CIO Note

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Chief Investment Office WM

The UK votes to leave the EU

In short

UK voters have chosen to leave the EU. It looks likely that the "leave" campaign will have secured 52% of the vote once the final count is in, whereas the percentage for remaining in the EU may stand at 48%.

The result will likely surprise markets, since polling momentum had shifted back in favor of the "remain" campaign in the last days of campaigning. And up until voting day itself, betting markets had ascribed just a 25% chance of a UK decision to exit the EU.

Initial reaction in global markets

Uncertainty over the implications of a "leave" decision for the UK and for the global economy spilled over into heightened volatility in global asset prices in Asian trading.

As we anticipated in our *Risk Radar Special: UK referendum & related investment ideas* of 2 June, the British pound has declined against the Swiss franc and Japanese yen, falling 8.5% and 15% respectively. The pound dropped 10% against the US dollar, to its lowest level in more than 30 year. The euro reacted to greater expectations of further European Central Bank (ECB) easing, by falling 3.6% against the US dollar and 1.9% against the Swiss franc.

Equity markets in Asia fell after the vote's outcome – Japanese stocks are down 6.5% at the time of writing. As we go to print, UK equity futures indicate the market will open sharply down, by 7%. US stock futures suggest 4.6% declines on Wall Street.

Global sovereign bonds have rallied in response to the referendum result – US 10-yr Treasury yields are down 24bps on the day, trading at a yield of 1.5%.

What to watch next?

Liquidity may be thin and volatility high in the immediate aftermath of the result. It may be several days before markets settle.

We would look to global policy makers and central bankers to issue statements over the coming hours and days. There is a strong likelihood of coordinated central bank action to support liquidity, including the provision of foreign currency swap lines. In the weeks ahead, we also expect the first steps in the early negotiations of a UK exit from the EU. A two-day EU Leaders' Summit starting on 28 June may provide some early clues as to the approach of European nations to the UK decision. Indications that EU Leaders propose to adopt a tough negotiating stance could unsettle markets. While the UK vote may give encouragement to anti-EU groups in other nations, our European economists do not expect any further referenda of EU membership in the short term, given a lack of necessary majorities.

In the near term, investors should pay close attention to domestic political developments in the UK, including any formal announcement (or indications on the timing) of a wish to leave the EU (invoking Article 50 of the Lisbon Treaty). Significant announcements could also include statements from UK Prime Minister David Cameron, and the initial official response to the vote from the EU. For more information on the potential uncertainties that the UK is likely to face, please see the latest report from our UK colleagues, *UK economy: Referendum on EU membership – the UK votes to leave the European Union*.

Market and portfolio implications

It is likely that European and US markets will open with a "risk-off" tone in response to the referendum result. Furthermore, we expect asset prices to be volatile, and liquidity in some markets may be significantly reduced, leading to potential market dislocations and price gaps.

UK companies and sectors most closely leveraged to the domestic economy (such as financials, consumer discretionary, and the FTSE 250 mid-cap index) should continue their pre-referendum underperformance, versus defensive names and international firms that benefit from a weaker pound. Increased uncertainty may lead to declines in Eurozone equities too, with financials likely to be hardest hit if they have significant UK exposure or large operations in London.

Euro-denominated high yield debt is likely to decline when the market opens, due to risk aversion. However, we would still expect the asset class to generate positive total returns over our six-month tactical time horizon. The euro high yield index's weight to UK issuers is only around 10%, so the direct fundamental impact should be limited.

Given considerable uncertainties, we refrain from making any changes to our tactical asset allocations at this stage. By constructing diversified multi-asset portfolios and using robust risk management tools, we have sought to mitigate risks from events such as the UK referendum. Therefore, we would encourage investors who follow this method of investing not to abandon their strategy, nor sell down risk assets in a time of heightened market volatility and lower-than-average liquidity.

We are committed to keeping you updated on the implications of the UK's decision to leave the EU throughout the day. We will publish a fuller *CIO Note* toward the end of the European trading session, outlining the day's developments in more detail and discussing the short and long-term implications for asset markets.

Should you have any comments or questions, please email ubs-cio-wm@ubs.com.

Best,

Mark Haefele

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