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"Brexit" and the Financial Markets

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Markets have fallen sharply over the past week as investors have begun to worry about "Brexit" in earnest. Brexit (the amalgamation of British + Exit) refers to the possibility that U.K. citizens may vote to leave the Eurozone in an upcoming referendum. The referendum is actually not legally binding upon Parliament. However, it would create great uncertainty and throw European politics into turmoil.

The referendum is being held because Prime Minister David Cameron promised to hold one if he won the 2015 general election. He made this pledge in response to calls from his own Conservative Party and the surging UK Independence Party (UKIP), which argued that Britain was overdue for a public vote. In the meantime, Cameron has negotiated for concessions from the E.U. that will go into effect if Britain stays.

What could happen if the U.K. leaves?

Until this week, concerns were low as few thought it likely the U.K. would actually vote to leave. Yet, by Wednesday polls showed the leave camp slightly in the lead. This prompted a sharp flight to safety in world markets as Treasuries and other high quality debt rose and stocks sold off. The primary fear is that uncertainty and volatility could tip an already weak world economy into recession. The Eurozone is clearly vulnerable to any Brexit-related shock given its economic ties with the U.K. (nearly 18% of EU GDP). In turn, the Eurozone economy is important on the world stage. The British pound would likely fall sharply against the Euro. At least in Europe, weakening business and consumer confidence could lead to delayed investment and reduced spending. Rising U.K. bond yields, if sustained, would lead to a rise in real interest rates, which would hurt economic growth.

It isn't just Brexit troubling the markets. Just before the worrisome polls, U.S. industrial production and job creation figures showed weakness, unnerving investors. On Monday, the Bank of Japan's decision to refrain from adding stimulus again disappointed investors, sending the Yen to its highest level since 2014. Worries about Chinese growth have also resurfaced, although the reality is that the near term news from China is better as fiscal stimulus has sparked a modest cyclical rebound.

In general, investors remain suspicious of the rally from the January-February lows. The best performing stock sectors this year are Utilities and Consumer Staples, non-cyclical sectors that often serve as bond proxies. Mutual funds and retail investor accounts are holding relatively high levels of cash.

What Should Investors Do?

Investors face the challenge of deciding whether a significant threat exists, or if this is merely a transitory concern. Investors also have to weigh whether a negative outcome is even very likely. Our bottom line is this: while further volatility is likely, we think trying to sell, then re-buy in advance of the vote will be counterproductive.

Investors should resist the temptation to change a long-term plan based on a short-term event.

The most likely outcome is still that the stay vote ends up winning. Although polls have tightened, betting houses in the U.K. are much more sanguine that the country will stay in the E.U. Events remain very fluid going into the June 23rd vote. After Thursday's horrific murder of leading "stay" politician Jo Cox, markets rose on the thought it would make an exit less likely. Despite voter anger over immigration and local control issues, leaving the EU really could damage the U.K. economy, a risk voters are aware of.

If the U.K. does vote to leave, there are good reasons to think the ultimate damage would be manageable. First, as mentioned, a leave vote doesn't mean Parliament will actually see this as a definitive mandate. Second, a British exit would probably not spark another Euro crisis, since it has already been thoroughly tested by more severe crises. ECB chief Mario Draghi would almost certainly step in with liquidity and reassurances. The Euro is now the world's second-most widely held reserve currency and there are trillions of euro-denominated assets outstanding, suggesting it now has credibility with investors who recognize the political will underpinning the currency. Investors who missed the recent rally may be interested in buying a dip given an overall positive backdrop.

Lastly, in response to weak U.S. data, the Fed will stay on hold this summer. Labor participation also declined, erasing much of the increase in the participation rate over the past eight months. In the end, investor-friendly central banks and adequate economic fundamentals will likely win out over Brexit concerns.

Important Disclosures: