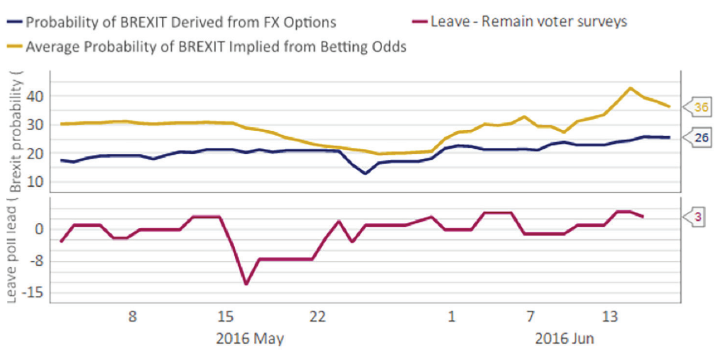
Credit Market Sensitivity to Brexit Risk

June 20, 2016

On Thursday (23 June), the UK will vote to decide whether it wishes to remain or leave the European Union with potentially profound consequences for the United Kingdom as well as for the rest of Europe. The focus of this Insight however is on the potential near-term implications for fixed-income and especially credit markets in the event that the UK votes to Leave or Remain (the latter is our base-case).

From the middle to the end of May, the probability of Brexit implied by betting odds declined by approximately 10 percentage points (pps) from 30% to 20% and in the first half of June rose by 20 pps to a peak of 40% on 14 June (see Exhibit 1).

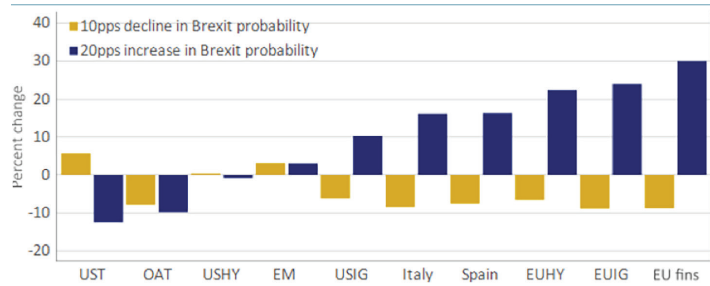
Exhibit 1
Implied Brexit Probability & Poll Lead for Leave



Source: Bloomberg; data at 17/06/2016, 17/06/2016, 15/06/2016

Exhibit 2 compares the percentage change in the spreads on credit derivative indices as well as 'core' 10-year bond yields over the period that Brexit probability declined by 10pps and subsequently increased by 20pps. The change in the French rather than German 10-year bond yield is shown simply because of the sheer scale of the percent decline in the latter as the yield fell from 17bps to less than zero during the period associated with a marked rise in Brexit probability.

Exhibit 2
Shifts in Brexit Risk - Credit and Fixed Income



Note: UST, OAT and JGB are 10-year government bond yields for U.S., France and Japan respectively; Italy and Spain is the spread of Italian and Spanish 10-year bond yields over German 10-year bond yield. EM, EUIG, EU HY, EUIG, EUHY and EU financials is the spread on Markit CDS indices for emerging markets, European investment grade, European high yield and European senior financial bonds respectively. The period of 10pps decline in Brexit probability is from 10 May to 27 May and 20pp increase in Brexit probability from 30 May to 14 June.

Source: Bloomberg; Macrobond; last data point at 14 June 2016

This simple analysis does not take account of other developments that have influenced the behaviour of investors over this period, including the weaker than expected U.S. jobs report and expectations regarding the Spanish general election next weekend. Nonetheless, the results confirm our current assessment and expert judgement regarding the potential near-term implications of the UK's EU referendum.

In terms of risk assets (equity and credit), the more 'distant' from Europe, the less sensitive to Brexit risk. In particular emerging market (EM) assets – equity as well as credit - in aggregate have been the least sensitive to Brexit risk while European bank, corporate and sovereign 'peripheral' credit appears to be the most sensitive. The recent fall in the US Treasury 10-year bond yield has also coincided with the rise in Brexit risk, though half the decline can be attributed to the weaker than expected US jobs report on the 3rd June.

The sensitivity of liquid credit derivative indices such as the Markit iTraxx Europe (or 'Main') credit default swap (CDS) index of 125 European investment-grade rated companies (EUIG) and CDS index of European senior financial bonds (EU fins) also appears to be asymmetric; spreads widened *proportionally* more in response to rising Brexit probabilities than they have narrowed during the period when Brexit risk declined. In our opinion this is likely to reflect hedging behaviour by credit investors suggesting that in the event of a Remain vote by the UK, the liquid derivative credit indices could tighten by more than many anticipate as hedges are unwound. Peripheral sovereign credit spreads would also likely narrow significantly especially if German bund yields, at least in the short-term, move higher.

A vote by the UK to leave the European Union will very likely trigger a 'risk-off' episode in global financial markets. 'Safe haven' assets such as core government bonds, the U.S. dollar, Japanese yen and Swiss franc will rally while risk assets and the Euro (and of course the British pound) will suffer. The near as well as medium-term outlook for UK sterling assets to the outcome of the EU referendum is further complicated by what is likely to be heightened political and economic uncertainty irrespective of whether the vote is for Leave or Remain.

The severity and persistence of a risk-off episode in the event of Brexit will in large part depend on the response of international policy-makers. If as we expect there is a timely response – political and financial – by European policy-makers to a Leave vote, the widening in peripheral sovereign credit spread will prove less dramatic than many commentators predict (though the evolution of periphery spreads will also be influenced by the outcome of the Spanish general election on Sunday 26th June). Moreover, the U.S. Federal Reserve is likely to defer future interest rate increases and the Bank of Japan and other central banks may implement additional easing measures. Higher quality corporate credit and emerging market debt would in our opinion benefit the most from additional central bank easing. Nonetheless, a Brexit vote would further heighten investor disquiet surrounding the perception of rising political risk, especially in the developed world.