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Global Investment Event

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UK 'Leave' vote triggers economic uncertainty

- **Given the significant volatility introduced to the market following the 'Leave' vote our investment views shall be under review in the coming days as the markets settle and opportunities become clearer. Any revisions will be published in the forthcoming Investment Monthly (IM).**
- At present, we continue to favour risk assets such as global equities, corporate bonds and high-yield debt relative to developed market (DM) government bonds. We also remain neutral EUR and GBP investment grade corporate bonds, neutral UK equities, and underweight UK government bonds.
- The vote by the UK to leave the EU means we can now expect to see a significant period of uncertainty as the UK moves into a transition period of negotiations of existing agreements. The political path ahead also is unclear as it is without precedent.
- UK economic data is likely to weaken further in the coming quarters as the economy adjusts during this transition period, with consumption and investment suffering the most. This uncertainty is likely to last into the medium term.
- The market reaction has been severe despite the outcome being less of a surprise than it would have been three weeks ago. At the time of writing, the FTSE 100 is down 7.2% while the EUROSTOXX 50 is down 9.5%. Meanwhile, 10-year UK gilt, German bund and US treasury yields are all lower on the back of heightened investor risk aversion. The US dollar index (DXY) rose, with both the GBP (-8.1%) and EUR (-2.0%) moving lower against the USD, although the 'safe haven' JPY rose 3.2%.

The facts

Despite polls for much of 2016 in favour of a 'Remain' vote, the UK electorate has voted to reject the status quo, signalling their wish to leave the European Union (EU). The result saw the 'Leave' campaign win by a margin of 3.8%, gaining 51.9% of the vote versus 48.1% for 'Remain'. The completion time limit for negotiations to leave the EU is two years from the triggering of Article 50 of the Lisbon treaty, during which time the UK will remain part of the EU abiding by all treaties and laws.

Given the complexity of the task, negotiations could take longer, however an extension would need to be agreed by the 27 remaining EU countries. This also provides an incentive for delaying the triggering of Article 50. Legal uncertainty will also be high, given European law is currently part of UK law. The key question remains around the degree of access that will be maintained to the European Single Market (ESM). Given the multi-faceted structure of this market - with the free movement of goods, services, labour and capital – negotiations are likely to prove complex and difficult. There will also be uncertainties relating to how successful the UK will be in negotiating other trade deals outside of the EU.The most optimistic scenario for UK growth prospects is that the UK can retain free and open access to the ESM, given that the EU is the UK's largest trading partner. However, the path ahead is unclear and not straightforward.

Next steps

With a vote to leave the EU, the following are key next steps for market participants to pay attention to:

- There remains the question of who will be the next British Prime Minister, although David Cameron will remain in power for the next three months, this is to ensure a smooth transition to the next Prime Minister who will begin the leave process.
- How long it takes for the UK to trigger Article 50, the legal pathway out of the EU, which was inserted into the 2009 Lisbon treaty. From the moment Article 50 is triggered, the UK will be granted a two-year window to exit the EU. This period can be extended by the unanimous agreement of the remaining EU-27 countries.
- The extent to which the EU could make the UK's exit path difficult, to discourage other "exiteers". The continued ascent of Eurosceptic political parties in the major Eurozone countries will be important to observe.
- The speed of the decision made on the UKs free movement of labour across the EU (and vice-versa)
- The UK's ability to re-negotiate 80,000 pages of EU agreements, including the decision on which agreements will remain part of UK law. If a conclusion is not reached within two-years, the UK is obliged to move to standard World Trade Organisation (WTO) terms for the 6,987 directly applicable EU regulations; this would for instance introduce a potential 10% tariff on cars for UK exports into the EU. The outlook for services is much less certain and potentially more punitive as the EU's willingness to grant cross-border access is comparatively low as in the case of Switzerland who does so under strict conditions whilst Norway has access via its membership of the European Economic Area (see Table 1).
- The passage of UK domestic legislation not-related to the withdrawal from the EU will potentially be compromised, to meet two-year deadlines. This may generate an additional domestic economic growth challenge.

