TCW

Manager of the
TCW, MetWest,
and TCW Alternative
Fund Families

INSIGHT

VIEWPOINT

What the Brexit?

BRIAN SMITH | JUNE 24, 2016

Brian J. Smith
Senior Vice President
U.S. Fixed Income

Brian Smith is a Senior Vice President in the U.S. Fixed Income Rates group. In conjunction with the generalist portfolio managers, Mr. Smith helps determine and implement duration and curve positioning across fixed income portfolios. While specializing in interest rate derivatives, he also trades Treasuries, agencies, TIPS, and futures. Prior to joining TCW in 2011, Mr. Smith was a fixed income trader at Barclays Capital. Previous to this, he was a fixed income trader at Lehman Brothers. Mr. Smith holds a bachelor's degree in Economics and Mathematics from Yale University.

Wait... What Just Happened?

Despite financial markets pricing in a Remain outcome going into the U.K. referendum on whether it should stay in the European Union, the Leave camp ultimately won out. This unexpected result caused immediate market turmoil. The British Pound (GBP) entered the vote at a six-month high, then dropped 12% to a 30-year low, before ultimately finishing 8% weaker. Global stock markets also suffered large corrections, with many British banks losing 30% of their valuations. Global rates saw immediate flight-to-safety moves with the 10-year U.S. Treasury yields touching 1.40% as German 10-year yields reached negative 0.16%, before both ultimately corrected 10-15 bps higher.

While the immediate market reaction was drastic, it also was more muted than some expected. Is Britain leaving the E.U. really that bad after all?

The "This is Very Bad" Take:

The pessimistic take rests on the pillars of weaker economic growth, diminished global influence and future European contagion.

Heightened market volatility in the U.K. will likely have an impact on the underlying British economy and the willingness of U.K. businesses to invest for the future. Thus, some degree of economic contraction in the British economy can be expected in the near-term. Outside of the protectionist precedent it sets, having a leading developed market economy willingly choose a tougher short-term economic road creates added resistance on an overall global economy that was already struggling to generate real growth. To the degree that global growth and global rates must ultimately rise in unison, the global economy's momentum has just been stalled by one team member tripping and face-planting.

Britain's influence in global affairs will also be significantly altered. As one of the United States' key allies in Europe, the separation of the U.K. and Europe is likely to significantly alter geopolitical developments going forward. Will the U.S.'s relation with Britain remain the same? What about the U.S.'s relationship with a Britain-less European Union? How will an independent Britain facing a large economic shock act on a global stage? Only time will tell.

Additionally, there is significant concern that the success of the British referendum could lead to numerous other referendums on E.U. membership from other disgruntled countries which believe the European Union is not serving their own best interests. Given the varied economic interests of each E.U. member, it would be logical for this to be a recurring concern going forward. After all, Germany's economy is relatively robust and in no need of the ECB's negative rates and monetary policy stimulation, yet Italy's economy is struggling and unlikely to be able to withstand a forced banking recapitalization. How does the E.U. come up with a one-size fits all monetary policy solution? It requires a strong commitment to the Union on behalf of all of the members, which implies varied degrees of sacrifice. Given that the U.K. just turned its back on this "commitment", will other European countries follow suit? If so, the fate of the European Union may be put to the test.

The "Maybe this isn't that Bad" Take:

What if the initial market reaction was just a giant head fake? Such an out-of-consensus view can be made based on the lack of financial contagion, the benefits of Pound depreciation, procedural uncertainty and Austrian economics principles.

While the press is inclined to label Brexit a "Lehman" moment, no bank is shutting down as a result of the Leave vote. Thus, there is no immediate financial contagion parallel. While the market volatility caused pain for leveraged market participants, financial asset price contagion proved contained. Animal spirits are certainly impaired, but businesses will still operate and consumers will continue consuming.

Furthermore, the United Kingdom was already a fringe member of Europe that never fully adopted the European Union's currency or monetary policy. The British Pound's recent devaluation could even serve as somewhat of an economic stabilizer, which supports economic growth as exports become more competitive and domestic goods become cheaper relative to foreign imports.

The process of getting from a Leave vote to actually withdrawing from the European Union is also very uncertain. While David Cameron has announced his resignation as prime minister, he will remain for the summer months, delaying his replacement's ultimate activation of Article 50 to officially withdrawal from the European Union. An extremely adverse market reaction in coming months could result in the populace changing their minds, or it could lead to a renegotiation of the E.U. Treaty (unlikely given the poor precedent it would set, but possible). Even if the non-binding referendum does proceed, it will take an additional two years for the official process of leaving to be finalized. This prolonged time frame means that businesses will have ample time to gradually adjust strategies and adapt to altered future trading arrangements. Thus, this could end up being much ado about nothing.

