26 April 2016

ETF Securities FX Research:
EU referendum unveils Sterling opportunity

Summary

- Gambling odds turn favourable for the ‘remain’ camp as political polls show tight referendum result.
- Adverse economic impact is expected to outweigh regulatory and fiscal benefits of the UK leaving the EU.
- Pessimistic sentiment is at the highest level on record in the FX options market for EUR/GBP. GBP should rebound.

Sentiment turning

According to the latest polls, the gap has narrowed over the past few months in favour of Britain leaving the EU.

The current polling suggests that around 44% of voters will support staying in the EU, with 42% in the ‘leave’ camp, leaving a significant undecided proportion. According to the website oddschecker, the referendum result is likely to be more stark than current polling indicates. Current betting odds across a number of online gambling sites suggest 78% of gamblers are expecting Britain to stay in the EU.

However, phone and online polling have seen diverging trends in recent weeks. Evidence indicates that when voting intentions are measured and there isn’t a ‘don’t know’ option, most undecided voters will choose the status quo, in this instance, for Britain to remain in the EU. Most internet polls have as a standard option, a ‘don’t know category and that is partially to blame for the divergence in views between internet and phone polls. While phone polls show a generally larger divide between the two camps (in favour of ‘remain’), recent evidence has been showing that the gap is narrowing between the ‘remain’ and ‘leave’ alternatives.

Will history repeat itself?

In 1975, UK voters were given the choice to stay or leave the European Economic Community. Voters were faced with the question, "Do you think the UK should stay in the European Community (Common Market)?". The 2016 question is very similar: “Should the United Kingdom remain a member of the European Union or leave the European Union?”

In 1975, the final result showed that there was 67% support from voters for staying in the EC, in line with current estimates ‘remain’ campaign.

Economic impact

The Bank of England have also weighed in on the June 23 vote, noting that growth could be impacted in the near-term. The central bank notes that ‘uncertainty relating to the EU referendum has begun to weigh on certain areas of activity’ with ‘capital expenditure and commercial property transactions...being postponed pending the outcome of the vote.’ The IMF has also indicated that a ‘leave’ vote would be damaging, with its chief economist stating that ‘a Brexit could do severe regional and global damage by disrupting established trading relationships.’

According to a poll by Greenberg Quinlan Rosner, the three most important issues for voters are the economy, immigration and the control of our (UK) laws. While the ‘leave’ camp appears mostly concerned with either burgeoning regulatory framework or immigration, financial markets are focussed on the adverse impact on growth via the external account. The European Union accounts for 45% of UK exports and 53% of its imports. Although the UK has a two year window to re-negotiate trade deals, bureaucrats generally move at snail’s pace. Such a timeframe seems a very tight window for a major project, with government efficiency growth very close to zero. US President Obama has indicated that a trade deal with the US could take as long as 5-10 years to reach agreement and

Investments may go up or down in value and you may lose some or all of the amount invested. Past performance does not guarantee future results.
that the UK would ‘move to the back of the [negotiating] queue’. Such comments highlight strong global concerns over the potentially adverse impact on financial stability.

There are modest fiscal benefits expected from not contributing to the EU budget if the UK leaves the EU. Depending on the final relationship of Britain and the EU, the Centre for Economic Policy Research calculates a best case scenario of a 0.31% saving in per capita income, not enough to offset the negative trade effects contributing to a decline of almost 3% in incomes.

However, any fiscal benefit could be offset by the need to create new administration regarding implementation of new domestic regulation and trade agreements.

HRM Treasury’s own calculations indicate that the UK would be between 3.4% and 9.5% of GDP better off remaining inside the EU within 15 years. The wide dispersion of the GDP range depends on the eventual structure of trade that Britain would adopt with the EU if it left the economic union.

Several economic consultancies have calculated the potential impact should voters decide to leave the European Union. On average a result of a leave vote is expected to make Britain worse off by between 0.1% and 5.5%.1

What’s the FX market saying?

Against the USD, GBP recently has experienced a modest bounce from multi-year lows. Against the Euro, GBP is hovering at the weakest level in the past 12 months. Negative sentiment is priced in as volatility has weighed on GBP.

Options market pricing is indicating that bearishness is at the highest levels in over a decade for GBP against the Euro.

Volatility is the status quo

Where to next for GBP?

With so many voters as yet to decide which way to vote, volatility will remain elevated for GBP crosses and will likely keep the pound under some pressure against major currencies. However, such depressed levels of GBP opens up buying opportunities in the medium term as uncertainty fades.

Historically, steep falls in the Pound have presaged strong rebounds. The subsidence of volatility following the financial crisis and the Scottish referendum, led to strong gains for GBP against the Euro. In the four months after the financial crisis, GBP rallied 4.3% against the Euro. Indeed, we expect that the EUR/GBP is the more favourable cross to implement views of Britain remaining within the EU, with the US expected to tighten rates further in 2016 and the ECB keeping the Euro weak with aggressive policy stimulus.