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Exit process: the near term political and economic path is highly fluid

David Cameron announced this morning that he was resigning and would serve for the next three months to ensure a smooth handover to a new Prime Minister, who would handle negotiations of the exit. This will add to the political uncertainty going forward as this will be a vital role in mediating between the EU-27 and the UK. The next Prime Minister will notify the European Council of the UK's intention to withdraw, but the exact timing of this remains uncertain. It is important to highlight there exists a wedge between the electorate - who have opted for Leave - against the House of Commons, where 463 MPs out of 650 have declared themselves in favour of 'Remain'. There is the potential for MPs to delay or potentially even block the negotiation of the leave process as much of the new agreements will require parliamentary approval. Since there is no precedent for this scenario in the UK it would mean a very uncertain path ahead. There is also the potential for early elections, either triggered by a vote of no-confidence in the government or if two-thirds of MPs vote for it.

Regardless, the UK will remain part of the EU political system until Article 50 of the Lisbon Treaty is activated, which would trigger a two-year window to negotiate the terms of exit. If both sides agree, and the exit process is concluded in less than two years, then a formal withdrawal would take place. It is important to note that this window can only be extended by the unanimous agreement of the remaining EU-27 countries.

In our view, given the complexities and high degree of integration between the UK and EU, the two-year timeframe is ambitious. In our opinion, an extension is more likely than not, and much like how nations slowly integrate *into* the EU, we think the UK's withdrawal would occur in stages rather than as a one-off.

It is also worth pointing out that **during the exit negotiations the UK would retain all of its legal, commercial, political and financial links to the EU.** Furthermore, following a withdrawal, should the UK want to re-join the EU, it could re-apply, although it would be treated like a new applicant. Looking back, the UK waited 16 years to join the EEC after it was established in 1957. So a quick turnaround is unlikely if the exit has been completed.

Options post-'Brexit'

A number of options are available to the UK in the event of 'Brexit'. Table 1 below compares EU membership with other major alternatives. The three main alternatives to EU membership that the UK could explore include:

(1) Negotiated bilateral agreements. The UK could attempt to negotiate a bilateral agreement with the EU. This type of agreement could mirror the current arrangement between the EU and Switzerland, Turkey and/or Canada:

(2) World Trade Organisation (WTO) membership. The WTO provides a global framework for trade between 162 nations. The WTO rules are a set of general terms that protect against discrimination but do not deliver free trade. Under this agreement, the UK would sit outside the EU's Customs Union, not be part of the EU's trade deals with the rest of the world, be subject to the EU's external trade tariffs, and would lose its *"passporting"* rights into the EU. Thus the key problem with this approach is that it would hinder significantly the access to the EU market for UK service producers. This would see the freedom of movement of labour cease but as the EU prohibits restrictions on capital mobility this would continue. However, It is worth highlighting, that upon leaving the EU, and until the UK reaches an agreement with the EU-27 members, it trade agreements would default to WTO membership.

(3) European Economic Area (EEA) membership

To be able to join the EEA, the UK would first need to become a member of the European Free Trade Association (EFTA), and then obtain unanimous support from the other EEA members. Within the EEA, the UK would have full access to the EU Single Market. Tariff and quota free trade with the EU would be permitted.

Table 1: Options available to the UK post-'Brexit'

Agreement	Example	Key characteristics
EU Membership	Germany, France	Full tariff-free trade Inside Customs Union. Access to EU FTA's Full contribution to EU budget Vote on regulations / EU rules
UK's Special Status	UK	Full tariff-free trade Inside Customs Union. Access to EU FTA's Not a member of the single currency Receives rebate on EU budget contribution Vote on regulations / EU rules
European Economic Area (EEA)	Norway, Iceland	Contributes to EU budget Free movement of goods, capital, services, people. Accepts most EU rules (such as product standards) Outside EU Customs Union. No access to EU FTA's Pays for EEA grants, admin costs and programme costs Limited influence on regulation / EU rules
European Free Trade Association (EFTA)	Switz.	Contributes to EU budget Requires trade agreements with individual EU countries and across sectors No passporting rights for financial services Outside EU Customs Union. No access to EU FTA's Limited influence on regulation / EU rules
Customs Union	Turkey	Tariff-free access to most of EU Single Market (except financial services) Adopt EU external tariffs for non-EU trade Limited influence on regulation / EU rules
Free Trade Agreement	Canada	Largely tariff-free Single Market access but need to comply with EU standards and product regulations No full access for services and no automatic passporting rights for financial services
World Trade Organisation	Russia, Brazil	Trade with the EU subject to the EU's common external tariff Outside EU Customs Union. No access to EU FTA's No influence on regulation / EU rules No passporting rights for financial services

