Brexit – Prepare for the worst hope for the best

Brexit has become a must-watch TV event. Millions in the U.K. and around the world are tuning in to proceedings of the House of Commons and the Supreme Court. And yet, the plot so far feels strangely familiar from your average online streaming series. Tension builds up, resulting in a clash. But before anything meaningful happens, the episode ends and you find yourself left puzzled what just happened. Cliffhanger. To be continued in the next episode.

With so much uncertainty, it is no wonder that markets are nervous. A combined signal of the sentiment from equity and bond markets is expressed in Figure 1 by the panic indicator we generate at DWS. The average value of the index over the recent weeks exceeds the levels seen at the Brexit referendum, mainly driven by a sharp decline in the yields on U.K. gilts.

Dr. Dennis Hänsel
Head Investment Advisory EMEA
dennis.haensel@dws.com

Niklas Heidenreich
Investment Advisory
niklas.heidenreich@dws.com
Multinational companies too are anxiously preparing for major economic disruptions. Domino’s Pizza Group, a restaurant chain, announced in the beginning of August it has spent GBP 7m on stockpiling ingredients including tomato sauce for its UK restaurants. “Tomayto, tomahto”, is also what equity markets used to say about U.K. stocks, echoing the famous song by Louis Armstrong and treating them as not all that different from European stocks more broadly. Figure 2 shows that this has changed dramatically since 2016, when UK stocks decoupled from European equity markets in the aftermath of the referendum.

The UK market has drifted apart from its European counterparts. The results mark the opposite of the well-known phenomenon of increasing correlations across national stock markets in times of a global financial crisis. Markets have, in other words, treated Brexit uncertainty as a U.K. specific risk. That is even more evident if you look at currency markets. Sterling increasingly acts as a key indicator for the market uncertainty around Brexit fears. A measurement of market uncertainty is the implied volatility retrieved from the option market. The left hand sided graph of Figure 3 shows the development of implied volatility on pound versus euro spot rate. Even though there is a surge in recent time, the implied volatility is historically still at moderate levels.

As a result, the comparison of pound currency and non-pound currency crosses in the table on the right hand side in Figure 3 shows heightened volatility for all three selected FX crosses including GBP (vs. EUR, USD and CHF). On the other hand, the selected non-pound FX crosses show implied volatilities of about half of the value seen for pound crosses. Therefore, hedging costs for pound sterling appear moderate based on historical levels, but emerge as expensive relative to other currencies.
All of which raises questions for asset allocators, which range from quite basic to pretty fundamental. At the most basic level, how much UK exposure do you really have in your portfolio? The answer might be less obvious than you think, once you look beyond the company’s headquarter location and consider the true exposures along its supply chain.

More fundamentally, are markets right to treat Brexit uncertainty as a U.K. specific risk? As the economist Frank Knight pointed out almost 100 years ago, there is a big difference between risks of the sort that you can measure, quantify and prepare for, and uncertainty, reflecting the essential unpredictability of future events. To us, it seems like Brexit firmly belongs to the second category. After years of globalization and integrating supply chains, a country’s disintegration from an area it has close economic ties with is novel and marks a structural break. But aren’t there already echoes of the same political and socio-economic processes that caused Brexit in other countries? And if so, might it not turn out that with the benefit of hindsight, U.K. assets could prove among the safer places to hide from coming political storms? After all, their valuations are already quite depressed. Clearly, there is plenty to discuss!