MARKET VOICE

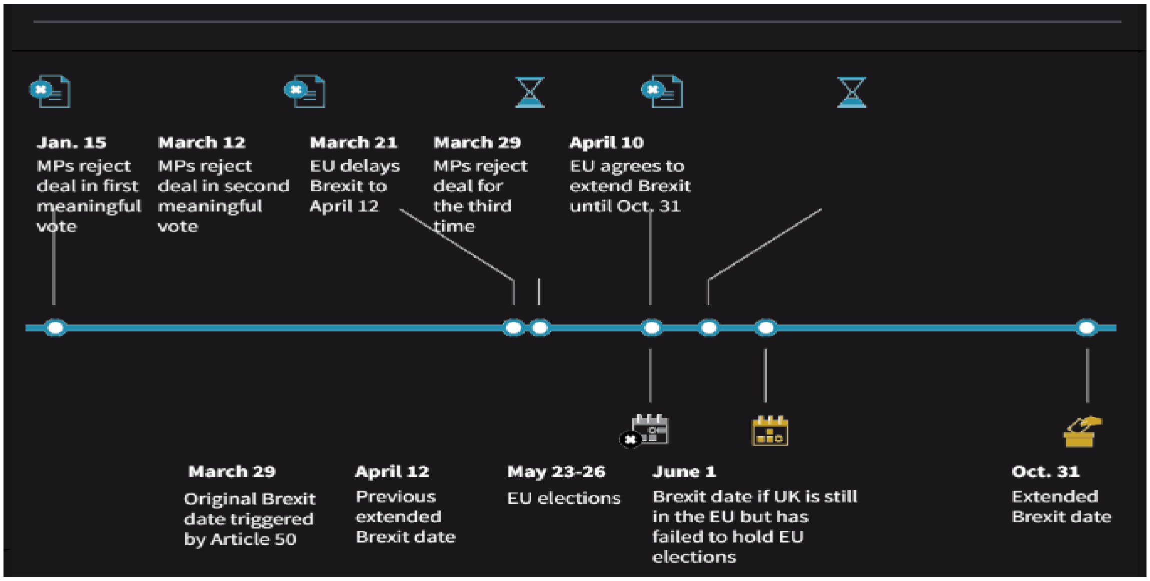
April 2019

The Brexit pause that does not refresh

Two months ago, the Market Voice considered what seemed like an imminent no-deal Brexit risk as the March deadline was approaching. The deadline turned out to be non-binding as all parties agreed to a one-month postponement and agreed last week to yet another postponement to October 31st. There is no guarantee of when Brexit will occur, if all parties – i.e., all European Union governments – agree, the rules do not limit the number or length of postponements.

UK Prime Minister May is now in negotiations with the opposition Labour Party to build majority support for a Brexit deal. As shown in the timeline taken from the Brexit page in Eikon (search ‘BREXIT’ on Eikon) the deadline is now October 31st, but PM May is hoping to have a deal in place by June, so the UK can avoid the need to participate in EU elections and still have an orderly Brexit departure. There are no current plans for a second Brexit referendum but that could change so the outlook and timing of Brexit has become even murkier with this most recent delay.

