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Brexit – What Happens Next and How It Impacts Institutional Cash Investors

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Abstract

We leave our readers managing intuitional cash portfolios with the following takeaways:

1. *Brexit will likely have a major impact on the UK, politically, economically and financially. It is less so on the EU and the US. Look for short-term volatility and maintain sufficient liquidity as market liquidity may be less predictable than before.*
2. *Expect more accommodating central bank policies. With BoE and ECB likely cutting rates and expanding asset purchase programs, yields on high quality liquid assets will remain low for months ahead. Expect the Fed to slow down its interest rate normalization process, possibly putting hikes on hold until the second half of 2017.*
3. *With low yield comes the tendency to reach for lower credit quality instruments. Beware of credit risk as the recent wave of mergers & acquisitions and share buybacks have dampened corporate credit strength and increased financial leverage.*
4. *Brexit came at an inopportune time as US prime money market reform is set to take effect in October. This may encourage more flight-to-quality induced asset outflows from prime funds into other instruments.*
5. *The drop in short-term government yields and steepening of the credit yield curve creates opportunities for separately managed account investors to own high-quality liquid credit instruments further out on the yield curve for attractive return potential.*

Introduction

"May you live in interesting times" is an often-cited British expression of unknown Chinese origin. On June 24, 2016, the British people woke up to a seismic outcome of historic significance – the nation voted to leave the European Union (EU) after 43 years with a margin of 51.9% to 48.1%.

The unanticipated nature of the outcome caught citizens, policymakers, and global markets by surprise. With mounting uncertainties and volatile market trading, the inevitable questions for market participants are: What does this mean to us? What happens next? How do I prepare for the fallout of the UK's separation from the EU, colloquially known as Brexit?

In a sea of press reports, political commentaries and macro-economic analysis, we take a narrow focus and discuss the potential impact of Brexit on US-based institutional cash investors. With less than four months to go before key money market fund reform taking effect, Brexit adds more to cash investor's anxiety over safety and liquidity of their portfolios. We hope to impart that, while a major political crisis with profound impact on the UK economy, Brexit likely is only mildly negative for US investors, principally in the form of lower yield potential and manageable counterparty risk in the near to medium term.

What Brexit Means and Why It Happened

Oddly, no one knows exactly what it means. The referendum asked British citizens a single question: "Should the United Kingdom remain a member of the European Union or leave the European Union?" Now that the country's majority decided to take the second option, its leadership is left to figure out what leaving the 27-country EU means – free from some or all of the privileges and obligations of a member country? This ambiguity is partly to blame for the anxiety among the British people and market uncertainty.

EU membership has been a controversial issue in the UK since it joined the European Economic Community, a predecessor to the EU. "Euroskeptics" argue that Brexit would free the country from EU regulations and bureaucracy, lead to better control on immigration, reduce pressure on public services, housing and jobs, and save it from heavy EU membership fees. Not unlike the rise of anti-establishment populist US presidential politics, older, less educated, and less affluent Britons in non-metropolitan areas tended to favor leaving the EU. Most voting areas in England and Wales voted to leave, while London, Scotland and Northern Ireland wanted to stay.

What Comes Next

The referendum is not legally binding, meaning that the British parliament may decide not to follow through with a formal divorce from the EU. Despite various scenarios outlined by political pundits, the Brexit decision is likely irreversible. Immediately after the vote, Prime Minister (PM) David Cameron offered to step down. He will let his successor, expected to be elected in early September, to officially start a process known as "Article 50 of the Lisbon agreement" which spells out the terms of separation to be completed within two years. If unfinished by then, the UK will automatically be severed from the EU unless member countries unanimously agree to extend the deadlines.

At the moment, the UK political picture is muddied. The British Parliament is tasked with carrying out the Brexit mandate, although three quarters of lawmakers are in the Remain camp. Applications for PM candidacy must be submitted by the end of June, but none of the leading contenders appear to have a well-formulated plan for the future UK-EU relationship, offering little clarity on the expected direction of separation. The leader of the main opposition Labour Party received a no-confidence vote from his own members in the parliament. These uncertainties may lead to another general election in the coming months. In addition, because Scottish voters overwhelmingly favored staying in the EU, the threat of a second Scottish independence looms large in the background.

Boris Johnson, former Mayor of London and a leading pro-Brexit Conservative Party politician, signaled that the UK is in no hurry to trigger Article 50. Several EU leaders, however, wanted the separation to happen as soon as possible. German Chancellor Angela Merkel warned the UK not to "cherry pick" the terms of separation, such as having access to the European Single Market while circumventing rules on immigration and EU budget commitments. She also ruled out any informal discussions before an official notification, which must be initiated by the UK.

In short, the end state of a Brexit may take several years to materialize and the negotiation process will be long and complicated. We expect many twists and turns from both the UK and EU sides. In the meantime, financial markets must face policy uncertainty, economic malaise and market volatility.

