

## Market Update

June 22, 2016

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## Brexit: What Cash Investors Need to Know

### Introduction

There has been an increasing amount of coverage in the financial news media recently about the United Kingdom's upcoming referendum regarding membership in the European Union (EU). On Thursday, British citizens will vote on the question: "Should the United Kingdom remain a member of the European Union or leave the European Union?" Should the Leave decision win, this would set in motion the scenario commonly referred to in the media as Brexit. We wanted to take this chance to explain our views on this issue and how it might affect your portfolio.

### To Leave or Remain

It is still uncertain at this point whether Leave or Remain will prevail in the referendum. In polls conducted over the past several months, Leave and Remain have generally received about equal levels of support, usually only separated by a percentage point or two. In the past few days, polls have shown that Remain has pulled to a slight lead of about one percentage point. These polls may not be indicative of the final result: about 10-15% of voters still report as undecided, although evidence from other referenda around the world suggests that voters who make their decision at the last minute are most likely to support the status quo – in this case, Remain. Aside from polls, we can also look at the odds offered by betting houses and back out the implied probability of Brexit. The website Oddschecker, which aggregates the current odds available at over 20 different gambling outlets, has shown in recent days that bettors assign a 65-75% chance of Remain winning the referendum. This percentage has fallen in the past few days from the 70-80% range, following the pattern shown by the poll results. What conclusion can we draw? Both Leave and Remain are real possibilities, with Remain appearing to be the favorite.

If the Remain camp should win, we expect the markets to breathe a sigh of relief. It is unlikely this result would cause disruptions to market liquidity. If the Leave camp should win, things may become a bit more complicated. The process of withdrawing from the European Union is outlined in Article 50 of the Treaty of Lisbon, which sets forth the legal structure and functions of the EU. Article 50 states that a country which intends to withdraw from the EU must give notification to the European Council. From the time this notification is given, there is a two-year period during which all of the provisions of currently signed treaties will still apply. This means that the UK will be treated as though it is still a member of the EU for two years, during which time the country will have to renegotiate the nature of its relationship with the EU. This renegotiation will include defining how trade policies, immigration policies, and regulatory policies will be structured. The UK will also have to negotiate new deals with its trade partners outside of the EU, which it currently trades with under terms negotiated by the EU as a bloc.

**Micro and Macro Considerations**

The credit strength of companies located in the UK should not immediately deteriorate as a result of a Brexit vote. The two-year window outlined in Article 50 will allow business conducted between the UK and the EU to continue as usual during this time. In the longer run, we think the outlook is less clear. If the new terms of the UK's relationship with the EU are not favorable to international companies operating out of the UK, we expect these companies would shift many of their employees out of the UK, which could be damaging to the UK's economy. This risk is especially high in the financial services sector, as many large companies use London as their base for doing business with all of Europe.

The macro considerations of a Brexit are harder to predict, although it is likely that markets will have a strong reaction. Any increase in uncertainty and volatility in markets could also provide further reason for the Federal Reserve to put off any additional rate hikes in the U.S. If increased volatility reduces market liquidity, companies with significant cash withdrawal needs from their portfolios may wish to shift their positioning to stay liquid, as needed. Given that the implementation of money market fund reform is also on the horizon, it may pay to be conservative in this environment.

**Conclusion**

To summarize, over the next few days this referendum will be front page news. Should the Leave camp win the referendum, markets may have a strong negative reaction, but the creditworthiness of individual credits will not likely immediately deteriorate, since the business environment in the UK and the EU will not immediately change. Nevertheless, a conservative approach may be prudent in the event that markets become volatile or less liquid.

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