

"Brexit" Update: Implications of the United Kingdom's Plan to Leave the European Union (05/16/2017)

On March 29, 2017, nine months after the United Kingdom's (UK) historic referendum on whether it should leave or remain in the European Union (EU), Prime Minister (PM) Theresa May sent a letter to EU Council president Donald Tusk officially triggering Article 50 of the Treaty of Lisbon, thus starting the two-year process for the UK leaving the EU. Article 50, which only became law in 2009, has never been invoked, so how Brexit will proceed, how long it will actually take and what a final deal with the EU will look like (assuming one can be reached) are not yet known. Still, with nearly a year having passed since the 2016 referendum, perhaps taking the time for a more informed review of the implications of "Brexit" is warranted, especially since the UK will hold a snap general election on June 8—nearly three years earlier than required by law—that promises to strengthen the Conservative party's majority in the House of Commons and consolidate Theresa May's power to conduct withdrawal negotiations as she deems appropriate.

Although financial markets initially reacted as if economic shock would immediately follow a "leave" vote last June, the impact on the UK economy and financial markets to date has been restrained, and predictions of recession, higher unemployment and falling home prices have failed to materialize thus far. Instead, UK gross domestic product (GDP) grew an estimated 1.8% in 2016, just behind Germany among the G7, and unemployment continued to fall, to an 11-year low of 4.8% as of February. The only lasting negative market responses have been in UK stocks, which on balance have trailed their U.S. and European counterparts, and the British pound (GBP), which fell sharply after the vote and remains about 15% lower against the U.S. dollar (USD) and 10% lower against the euro. The weaker GBP modestly spurred headline inflation, which rose to 2.3% in February.

The long-term implications of Brexit are far from clear. Official forecasts vary, but most expect a material slowdown in growth from 2017 to 2019; the Bank of England raised its 2017 GDP growth projection to 2% from 1.4% last November, but still expects it to slow to 1.6% next year and 1.7% in 2019. Macroeconomic implications for the EU are less significant. At worst, Brexit could affect not only the British economy, but also the political stability of the UK. Nicola Sturgeon, the First Minister of Scotland, has promised to move forward with a fresh independence referendum, since most Scots want to remain within the EU. In Northern Ireland, Sinn Fein, which has been gaining popularity, has called for a referendum on reunification with the Republic of Ireland, although polls show a majority still prefer to remain in the UK.

The impact of the Brexit process on world financial markets is difficult to isolate from the larger context of diverging economic and interest rate trends in different parts of the world, a heightened focus on policy risk that extends beyond Brexit and the U.S. presidential election, to include France and Italy, most notably, and other global economic and geopolitical factors. The following includes a recap of the key financial market effects of the Brexit vote in recent months, as well as some related key market risks for the next couple of years.

Interest Rates

As Chart 1 shows, following Britain's vote to leave the EU, government bond yields fell (and thus prices rose) as investors sought safety. This initial flight to quality was short-lived, however,

as other macroeconomic and geopolitical factors held sway; 10-year yields began to rise, and yield curves began to steepen late in 2016, as the one-year to 30-year spread in most major government markets widened significantly on worries that central bank bond-buying programs would wind down, increased fiscal spending would lead to more long-term debt supply, and global inflation would pick up. Thus far in 2017, the major government yield curves have been quite stable. With economic growth expectations in the EU, the UK and Japan, and inflation still shy of central banks' objectives, bond investors expect easy monetary policies and central bank bond purchases to continue for now, keeping a lid on long-term yields.

Chart 1: 10-Year Government Yield, Select Advanced Economies (12 Months Ending May 9, 2017)



Currency Exchange Rates

As Chart 2 shows, the GBP fell 16% after the June 23 referendum, hitting a three-year low in October of 1.10 against the euro. Since then, the GBP has recovered a bit and has been largely range-bound between 1.15 and 1.20; against the USD, the GBP has mostly remained in a \$1.20 to \$1.25 range, near its post-referendum low, although in recent weeks it has inched higher against the USD, to about \$1.29. The weaker GBP supports UK exports and tourism but raises the risk of importing inflation; raw materials, fuel and producer price inflation are accelerating, but British consumers have yet to be significantly affected by higher prices.