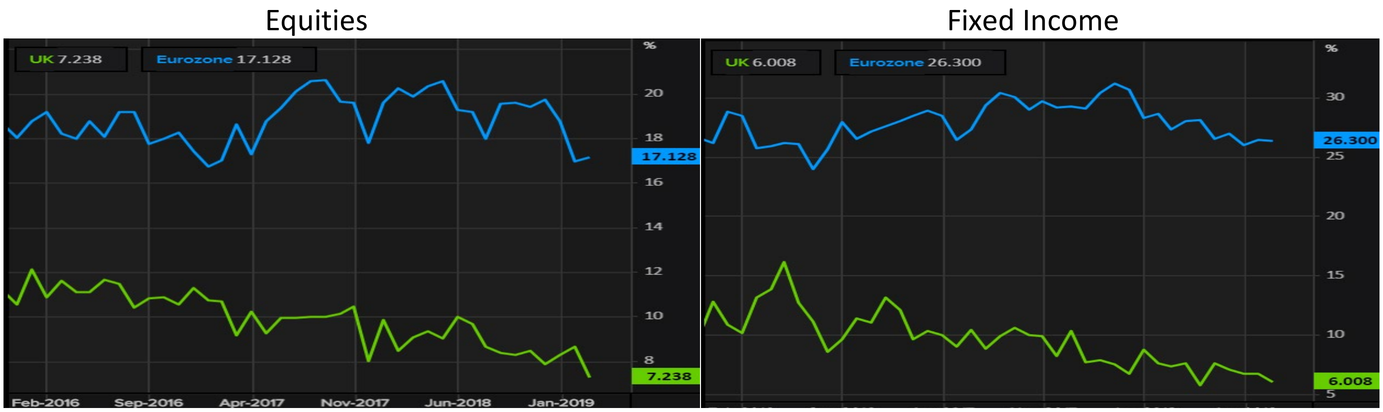
Figure 1: Brexit Timeline



Source: Eikon

There have been negative consequences for the UK from the ongoing uncertainty on the timing and form of Brexit. The Eikon Portfolio Allocation App (search ‘AAP’ on Eikon) provides the results of a monthly survey on allocations across asset type and geography. The charts below are extracted from the app and show the surveyed indications for global allocations to the UK and EUR area bond and stock markets over the past two years. While the percentage of global allocations to Europe's stock and bond markets remained flat, the UK saw steady declines in surveyed allocations in both markets – and particularly to equities. While cause and affect remain moot, it is reasonable to blame Brexit for this divergence, especially as economic and interest rate performance have not significantly diverged in the two regions.

Figure 2: Monthly Survey of Portfolio Exposure to UK and Europe



Source: Eikon

The Eikon Global Fund Flows App which shows net flow of investor funds across the globe suggests portfolio managers are not just talking the talk in the survey data but also walking the walk. Over the past year, the UK has seen a substantial (dark red) net outflow of investment funds while most of continental Europe has experienced inflows. Italy is a notable exception likely reflecting growing concerns on the ability of the government to continue servicing the large and rapidly growing sovereign debt burden – an intended focus of a future Market Voice. Again, the cause remains moot, but we believe the outflow from the UK is at least in part a by-product of concerns of the potential disruptions from Brexit.

Figure 3: Net 1-Year Cross-Border Flow of Funds by Country (Red is and Outflow)

Source: Eikon

Reflections of Brexit in the Market

There is a lot of anecdotal evidence that companies in the UK and Europe are taking defensive action – mostly stockpiling – to protect against potential Brexit-related trade disruptions but it is hard to detect the impact in market performance. While UK equities underperformed in the US market, they paralleled the German market, so it seems macroeconomic forces continue to dominate equity pricing. Bond markets are the mirror image with parallel outperformance in the UK and Germany vs. the US market.

The chart below shows one place where the negative pricing impact of Brexit is manifest – the sovereign default market. Prior to the UK referendum on Brexit, the credit default spread (CDS) on 10Y gilts was roughly in line with US and German levels. The UK spread initially surged in the wake of the 'yes' vote but then gradually recovered as the UK and Europe seemed to be working toward an orderly UK exit. But the UK CDS has widened out again in recent months and, at least so far, has not seemed to get much benefit from the postponement to October.

