

## Brexit Aftermath: Impact and Implications



All examples in this report are hypothetical interpretations of situations and are used for explanation purposes only. The views in this report reflect solely those of the authors and not necessarily those of CME Group or its affiliated institutions. This report and the information herein should not be considered investment advice or the results of actual market experience.

Markets have reacted in much the way that we had expected in the first 18 hours after Britain's historic vote to leave the European Union. European stocks initially fell 5-10% before rebounding, the pound is off 8%, dragging other currencies (except the yen) down versus the U.S. dollar, gold has risen past \$1,300 an ounce while the 10-year U.S. Treasury is moving towards its 2013 yield low of 1.38%.

### Next Step: CALM DOWN.

Based on observations in options market, we are probably past the peak in volatility on most assets. That said, the "Leave" vote leaves numerous uncertainties in its wake, including the future of the United Kingdom, the European Union and their bilateral relationship. The "Leave" victory might lead to a structurally higher level of volatility in FX and equity markets than would have been the case under a "Remain" win.

### What Might Happen Next

- 1) Investors will reassess the GBPEUR exchange rate. Should the pound have fallen versus the euro? The U.K. has lower unemployment, higher inflation and a smaller output gap than the Eurozone. Moreover, the U.K. has been doing a better job of deleveraging post-crisis than the Eurozone. If it weren't for the uncertainty surrounding the referendum and the U.K.'s departure from the EU, the Bank of England (BoE) would probably be thinking about hiking rates, and we would likely be seeing a stronger pound.

For the euro, on the other hand, the referendum's outcome is an unmitigated disaster. It shows that it's possible to leave the EU, and that other countries might be tempted to follow suit. The nations that are the most likely to leave, in the short term, may not be the economically distressed countries like Greece (though that is possible), but rather the fairly robust countries like the Netherlands, Denmark and Sweden, which don't use the euro, could also find themselves tempted to leave.

Watch out though for the pound to re-test its lows. Markets have historically revisited and retested intraday lows. For the pound, this is 1.32 versus USD.

- 2) Interest rates: the Federal Reserve (Fed) probably won't hike rates in 2016, but Fed Funds Futures are no longer fully pricing rate hikes for 2017 either. Is this rational? Will the Brexit vote have any material impact on the U.S. economy? It's doubtful. If the Fed won't hike rates because the S&P has one 3-4% intraday drop in a year, they'll never hike again. If the S&P 500® rebounds and if we get a more solid employment report for June (a distinct possibility), U.S. interest rate markets might begin to re-price the probability of rate hikes – maybe not in 2016 but probably for 2017. The U.S. 10-year Treasury will likely run into strong resistance at around 1.38% yield, and might be vulnerable to a summertime selloff.
- 3) Based on observations in options markets, implied volatility may be in the process of peaking, overall,

across many asset classes as realized volatility may have reached or past its crescendo. The one instrument that is especially concerning though is the euro, where implied volatility may not reflect the true risks.

- 4) Commodities: there are plenty of reasons to be bearish on commodities -- inventories are continuing to grow for crude oil on a seasonally-adjusted basis, La Nina is typically bearish for agriculture, China might continue to slow, which would be negative for industrial metals, etc., but the immediate impact of the higher dollar, which sent most commodity prices lower overnight, is probably over for the moment. Commodities might find some near-term support before resuming their normal course.
- 5) Gold: One of the rare commodities (along with silver and platinum) that rallied. Is Brexit really good news for gold? It certainly was overnight but I'd argue that it's not good news to have gold at over \$1,300 an ounce because it makes most mining activity highly profitable again, which could boost supply later this year and next year, eventually putting downward pressure on the metal. Moreover, any rebound in U.S. rate hike expectations could be highly bearish for the yellow metal. On the flip side, concerns of a EU break up may push the European Central Bank (ECB) to move further into negative rate territory. This would be positive for gold. If the ECB, however, were to back away from negative rates, the bull market for gold could come to an end and this goose's golden eggs would be scrambled.

**To read more economic research reports like this one or subscribe to the mailing list, visit [cme.com/research](http://cme.com/research).**