

# Letter from London: Effects of Brexit on Credit and Fixed Income

Stockholm (HedgeNordic) – It is mid-November in London and Brexit is on everyone's lips but trying to get investment professionals to put their name to a comment predicting the effects on the fixed income and credit markets is like trying to boil the ocean it seems.

Before we get into the specific event risks for credit and fixed income we must briefly talk politics and sterling; both seem equally volatile at the moment

This morning (Nov15) Dominic Raab, the Brexit secretary, resigned and others followed suit, leaving Theresa May's deal in tatters. It resulted in the Sterling initially falling more than 100bps against the dollar and 80 against the Euro leaving market observers to conclude that a no-deal may, after all, be a likely outcome. This has added to not only concerns over UK leaving the EU without a deal but also the stability of the UK government. If the deal fails to go through parliament it could lead to a general election, a new referendum or both.

David Lamb, head of dealing at FOREX specialists Fexco Corporate Payments, likened sterling to a cat on a hot tin roof as leaping to month-highs one day only to sag the next, depending on Brexit news. "After two-years of pot-holed progress, Britain's Brexit negotiations are approaching the end of the road. Expectations, and heartbeats, are accelerating – but it's still not clear if what lies beyond is a smooth exit or an abyss," he said.

The constantly evolving political environment is creating uncertainty in the markets and this Brexit cloud over the UK 'and that is the front and centre of the Bank of England's, and Mark Carney's mind, according to Alasdair Ross, head of investment grade Credit, EMEA at Columbia Threadneedle Investments. He predicts that the current environment means the BoE will be cautious about raising rates too aggressively ahead of the Brexit deadline of March 29, 2019 or beyond, until there is more clarity on what the future holds. "The market is priced for about 50/50 chance of the next rate rise happening in August 2019," he said.

Moving onto the event risks or what a hard Brexit or no-deal might mean. Today's events and consensus suggest that further collapse of the sterling is in the cards. A weaker currency, in turn, would lead to a potentially sharp hike in UK breakeven rates as index-linked gilts factor in rising UK inflation, as a result of rising import costs. This is a familiar scenario as it also happened in the months following the 2016 referendum. The impact on gilt yields is more difficult to estimate. The BoE might respond with interest rate cuts to stimulate the economy which could be expected to dampen gilt yields. On the other hand, the political turbulence could result in higher yields. Whichever way the dice rolls, expect significant volatility in the gilt market.

Another risk is, as mentioned above, if the Prime Minister does not get her deal through parliament and there is another general election and the Labour Party, led by leftist Jeremy Corbyn, comes to power, a fall in sterling is again expected as his anti-capitalist stance is likely going to make investors jittery, moving capital away from the UK. As in the no-deal scenario a rise in UK breakeven rates would follow. Some argue that the biggest impact of a left-wing government would be in increased government spending, requiring more gilt issuance, pushing up gilt yields.

Most bond market observers agree with Ross' assessment and predict that should negotiations continue to be problematic the BoE may be forced to adopt a more accommodating monetary policy,

likely pushing bond-yields lower.

While UK markets have performed well in general after the Brexit vote in June 2016 the economic indicators are not as rosey particularly as retail sales slumped to a six-month low in mid-November

Michael Siviter, Senior Portfolio Manager at Invesco, said in the Invesco Global Fixed Income Strategy paper: "We are currently 'neutral' on sterling credit. Sterling credit yields do not currently build in much of 'Brexit' risk premium vs European credit (after hedging costs). We are specifically cautious on consumer discretionary names given continued weakness in UK consumer confidence figures and the impact of higher inflation (from the fall in sterling) on real wages. However, we continue to see pockets of opportunities for non-UK exposed global companies who have issued in the sterling market."

The exact impact of a messy Brexit is anyone's guess but UK investment consultants are advising clients to conduct scenario and worst-case scenario testing and reduce risk as well as revising their investment strategies to fit a more volatile environment and perhaps even prepare for a hard or no-deal Brexit.