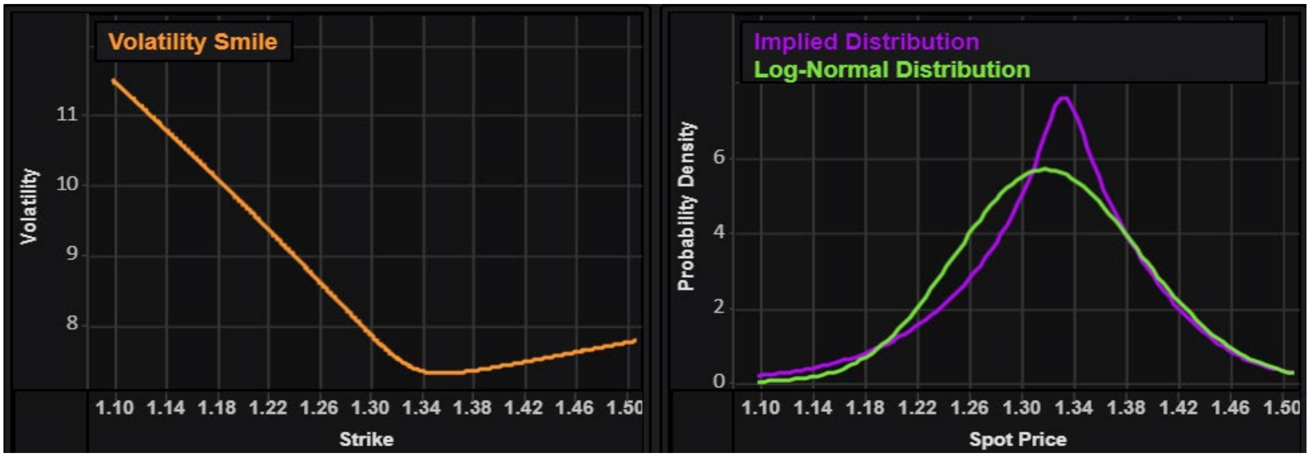
Figure 4: 10Y Sovereign CDS Spread

Source: Eikon

The implied volatility markets are only selectively pricing in potential Brexit stress. The chart to the left below from the Eikon FX Volatility Explorer App (search 'FXVE' on Eikon) shows the implied volatility "smile" for 6M GBPUSD options – just ahead of the new October deadline. The smile represents the rise in implied volatility for both call and put options as the strike moves out of the money – e.g., away from the forward rate. The smile is more of a smirk with a much steeper slope for downside strikes; the implication is that the market sees more risk of a big GBP decline than a rally. A more nuanced interpretation of the volatility surface is shown with the purple implied probability curve in the right-side chart compared to the green skew-neutral distribution. The elevated narrow peak of the purple curve indicates a high probability of the status-quo – some combination of further delay or a benign Brexit – keeping the GBP rangebound. The "fat tail" to the left indicates market belief that the alternative is a much weaker GBP. Overall the market is pricing a binary world where GBP either stays where it is or is subject to extreme weakness.

The implied probability of a large positive GBP surprise is below neutral, but this seems in line with reality. We believe the market's preferred outcome would be no Brexit, but this outcome would require another referendum which would be a lengthy undertaking and probably require yet more postponement into 2020. In the meantime, the uncertainty of the outcome would overhang the market, making it difficult to see how a highly positive GBP outcome can emerge on a 6M horizon.

Figure 5: The GBPUSD 6M Implied Volatility "Smile" and Implied Probability Distribution



Source: Eikon

As noted, the probability curve implies a high chance that the pound stays close to current levels for the next six months – i.e., until just ahead of the Brexit deadline. We believe this creates a seeming mis-pricing in the volatility market; as was shown in the Chart 1 timeline, there is risk of some turmoil ahead of the EU elections. If Parliament fails to approve an exit plan by mid-May, speculation that they might sit out the elections would cause concern of a June no-deal Brexit.

The table shown below comes from the Currency Performance/Value Tracker which allows users to rank currencies by measures of volatility and carry embedded in the forward curve. In addition to the current spot rate, the table shows 3M (at-the-money) implied volatility and the percentile of this volatility vs. how it traded over the past three years as an indicator of relative expense. The last column shows the 3-year percentile for 3M implied vs. 3M realized volatility to give an indication whether the market is pricing volatility cheaply compared to recent actual performance.

Blue cells denote relatively low numbers and red are relatively high, so despite the possible threat of a June no-deal Brexit, 3M implied vol for GBPUSD, EURUSD and EURGBP are all trading close to, or at, 3-year lows. GBP vs both the USD and EUR vol is also near 3-year lows even compared to where volatility has been realizing. We have also included BRL and TRY vol figures in the table to highlight that the super low GBP and EUR vols are not simply a by-product of super-low vols across the whole currency space. The extremely low implied volatility levels would seem to create an attractive vehicle for investors looking for protection against speculation of a no-deal Brexit occurring in June.