Source: UK Treasury

Economic implications of 'Brexit'

There is no precedent of a major nation leaving the EU to benchmark against, but in our opinion, a decision to leave would have negative short and long-run implications for the UK economy. In the short run, the risk of a UK recession in H2 2016 /early 2017 can be expected to rise. The key drivers of this would be heightened uncertainty due to the withdrawal process, and the longer-term impact of leaving the EU, weighing on UK business and consumer confidence. UK businesses are likely to adopt a 'wait-and-see' approach to investment and employment during the EU exit negotiations. Nevertheless, a weaker GBP is likely to prove supportive for exports, at least whilst the UK remains in the EU and retains single market access.

Inflation is the least of our worries

There was no inflation shock after the UK left the ERM (European Exchange Rate Mechanism) in 1992 and UK growth actually improved as a result of increased competitiveness from a weaker pound. We are not concerned that there would be an inflationary shock in the short to medium term, but even if a weaker GBP were to deliver some upward price pressure, inflation is still well below the Bank of England's 2% target level (and has been for some years). Nevertheless, access to global trade markets is likely to be more restricted in the medium term as the UK renegotiates various trade deals whilst the associated weaker growth could deliver wider government deficits with a risk that these become inflationary in the longer term.

Bank of England and gilt yields

Without providing too many specifics, the Bank of England (BoE) has said it has *“contingency plans”* to cope with the ‘Leave’ vote. One measure that has been announced is that indexed Long-Term Repo (LTR) operations (a cheap money facility) will be offered to UK banks, building societies and brokers to ensure enough liquidity in the system to keep markets functioning smoothly. Broader contingency plans could also involve co-ordinated foreign exchange intervention between the major central banks to stabilise markets.

We anticipate that the BoE would acknowledge the risks to the economic outlook, most likely committing to keep policy rates on hold throughout the ensuing process and potentially as far as 2020. This would delay the hiking cycle, placing it more in line with what we expect for the ECB, rather than as previously expected being closer to the US Federal Reserve.

Similarly, should it be required, additional quantitative easing could be conducted to avoid gilt yields spiking in the case of significant capital outflows and also in order to support the economy. However, gilt yields could remain compressed on the back of safe-haven demand as investors may shun UK risker assets such as equities and corporate bonds. Overall, while we see UK government yields as unlikely to see a sustained move higher, it is not impossible that we could see periods of episodic volatility.

Sterling poses the greatest risk

GBP will likely see continued instability in the short term given the uncertain economic and political outcome. In our view the BoE, given it only accounts for less than 1% of global reserves, would be unable to intervene in the FX market to support the pound. Based on multiple measures GBPUSD was trading at or close to fair value as a member of the EU, suggesting that there is room for further falls in the case of an exit unless multiple robust trade agreements are reached.

Equities may benefit once risk aversion lifts

In the medium term, greater weakness in GBP may support UK equities considering their relatively high dependence on foreign earnings, particularly in a stronger environment for commodities of which UK indices are heavily weighted. UK indices, particularly the FTSE 100, also benefit from attractive dividend yields. There could also be a severe drop in the discount rate, driven by the collapse in the cash rate curve, reemphasising further the low return world, driving the equity risk premium higher. We must caveat this with the fact that the UK equities risk premia offers a lower margin of safety than other markets, given the potential range of outcomes.

Renegotiate trade agreements

Upon leaving the EU, there will be a significant number of trade deals to be renegotiated in the coming two years given the UK’s ex-EU trading relationships will no longer be bound by existing EU agreements. The UK is the second most important trading partner of the Eurozone after China and the main export destination in the EU. While aggregate Eurozone exports to the UK account for 3.8% of GDP, individual country trade exposure to the UK varies substantially (Table 2). Ireland is most exposed to any potential disruptions, with total exports accounting for 17.8% of GDP and imports accounting for 16.9% of Irish GDP. At the same time, the four largest Eurozone economies – Germany, France, Italy and Spain – accounting for around 77% of Eurozone’s GDP have a relatively limited trade exposure to the UK, with for example, German exports to the UK accounting only for 3.4% of GDP and imports for 2.1% of GDP.

