



## Brexit shock - our first market thoughts

In a shock result versus yesterday's market expectations, the UK has most likely voted to leave the EU. Here are our initial thoughts:

1. **We think the extreme market reaction in GBP is right.** We have consistently argued that the implications of Brexit for the UK and sterling in particular are very negative given the country's large current account deficit financing needs. A period of exceptional uncertainty now starts for the UK, including a potential leadership battle in the Conservative party, the timing of the trigger of the EU's Article 50, as well as potential Scottish referendum too. Oliver Harvey will provide a more detailed update in an upcoming note. Our GBP/USD forecast was 1.15 for 2017, we now think this will be reached this year. We think GBP/USD is likely to reach 1.30 today. the BoE is very likely to ease policy but the extent will depend on the FX move.
2. **It's all about BTP's and European banks on Friday open.** For the rest of the world the transmission mechanism of Brexit works via Europe and a re-pricing of higher political risk premium. As a result, we think only two key variables will matter as the world wakes up to Brexit: European financials and Italian bonds. The reaction of these assets will be key for the broader market to assess global contagion risks and the follow through in asset prices inclusive of the S&P and Emerging Markets. Our prior is that a combination of resolute ECB action, large and unquantifiable time lags in terms of the political risks and light positioning should mean that the market is more orderly than what is taking place in FX. But this remains to be seen, together with the outcome of the Spanish election this Sunday.
3. **We are bearish EUR/USD but are not changing our forecasts yet.** The Brexit outcome has clear negative medium-term implications for EUR/USD but our forecasts are already bearish and we are keeping them unchanged for now. We expect a move to 1.05 by year-end and 95cents next year. The reasons behind our cautiousness were expressed earlier this week but include a likely repricing of Fed expectations as well as the tendency of the euro to benefit from risk aversion via the repatriation of foreign assets. We will be closely watching the systemic implications of Brexit in coming days and will re-assess our EUR/USD forecasts accordingly.
4. **Goodbye animal spirits.** -Beyond the UK and Europe, the impact of tonight runs beyond the geopolitical implications: yesterday the market was pricing a 90% probability of remain. The surprise of the result and the unpredictability of the political process will impose a big cost on the market's self-confidence, ability and willingness to take risk. In a world already pre-disposed to secular stagnation, the hit to animal spirits and the market's risk-taking capacity will be big.