Figure 6: The Value Tracker Assessment of Volatility

MIN MAX

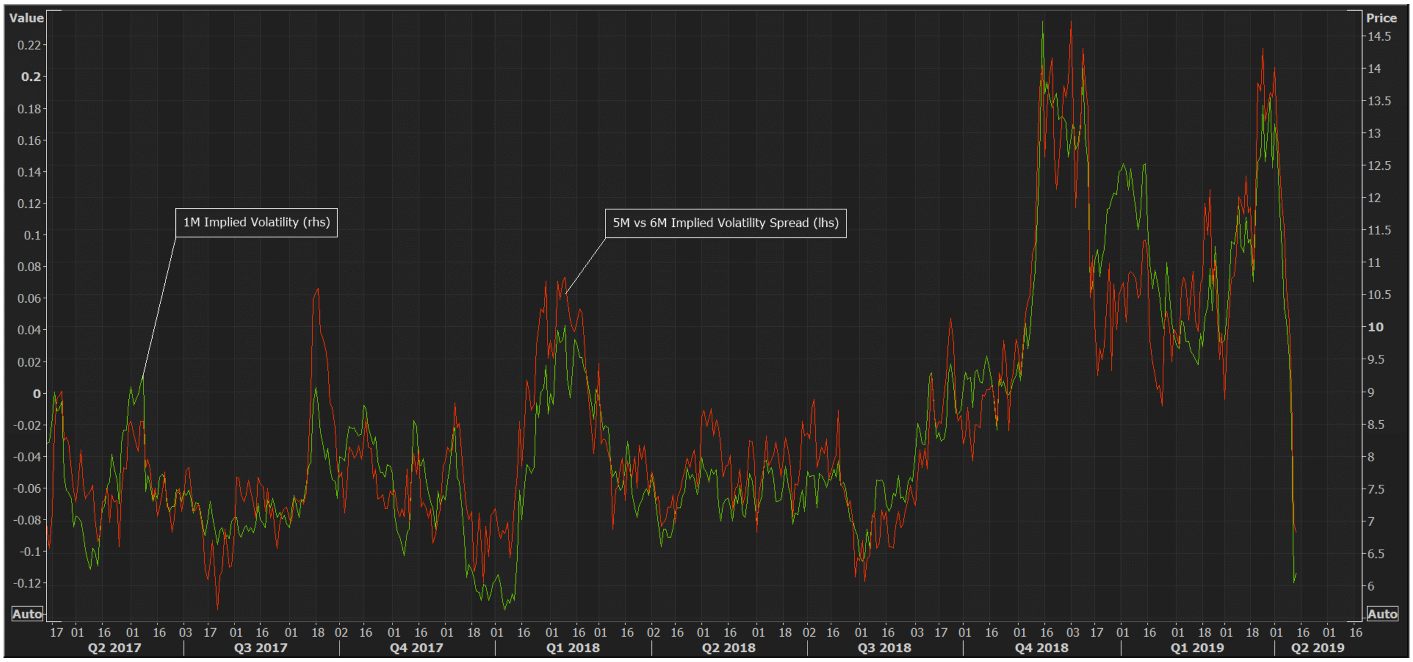
GBPUSD and 4 more

Currency	Spot	3M Implied Vol Value	3M Implied Vol Percentile	3M Implied Vol / Realized Vol Percentile
GBPUSD	1.31	6.85	1.02	8.05
EURUSD	1.13	4.89	0.00	29.50
EURGBP	0.86	5.99	0.00	6.64
USDBRL	3.86	13.37	33.59	18.39
USDTRY	5.74	23.55	93.49	65.52

Source: Eikon

While a 3M option can potentially buy protection through the window of the May European Union elections, there is clear possibility that the UK opts to participate in keeping GBP stable into the end-October window. However, as was the case in the run-up to the 2016 Brexit vote, forward volatility offers an attractive way to hedge against market turmoil ahead of the October deadline. The chart on the next page shows that 1M GBP implied volatility at 6.2% is near the lowest levels since Brexit became an issue. The chart also shows the spread between 5M and 6M implied volatility which gives an indication of the level of 1M implied vol five months forward. While it has moderated, there is still a modest inversion between 5M and 6M implied volatility – 6M vol is 8bps lower – suggesting that forward vol is not being aggressively priced. Indeed, 5-month forward 1M implied vol at 7.0% is above current 1M vol but it is still well below the average levels seen in recent years and very low compared to the double-digit levels that emerged when a no-deal Brexit was an imminent threat. So being long forward vol appears to be an attractive way to get low cost protection for potential fears of an ugly Brexit ahead of the October deadline.

Figure 7: 1M GBP Implied Volatility and the 5M vs 6M Implied Volatility Spread



Source: Eikon

The Bottom Line

The UK and the European Union have manged to kick the Brexit can still further down the road. While the net impact of Brexit on real economic activity remains unclear, there is strong evidence that investors are voting with their feet on UK holdings. There are two key risk windows now forming in the months ahead: late May when failure of the UK to participate in European elections would trigger a disorderly Brexit in June and at the end of October when the most recent postponement expires. Volatility markets are not yet pricing in much volatility around either of these windows making options or volatility swaps a relatively attractive vehicle for hedging Brexit risk.

About the Author

Andrew Hollins is the Director of FX and Corporate Treasury Desktop at Refinitiv and has previously worked in the Financial & Risk business of Thomson Reuters since 2002 in various roles in product development, product management and proposition management.

Prior to this, Andrew was the manager of the Emerging Markets Rates Derivatives desk at Prebon Yamane, London and worked on the Equity Derivatives team at Merrill Lynch in Sydney.

Andrew studied at the University of Leicester and postgraduate at the London School of Economics in the UK.

Send comments or questions on this publication to trading@thomsonreuters.com