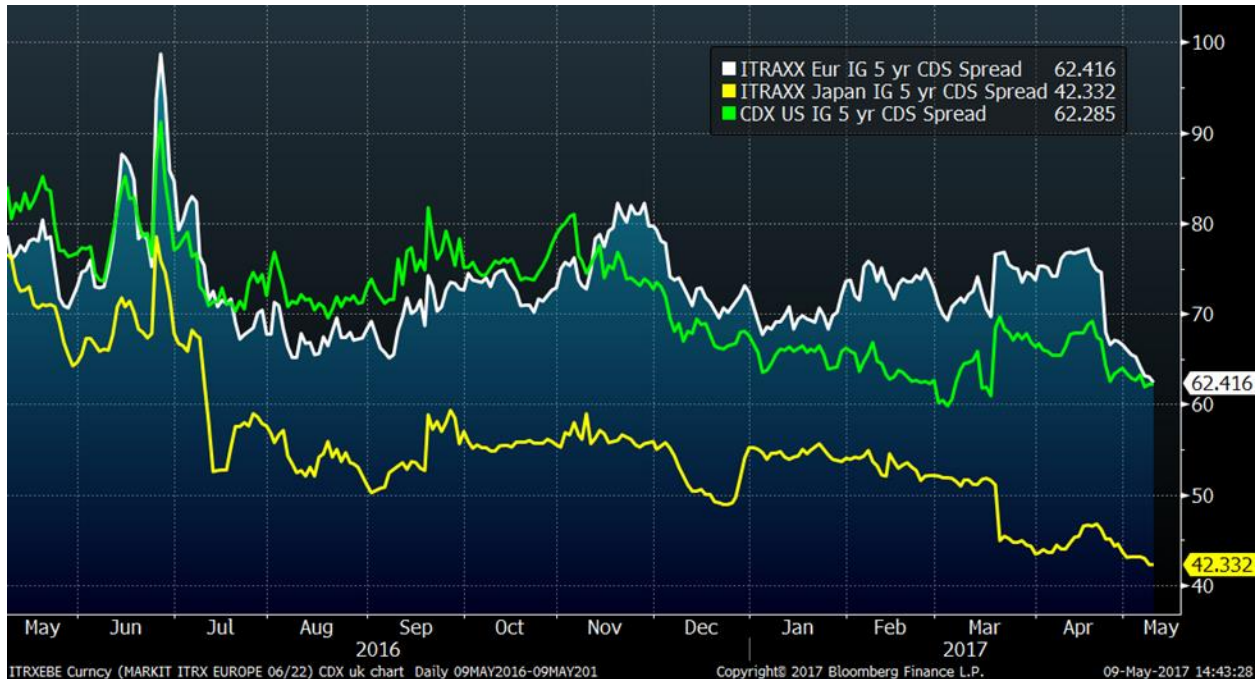
Chart 2: GBP to USD, EUR Spot Exchange Rates (12 Months Ending May 9, 2017)



Credit Risk

As Chart 3 shows, the Brexit vote briefly increased credit risk concerns because of the heightened potential for negative economic consequences and increased operating costs for many companies. Following the "leave" vote, all three major rating agencies—Moody's Investors Service (Moody's), Standard & Poor's (S&P) and Fitch Ratings (Fitch)—agreed that the decision was a credit negative for most sectors in the UK, and cut their respective sovereign credit ratings to Aa1, AA and AA from AAA, AAA and AA+. Brexit-related credit risk concerns were reflected in the credit default swap index (CDS) markets; the Markit iTraxx European, North American and Japanese indices—comprised of investment grade (IG) issuers in those markets—spiked after the vote, to 91 basis points (bps), 84 bps and 76 bps, respectively, but almost instantly recovered. The U.S. and Japanese IG indices have trended tighter and—at a respective 62 bps and 42 bps—are substantially tighter than pre-vote levels. European IG credit spreads had been range-bound between 70 bps and 80 bps, about the same as pre-referendum levels, until late April, and since then, they have converged on U.S. spreads.