Finally, from a bigger picture perspective, to the degree that extraordinary monetary policy measures globally have impaired free markets and needed reforms, maybe this is a global catalyst towards better fiscal responses in the future that rely less on the monetary policy of central banks to generate growth. If global central banks' foray into negative rates and balance sheet expansion has only served to paper over structural growth problems rather than truly address them, then some short-term pain is needed to facilitate the longer-term gain that results from structural reforms and better fiscal policies.

Thus, while the initial Brexit reaction was pessimistic, a more constructive longer-term outcome is possible. Only time will tell.

The Rise of Populism & Rejection of the Establishment:

One thing that is less up for debate is the undeniable rise of populism on a global scale. This populist rise has emerged from persistently low and unevenly distributed global growth. A disgruntled and financially struggling electorate is deciding that the current status quo is no longer desirable. As a result, extreme political measures that may have previously been unthinkable are coming to fruition. Voters may not necessarily know what it is they want, but they are looking for change. Evidence of this can be seen in the rise of the 5-star movement in Italy, Marine Le Pen in France, Bernie Sanders' close run for the Democratic nomination, and Donald Trump's capturing of the Republican nomination. The Brexit vote, however, was the first example of populism actually winning an election outright, and it raises the spectrum of more populist victories to come globally.

While immigration policies certainly play a large role as well, one major takeaway is that weak global economic growth has humanistic implications. When an electorate feels left behind in the financial status quo, societal structures and political status quos are also disrupted.

Similar to how the polls and so-called experts were blindsided by the success of Trump and Sanders in the U.S. primaries, the polls and market experts were similarly caught off-guard by the U.K. referendum. Why then should the polls and established opinion be trusted going forward? The certainty of past paradigms is being replaced with persistent uncertainty, as the unthinkable repeatedly becomes reality.

Increased domestic and global uncertainty makes longer-term investing more challenging. This has prolonged and significant implications for risk premiums on asset pricing.

What Specifically to Watch For – Continued Dollar Strength:

U.S. Dollar strength was the primary cause of the recent risk-off moves that occurred in August of last year and February of this year. Yet, in both of those instances, Dollar strength was domestically led due to increased Fed hiking expectations (and corresponding wider global yield differentials). This time, however, Dollar strength is being driven by foreign influences as non-U.S. rate expectations are plummeting (British 10-years rallied close to 40 bps on the vote, and Japan and German yields went deeper into negative territory) and expectations for further non-Fed central bank easing have made the Dollar more attractive relative to other global currency options. If recent Dollar strength continues, investors will be closely monitoring China's CNY fixing.

Despite officially targeting a trade-weighted basket, China's currency is still largely pegged to the U.S. Dollar. Yet, China's economy is in need of monetary stimulus. Thus, when the Dollar strengthens globally, it provides significant headwinds for the Chinese economy at a time when it is need of the opposite. As a result, China is forced to let the Renminbi (CNY) slightly devalue to the U.S. Dollar to ensure continued competitiveness on a global scale. CNY devaluations preceded the risk-off periods of last August and this February, as investors feared China was exporting deflationary forces on the rest of the world. Going forward, watch closely for continued Dollar strength and any corresponding CNY devaluation, as this could once again be the catalyst of any further risk-off correction.

But Won't Global Central Banks Step in Again and Make Everything Alright?

While it is logical to expect them to try to do so, the ability of global central banks to dictate market pricing appears to be nearing an end as their non-traditional monetary policy efforts grow less supported and less impactful. To the degree that quantitative easing and negative rates won't be as enthusiastically pursued, then expect markets to re-price to true clearing levels that are more representative of economic fundamentals rather than central bank dictated levels.

While the short-term global market and economic responses could be painful, ultimately this may be needed to enact better fiscal policies and true structural reform which facilitates longer-term growth.

Conclusion – The Long Path Forward:

Overnight, the Brexit vote shifted the world's equilibrium and markets reacted in kind. The "this is very bad" take is that Britain shot itself in the foot and a contagion induced collapse of the European Union is imminent. The "maybe not" take is that fears are overblown and failed global Keynesian policies need disrupting anyway. Everyone, however, can agree that populist trends are rising globally and this creates a more uncertain future as traditional establishments and status quos are challenged.

Where do we go from here? Beware of continued U.S. Dollar strength (and any Chinese reaction to it), as this will likely foreshadow any continued risk-off move in global markets. Additionally, expect global central banks to continue to attempt to intervene to support current market levels, but beware of their increasing impotence in doing so. While reduced central bank effectiveness may be painful in the short-term, it could ultimately result in the fiscal actions and structural reforms necessarily for enhanced longer-term economic prosperity.

Whatever you do, don't trust the polls! Persistently weak global economic growth results in increased structural and political surprises. Heightened uncertainty requires appropriately adjusted financial asset pricing. Invest accordingly. ■

865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup