Brexit Tail Wags The Dog

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Financial market moves yesterday seemed to be connected with the polling for Britain's EU referendum

If anyone still doubted the claim expressed here on May 25 that politics is now driving global financial markets far more than economics (see **The Brexit Vote As Harbinger Of A Populist Age, Or Not**), those doubts should have been dispelled by Monday's trading. From the moment that currency trading started in the New Zealand morning, through the Nikkei and Hang Seng openings in Asia, to the main forex business in London and finally the stock markets on Wall Street, the dominant trends all seemed to be connected with polling for Britain's EU referendum on Thursday, and speculation about what additional news events might influence the vote. As it happened, all the news since Friday's close was favorable to the Remain camp: first the neo-Nazi madman who on Thursday murdered Jo Cox, a popular pro-Europe member of the British Parliament, decided to shout "death to traitors, freedom for Britain" at the judge in his first court hearing. Then pollsters detected a modest shift in favor of Remain even in the surveys conducted before the Cox assassination. Next, a collective statement in support of EU membership was issued by the Premier League football clubs. Finally, late on Monday, George Soros took over media headlines with a powerful warning that sterling would collapse by -20% to -30% after a Leave vote, resulting in the pound being worth about one euro—"a method of joining the euro that nobody in Britain would want."

As the odds of Brexit dropped, risk assets around the world followed sterling higher

This full-scale escalation of the rhetorical technique denounced as "Project Fear" by the Brexit camp seemed to be working, at least in the market's view. The pound experienced its biggest one-day gain since the end of the 2008 crisis; the Brexit odds in betting markets collapsed from 38% to 25%; and risk assets of all kinds, from equities to commodity prices, followed sterling higher all over the world. And Soros's prediction

Checking The Boxes
Our short take on the latest news

Fact	Consensus belief	Our reaction
Eurozone construction output fell –0.2% MoM in Apr, from –0.1% in Mar	N/A; YoY, construction fell –0.4%, from 0.5%; construction in all major EZ countries remains weak	Early year boost has now faded; EZ construction has flatlined since mid-2013
German PPI fell –2.7% YoY in May, from –3.1% in Apr	Above –2.9% expected; PPI excl. energy fell –0.8% YoY; energy fell –8.0% YoY	Energy still exerting strong deflationary pressure; few signs of inflation building elsewhere
Net forex sales by Chinese banks fell to US$12.5bn in May, from US$23.7bn in Apr	N/A; lowest since Jan	Capital outflow continues to abate, easing pressure on the renminbi
India announced measures to further liberalize FDI regime	N/A; "sensitive" defense and aviation sectors opened to 100% FDI and reduced restrictions	Modest reforms meant to mitigate impact from exit of central bank governor

that the pound would either rebound to above US$1.50 or slump to around US$1.15, depending on the outcome of Thursday's vote, accorded with the calculations presented here two months ago (see **The Case For Sterling**), and with the three-to-one ratio of Remain-to-Leave probabilities shown in betting markets by Monday night.

Financial markets are rightly worried about worst-case impacts of Brexit—from a breakup of the EU to a repeat of 2008

There seem to be three possible reasons for this tail-wags-the-dog market behavior, discussed in several of our recent pieces. A first and obvious explanation for the sudden importance attached to British politics by all global markets is the possibility that a vote to leave the EU by Britain would trigger a chain reaction, reviving the euro crisis, and possibly risking a chaotic breakup of the entire EU. A second explanation is the risk of the financial crisis and recession in Britain predicted by Soros turning into a renewed banking crisis that spreads, as in 2008, to banks in other European countries and around the world. A third possible reason is the political contagion effect discussed here last week (see **Populism And A New Financial Crisis**): a Leave win in Britain would increase the perceived odds of Donald Trump becoming US President and of anti-establishment parties winning elections in Italy, Germany or France in the coming months. Whatever the rights or wrongs of anti-elitist politics and the grievances it may or may not reflect, there can be little doubt about the preference of financial markets. Just as turkeys don't vote for Christmas, it is hard to see how anti-elitist populism could be welcomed by financial markets that are dominated by financial and business elites.

Populism riles the financial elite