

Showing how EU solidarity calmed markets over Brexit

By

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By leaving the European single market on New Year's Day, the United Kingdom concluded a chapter first opened four and a half years earlier. At the time, the outcome of the Brexit referendum caught capital market participants by surprise, leaving them wondering whether the European Union (EU) would further dissolve or if European solidarity and integration would continue. Yet market sentiment quickly swung positive: by staying united in the first few weeks after the Brexit referendum, the EU calmed markets.

In this blog post, we track market responses in the weeks before and after the Brexit vote as well as in the first week of January 2021 when the EU-UK agreement entered into force. It reveals that market tension has never again reached the peaks attained back in 2016, not even during the current pandemic or when the UK left the single market earlier this year. Instead, tensions eased soon after it became clear that the EU would remain intact despite losing one member - testimony to the strength of a united Europe.

We use the relationships, or correlations, between bond price returns to indicate swings in market sentiment. Government bond price returns tend to correlate positively when the market is stable. Negative news concerning a specific country can, however, lead to negative correlations between this country and others.

These correlations are visible in heatmaps. Each heatmap cell displays a pairwise correlation, from 1 (dark blue, prices tend to move in the same direction) to -1 (dark red, prices tend to move in opposite directions) over a period of one week. In other words, the bluer the heatmap, the calmer the market sentiment, as bond prices are moving in the same direction. Conversely, if the heatmaps show a lot of red, prices are moving in different directions. This means that there is a flight-to-safety away from one group of bonds to another, a sign of negative market sentiment.

Heatmap 1 shows the bond market correlations in the six weeks around the Brexit referendum in 2016. It includes the generic 10-year bonds of euro area countries with liquid bond markets plus three issuers with a particularly strong connection to the euro area: the ESM, the United Kingdom (UK), and Switzerland.