Chart 3: Corporate CDS Spreads (12 Months Ending May 9, 2017)



Equity Markets

Global stocks tumbled last June 23, losing approximately \$2 trillion in market value. London's FTSE 100 Index dropped 3.2% and was down 1.7% year to date (YTD) through June 2016 after a volatile two weeks where prices were driven by opinion polls. Global stock markets—including the UK—subsequently rallied back and generally moved sideways for the remainder of 2016, before staging another rally that is ongoing despite growing concerns that valuations are becoming frothy. UK shares have participated in this global trend, to be sure, but they have lagged their European, U.S. and Asian counterparts. As a result, while the Nikkei 225, S&P 500 and DAX indices all have risen approximately 15% to 20% over the past 12 months, the FTSE 100 is only up about 8%.

Chart 4: Select Major Stock Indices (12 Months Ending May 9, 2017)



Focus on Financial Institutions

UK and EU financial stocks were hit hard by Brexit concerns in the months leading up to and after the vote. The ongoing consensus is that the impact of Brexit will be greatest on financial institutions, on both sides of the Channel, particularly given London's status as the world's premier financial hub. The ramifications for EU and UK institutions will take time to sort out, but likely there will be several years of regulatory uncertainty that could depress trading, underwriting and merger activity, thus cutting into fee revenue, while currency volatility could hurt foreign exchange (FX) trading. Ultimately, negotiations between the UK and EU will determine how much harder it will be for UK firms to engage in cross-border business with the EU, and whether immigration restrictions will hamper their ability to hire European staff. The outcome will affect British institutions, as well as foreign institutions with European operations concentrated in London.

It is likely there will be some negative impact if UK-EU negotiations fail to produce a clean resolution to issues such as the EU financial "passport"—a legal device that allows financial services companies based and regulated in one country within the EU or the broader European Economic Area (EEA) to conduct business in other member states solely on the basis of their home state authorization. At this juncture, the simpler solution, which would involve joining the EEA single market, seems unlikely because in doing so, the UK would have to accept free movement and rulings from the European Court of Justice, with no representation in the EU's regulatory bodies. A more likely—albeit less efficient and more costly—solution is that UK firms would set up subsidiaries in the EU that would have passport privileges.

As an alternative to passporting, the UK and EU could pursue an agreement based on the principle of equivalence, which would preserve each regime's access to each other's market without requiring them to mirror each other's laws and regulations. However, there are no current provisions in EU law for equivalence in either commercial banking or primary insurance, and under EU law, a declaration of equivalence can be easily revoked. To ensure financial system stability, a very detailed agreement would have to be worked out.

U.S. Insurer Exposure to UK Issuers

As of year-end 2016, U.S. insurers' unaffiliated exposure to UK debt and equity totaled \$102.9 billion, with \$98.7 billion in bonds and \$4.2 billion in stocks. That represents a modest decline from 2015 year-end exposure of \$109.8 billion, comprised of \$105.4 billion in bonds and \$4.4 billion in equities. About 85% of 2016 year-end exposure was U.S. dollar-denominated, with another 9% in GBP. UK bonds represented about 17% of the U.S. insurance industry's foreign bond exposure (approximately \$582 billion) at year-end 2016, second only to Canada (18%). Exposure to UK sovereign debt accounted for 16% of UK bond exposure, while financial bonds made up 27%. UK equities were the largest foreign stock exposure for U.S. insurers, at 17% of total foreign stock exposure; 9% of UK exposure was in financial stocks, whereas 25% was in energy and 18% in basic materials.

Conclusion

As the Brexit situation evolves over the next two years (or longer), its actual impact on markets and economies will become clearer, including secondary and tertiary impacts on other EU countries. These impacts include concerns—however remote—that populist/nationalist movements in continental Europe could raise policy risks and might even threaten the fabric of the EU. While recent electoral results have eased these fears, most notably Emmanuel Macron's victory over Marine Le Pen in France, some populist/nationalist influence remains part of the EU political landscape.

From the perspective of the U.S. insurance industry, the impact should be relatively modest.

The U.S. insurance industry's investment exposure to the UK is significant but not extraordinarily so, and to the extent that UK entities engage in transactions with U.S. insurers, it is often through a U.S. legal entity.

The NAIC Capital Markets Bureau will continue to monitor these developments and report as appropriate.

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