The Brexit vote - what is the impact?

27th June 2016

On Thursday, June 23rd, 2016 the UK voted to leave the European Union (EU) by 52% to 48%, in the so-called “Brexit” referendum. The outcome was a shock to financial markets and many investors (as well as pollsters), who had considered that the result of the election would be to remain in the EU. As a result of the unexpected outcome there were significant moves in asset prices, particularly shares and exchange rates, as the results were released.

AMP Capital believe that to a large extent the volatility is due to the unexpected result, as opposed to an indication that investors have taken a view that the vote will lead to significant economic impacts. Important to note is that financial markets are continuing to operate normally, with central banks ready to intervene to smooth any disorderly trading and provide further liquidity to the banking system.

Why the Brexit frenzy and is it justified?

AMP Capital makes the following points about the impact. First, there are concerns about the impact of Brexit on the UK economy, given that its exit from the European Union would likely restrict its access to its principle export market – the European Single Market takes 44% of UK exports. Furthermore, Brexit would place pressure on labour mobility that is highly valued by large global companies which base their European operations in London, thus reducing foreign investor confidence in the UK financial sector.

The result of the vote is likely to be negative for the UK and European economies, at least in the short run due to both real changes in business conditions as well as heightened uncertainty.
Second, the concern globally is that a Brexit vote could lead to renewed fears about the durability of the euro if the vote encourages public opinion in Eurozone countries, such as Sweden and Italy, to support parties committed to exiting the European Union. This in turn could reignite concerns about the credit worthiness of euro-denominated debt issued by peripheral countries such as Greece and lead to a flight to safety out of the euro and into the US dollar.

Finally, if financial markets believe a Brexit-triggered recession is a reasonably likely prospect, then in the short term the result could see further market volatility. This may negatively impact those companies on the ASX200 that generate revenue in British pounds or who have UK assets. Overall we expect the impact on the Australian economy and market would be quite limited, as Britain accounts for only 2.7% of Australia’s exports.

It is important to understand what has not changed as a result of the referendum result. First, the UK will remain a member of the EU. The UK government has confirmed it will invoke Article 50 of the Treaty on European Union and start negotiations with the EU in October on how it will exit. Article 50 allows for negotiations to last up to 2 years, and this can be extended, if necessary. Second, while the negotiations are taking place, EU treaties and laws continue to apply in the UK. Companies in the UK will continue to operate as usual.

Over the longer term the broader implications of the vote are dependent on the result of the negotiations and there are a number of potential outcomes, contributing to volatility.

Conclusions

The financial impact of the Brexit vote on the underlying value of most assets in investor portfolios is likely to be minimal. However, as discussed above, the impact on prices will take some time to play out, given the uncertainty. As has been the case in previous periods of market uncertainty, e.g. Grexit concerns, our view is that quality assets purchased at sensible prices, in a diversified portfolio generally remain a sound strategy to produce a solid income stream and longer term capital growth. There will be investment opportunities in this environment as some markets become oversold, and we will continue to carefully consider portfolio strategy.