What to Expect

Central banks quickly sprang into action. The Bank of England (BoE) said it stands ready to provide more than £250 billion of additional liquidity, as well as foreign currencies if required. The European Central Bank (ECB) and the Federal Reserve also expressed their intention to provide additional liquidity. At the same time, most central banks remained calm and restrained from deviating from current policy paths or intervening in the currency market.

Despite being a major political and economic event, Brexit's impact on the UK, Europe and the United States diminishes progressively in concentric circles. We discuss these influences from economic, monetary and credit points of view below.

United Kingdom

Economy

There is no underestimating Brexit's impact on the domestic economy. For the time being, however, the UK remains a member of the EU, so most of the economy should be relatively unscathed. Foreign investments, construction and real estate may feel the immediate impact, especially from firms conducting EU business from their UK offices, a practice known as "passporting." Another negative impact comes from reduced spending due to lower consumer confidence. Economists generally agree that economic growth will stall in the third or fourth quarter of 2016 or and the UK will enter into a mild recession with overall GDP lowered by 3-4%. Inflation may accelerate to as much as 6% from double-digit depreciation of the pound sterling against other currencies.

Monetary Policies

The BoE is expected to lower the benchmark interest rate by 0.25%-0.50% and restart a quantitative easing program of buying government securities in 2016. It is not expected, however, to intervene in the currency market as a weaker sterling is beneficial to exports.

Credit Implications

Rating agencies were swift in issuing negative actions on UK sovereign debt. S&P lowered its AAA rating by two notches to AA with a negative outlook. Fitch lowered it by one notch from AA+ to AA, also with a negative outlook. Moody's affirmed its Aa1 rating, but changed the outlook from Stable to Negative. Ratings on a number of sovereign-linked entities also were downgraded. In addition, Moody's assigned negative outlooks on a select group of large UK investment and universal banks. We expect similar actions to come from the other rating agencies.

For frequent issuers in the short-duration credit markets catering to US cash investors, we expect a period of volatility and lower profit opportunity but are not overly concerned with significant deterioration in their fundamental credit strength in the near to medium term, specifically:

UK agency and sovereign-linked credits: Despite political uncertainty and reduced growth prospects, we expect the UK to remain a solid sovereign credit, and thus are comfortable with UK agency and sovereign-linked credits.

Banks and financial firms: UK financial companies will likely be the most impacted among non-government issuers. There may be a period of uncertainty in accessing the wholesale funding market. Income may be pressured by lower interest rates, reduced capital markets activities, and lower property values. Over time, internationally active banks may incur higher operating expenses of relocating divisions and personnel to EU locations and securing additional licenses. Those reporting profits in US dollars also may suffer currency translation losses. However, most large UK banks, especially those with high ratings, have disposed of most of their distressed assets and resolved financial conduct liabilities, built capital, and improved their balance sheet liquidity since the financial crisis. Banks with mostly domestic operations should feel even less impact from Brexit.

In general, Brexit's negative impact on non-financial corporate issuers should be moderate. We expect slower growth and reduced investments to have less impact on large non-financial corporate issuers due to their diversified and global nature. Issues to watch out for:

Integrated oil and gas companies: Over time, trade barriers and changes to tariffs on imports and exports of petroleum products may affect the major UK firms, but overall impact will be limited due to their global integrated business.

Consumer products: Barriers to trade with increased tariffs will likely have a negative impact on sales. Supply chain disruptions may increase as imports and exports are restricted. Volatile currencies could hurt margins. Prolonged negative consumer sentiment may impact sales. Restrictions to migration flows may impact the labor force and increase labor costs.

Pharmaceuticals: Regulatory changes to the process of patent approvals could slow the pace of drug approvals in both the UK and European markets. Additional regulatory hurdles may arise if the UK creates its own regulatory system. Foreign investments may slow until clarity develops.

Auto Manufacturers: We expect a slower pace of investment until trade agreements become clearer. Higher tariffs may be in place until more favorable terms can be agreed upon. Consumer sentiment could impact the pace of car sales.

Europe

Economy

We expect Brexit's negative impact on Europe to be less severe. Overall, UK accounts for just 7% of the region's overall export business, with Ireland (14% of total exports), Netherlands (9%), Belgium (9%) and Germany (8%) having the most exposure. Most economists expect a slight slowdown in the euro area from Brexit, with an impact on the GDP of less than -1%. It likely will come from a spillover effect on euro area confidence and financial markets. The consensus view is that nascent growth in the area will continue and no near-term recession is in the cards.

Monetary Policy

The ECB is expected to express its commitment to price stability and the integrity of the euro currency block. The central bank may cut its policy rates by 0.10%-0.20% (to -0.50% or -0.60%) by the end of the year. It may also extend the deadline of its €80 billion per month asset purchase program from March 2017 to September or December 2017.

