also by leaders of the EU. The Governor of the Bank of England has also made a statement emphasizing the support the markets will receive from the Bank to ensure stability.

– Why did markets fall so much?

Most of the discussion in the markets has been based on a simple set of assumptions: 1) withdrawal will be bad for the U.K. economy, and 2) a Brexit was unlikely. Recent polls seemed to show Remain was the likely result. The media and market discussion happened in somewhat of an echo chamber because the participants were mostly based in London, a part of the U.K. which voted overwhelmingly for Remain. This led to excessive groupthink, underrating the chances of Brexit. Markets traded up, based on a relatively simple presumption that Brexit would be bad. When it became clear that the result was for Leave, traders who had placed positions assuming a Remain vote found themselves the wrong way in volatile markets. That is an environment where sudden moves can happen. We should likely think of these recent moves, then, not as a rational thought-out reaction based on sophisticated economic analysis, but more of a knee-jerk reaction, responding to surprise and uncertainty in the way that markets tend to do – by selling.

– Won't leaving the EU be terrible for the U.K.?

As we wrote in our recent Quarterly Investment Landscape, this is a nuanced issue. Many of the predictions of economic catastrophe came from organizations which were themselves committed to the Remain agenda, and should be thought of as part of the campaign rather than independent analysis. There were strengths and weaknesses on both sides of the argument, and the likely result of the protracted discussion and negotiation process is a mixture of good and bad effects. Leaving the EU may mean new deals are needed to retain full access to trading goods and services with the single European market, but at the same time it would allow the U.K. to repatriate trade policy and negotiate deals more tailored to the U.K. economy with India, Australia, Canada, the U.S. and other countries with which the U.K. has strong ties. So it is likely to be a mixed picture, rather than one-sided.

– Why did global markets sell off, rather than just the U.K.?

Markets do not like uncertainty, and the surprise associated with the Leave vote is the perfect example of sudden uncertainty. Economic conditions around the world remain challenging, and that means markets are likely to over-react on the downside when surprised. At the same time there are real, broader concerns. While leaving the EU may be neutral, or even positive, for the U.K., we need to remember that the U.K. is the fifth largest economy in the world and should be fairly secure in a range of situations. More broadly, though, this vote calls into question the future of the EU itself – there has already been discussion of a possible Dutch referendum, and other countries may also consider leaving.

Euroscepticism is here to stay, and the European Union will have to spend significant time and energy dealing with it. This process may be negative – battles to stop countries leaving – but may be positive – a driver to significant reform.

– What should investors do?

As markets assess the situation, and begin to take a more appropriate, nuanced, view of the effects of the outcome there is a likelihood for a short-term retracement of market declines, although timing this move is unpredictable. We anticipate increased volatility across continuing EU members, with particular focus on the countries that may begin discussing the possibility of leaving. As we get more clarity on the potential new dispensation, both for the U.K. and within the EU, it is possible that we may suggest that investors adjust their allocations. However, short-term reactions to short-term market movements, other than rebalancing where appropriate, should be avoided.

Best Wishes,

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