Table 2: Eurozone trade with the UK

% GDP as of 2014

	Exports to UK				Imports from UK		
	Total	Goods	Services		Total	Goods	Services
Ireland	17.8	7.1	10.7	Ireland	16.9	10.9	6.0
Belgium	9.4	7.4	2.0	Netherlands	6.0	4.0	2.0
Netherlands	9	6.7	2.4	Belgium	6.0	4.2	1.8
Cyprus	8.4	0.8	7.6	Cyprus	5.8	2.1	3.7
Germany	3.4	2.7	0.7	**Eurozone**	**2.6**	**1.6**	**1.0**
Eurozone	**3.8**	**2.5**	**1.3**	Germany	2.1	1.4	0.7
Portugal	3.6	1.7	1.9	France	1.9	1.0	0.9
Greece	3.4	0.6	2.8	Spain	1.8	1.1	0.7
Spain	3	1.6	1.4	Portugal	1.8	1.0	0.8
France	2.6	1.4	1.1	Greece	1.8	0.7	1.1
Finland	2.1	1.5	0.6	Finland	1.7	0.9	0.8
Austria	1.8	1.2	0.6	Austria	1.2	0.7	0.5
Italy	1.7	1.3	0.4	Italy	1.1	0.6	0.5

Source: Eurostat, data as at March 2016

Risk of contagion

There is not just significant economic uncertainty for the UK, but for that of Europe as a whole. The exit of a significant member such as the UK from the EU could trigger a desire by other major countries such as France, Spain or Italy to renegotiate or even reconsider EU membership themselves; not impossible in an increasingly polarised continent. This would have significant economic implications for the region in the medium-term, with uncertainty being the largest drag on activity. However, the economic impact of a Leave vote on the US, China and Japan is likely to be minimal.

Over the **long-run,** the impact on the UK economy is hard to gauge and will depend on the outcome of negotiations of the UK relationship with the EU and other major global trading blocs. The EU may not offer the UK a better trade-off between market access and sharing of sovereignty than already offered to others. As a result, the UK commitment to control its borders suggests that it could receive less access than is currently afforded to Norway or Switzerland.

What do economists think?

Various economists have provided a range of economic forecasts in the event of a ‘Leave’ vote, almost all negative. The UK Treasury assume that the UK utilising the WTO route i.e. charging and also paying the same tariffs as all other WTO members for goods (whilst the outlook for services would be significantly jeopardised) would result in a shortfall in the level of UK GDP by 7.5% between now and 2030. A more optimistic take from Oxford Economics sees a 2.0% GDP shortfall assuming that the UK can reach a favourable free trade agreement. Economists almost universally agree that the greatest level of uncertainty arises from trade and investment, with the importance of the EU evident.

Market reaction

The overall market reaction following the confirm of the ‘Leave’ outcome led to a predictable bout of extremely heightened global risk aversion, especially given that the result was not in line with the majority of poll expectations heading into the referendum. At the time of writing, the FTSE 100 is 7.2% lower, the Euro Stoxx 50 is down 9.5% and all the other major European bourses are also in deep negative territory on the day. In government bond markets, 10 year UK gilt and German bund yields are 30bp and 19bp lower, at 1.07% and -0.10% respectively, both hitting fresh record lows. Meanwhile, US treasury yields also fell along the curve, with 10-year yields hitting their lowest level since level since 2012. Peripheral European government bonds also fell sharply, led by losses in Portugal and Greece. In terms of currency markets, the pound sterling is 8.1% lower on the day against The USD, a record one-day fall, whilst the ‘safe-haven’ yen is

up 3.2% against the US dollar, at one point reaching 99.2, leaving the broad based dollar index (DXY) up 2.5%. Meanwhile, other ‘safe-haven’ assets are also broadly stronger, with gold at its highest level since early-2014.

Investment implications

Given the significant volatility introduced to the market as a result of the ‘Leave’ vote our investment implications shall be under review as the markets settle in the coming days and any revisions published in the forthcoming Investment Monthly (IM). For the time being, we maintain our neutral outlook for UK equities, highlighting the downside risks that this vote entails. However, it is also worth bearing in mind that greater weakness in GBP may ultimately support UK equities in the medium term considering their relatively high dependence on foreign earnings. We also continue to prefer an underweight positioning on core developed market government bonds (including the UK) with yields at current levels. However, this outcome may allow the BoE to stay accommodative for longer, buoying the gilt market. Nevertheless, we still maintain a preference for risk assets such as equities, high yield credit and EM debt, within the context of a well-diversified multi-asset portfolio, from a strategic and long-term perspective.

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