EU Politics

Brexit may be a bigger political headache to EU leadership than an economic one. Regardless of its outcome, the EU's long-term viability is at stake. The UK referendum likely energized anti-EU movements in other countries, notably France and Netherlands and raised the risk of 'copycat' referenda. This risk is low in the near term as euroskeptics in these countries are not in power in parliament to initiate the process. We expect EU leadership to express strong commitments to stay together, but will not see concrete steps towards further integration until after the German and French elections next year. Meanwhile, financial markets may be subject to repeat headlines questioning the EU's credibility.

Credit Implications

Expecting a slow negotiating process, we think EU sovereign, financial and corporate credits, being a step removed from the epicenter, to feel less of an impact. This is especially true for euro area banks, which benefit from the ECB's long term refinancing operations (LTRO) program that provides a sufficient liquidity backstop in volatile markets. European banks, while enduring low profitability in a negative interest rate environment, have built strong capital and loss-absorbing debt levels and reduced their trouble assets from the financial crisis. Internationally active banks may incur higher operating expenses and lower UK market making revenue, but we do not expect solvency and liquidity issues directly related to Brexit. Other than specific Irish and Swedish banks, European banks are not overly dependent on revenue from the UK.

Similar to UK-based non-financial corporate credits, we expect large euro area corporate issuers to be relatively insulated from the immediate impact from Brexit.

United States

Other than a change in interest rate expectations and headlines-induced volatility in market liquidity, we think the US impact from Brexit is more muted than Europe.

Economy

The strengthening dollar against the sterling and the euro is the expected economic impact, not unlike the impact from the 2011 euro zone debt crisis and the 2015 Chinese RMB devaluation. As an example, Deutsche Bank economist Torsten Slok estimated with the Fed's own projection tool that a 10% gain in the trade-weighted value of the dollar for one year would lower US growth by 0.4%, and by 1.5% over three years.

US economic activity showed signs of slowing momentum before the Brexit vote, seen in an inventory buildup, slowing durable goods sales, and subpar growth in nonfarm payrolls. These factors partially gave the Fed reason to not follow through with the projection disclosed at its December 2015 meeting of four interest rate hikes in 2016. Brexit likely will reduce corporate earnings from multinational firms, but should not materially change the trajectory of economic growth for the rest of the year.

Monetary Policy

The June 2016 FOMC statement communicated the Fed's hesitance to raise interest rates partly due to the uncertainty surrounding the Brexit vote. Economists now largely expect the Fed to raise rates once in 2016 at the most, instead of two hikes implied in the summary of economic projections accompanying the June FOMC meeting. As of June 29, the fed funds futures market places less than 50% chance of a rate hike through the end of 2017.

Credit Implication

As of 2015, EU exports account for 18% of total US exported goods and services, of which UK accounts for 3.7%. While the UK number is not insignificant, the timing of the EU separation should greatly reduce the potential impact on corporate earnings in the non-financial sectors. We, therefore, think US impact falls mostly on internationally active US banks.

As widely reported, large US banks have significant UK presence as part of their passporting strategy in establishing the UK as their EU operations headquarters. Brexit could reduce EU markets' related revenue for the banks and increase uncertainty regarding future business strategies and licensing requirements in the region.

However, this impact should be moderate as the banks also maintain a presence in other parts of the EU through various subsidiaries. Many banks also developed contingency plans leading up to the Brexit vote. Again, we expect Brexit to be a profitability issue for US-based banks, especially given the fact that US capital and liquidity requirements for internationally active banks are stricter than prescribed by the internationally accepted Basel Accord. Increased foreign exchange and bond market volatility could actually increase revenue for market makers, although corporate issuance and mergers & acquisitions activity may decline.

Money Markets

Developments in the money markets are of particular interest to institutional cash investors. The immediate market reaction to Brexit in the US market is the reduction of yield in Treasury bills and increased usage of the Fed's reverse repo facility (RRP). At the same time, both tri-party and inter-dealer repo rates spiked, suggesting the market's reluctance to lend to financial intermediaries. While the longer end of the treasury yield curve flattened, higher LIBOR rates resulted in a steeper short-term credit yield curve.

Given near-term uncertainty of the UK-EU negotiation and the potential spillover effect, we expect less appetite from US money market funds for commercial paper debt and certificates of deposits issued by institutions domiciled in the UK and, to a lesser extent, the EU. This reduction is on top of the already reduced appetite for non-government issuers as the October money market fund reform deadline approaches.

How US-based Institutional Cash Investors Should Cope

After the initial shock, global financial markets appear to have calmed down in recent days. As leaders from the UK and EU are digging in their heels, we expect the separation to be a long and drawn out one. Immigration and trade issues also will linger in other EU countries. We leave our readers managing intuitional cash portfolios with the following takeaways:

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About Us

Capital Advisors Group, Inc. is an independent investment advisor specializing in institutional cash investments, risk management, and debt financing.

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