Global Asset Management

BlueBay Asset Management

‘Brexit’ Fears Weigh on UK Corporates Credit

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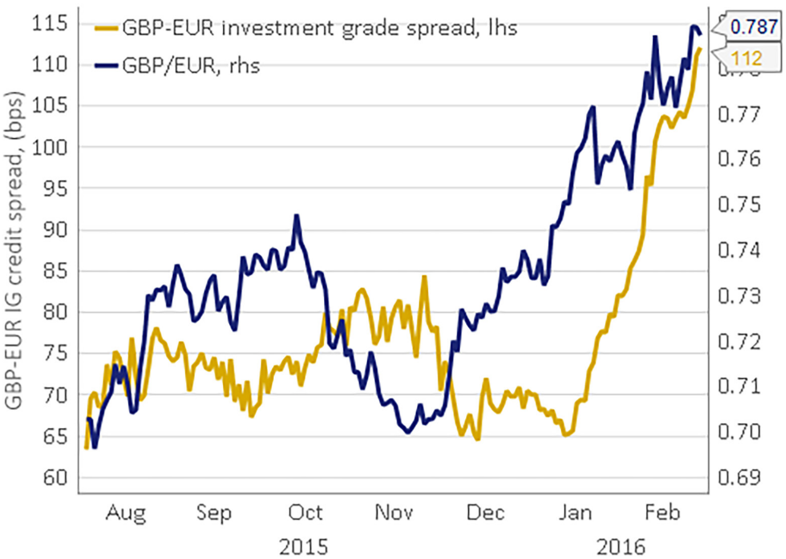
Both Sterling and Credit Markets are Responding to the Risk of ‘Brexit’; with the GBP ‘Credit Premium’ Increasing, how might International Investors Respond?

The British pound (GBP) is not the only casualty of the uncertainty associated by the UK’s looming referendum on whether to remain or leave the European Union (‘Brexit’). Credit markets are also starting to respond to the risk of ‘Brexit’ with the credit spread on GBP corporate credit increasing relative to euro-denominated credit. In our opinion, the transitional costs and uncertainty associated with ‘Brexit’ and heightened political risk premiums will have an adverse impact on European as well as UK assets in the event that the UK votes to leave the European Union on the 23 June.

Spreads on GBP company debt are typically wider than euro-denominated debt reflecting the much greater depth and breadth of the European corporate bond market. But since the middle of January, credit spreads on GBP investment-grade-rated company bonds have increased by more than 40 basis points (bps) relative to euro-denominated corporate credit (GBP high yield has also underperformed, though less notably perhaps because of less exposure to the financial sector). As highlighted in the chart below, the more than fifty percent increase in the GBP ‘credit premium’ has coincided with the weakening in the value of the pound versus the euro. We believe international investors are likely to be increasingly wary of sterling assets, including corporate credit, as the referendum approaches and if the opinion polls suggest that a vote to leave is likely.

GBP-EUR Investment Grade Credit Spread (bps)



Data source: Bloomberg; Macrobond data as at 26/02/2016

In the short-to-medium-term, most economists believe that ‘Brexit’ would damage the UK economy (the conclusion of almost three-quarters of economists polled by the Financial Times, including yours truly). This is in part because of the negative impact on investment and consumer spending associated with the potentially prolonged renegotiation of the UK’s trade and commercial relationships with its largest export market, especially if accompanied by a dramatic depreciation of sterling. For the heavily-regulated financial sector, uncertainty over the potential changes in regulatory regime and ability to continue to ‘passport’ services into the EU could prove especially concerning.

In our opinion, political risk premium on other European assets would also likely rise in the event that the UK chooses to leave the European Union. The cohesion of the EU is under severe strain from the migrant crisis and ‘Brexit’ could further boost anti-EU (and euro) political movements across the continent. And if the economists are correct that at least in the short-term the effect on the UK economy would be negative, EU growth would also suffer.

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