Market Bulletin

24 June 2016

Brexit - a shock for markets, or a crisis?

Investors have been seriously wrong-footed by the result of the EU referendum. But the shock of City traders this morning is nothing compared with the stunned response of the people who thought they ran the country. The economic and political questions raised by this vote will not be answered for years, possibly decades. But the immediate questions for investors are how long the "risk-off" mood in markets will continue and how much damage it will do in the process.

Our first assessment is that this is a large shock but, ultimately, a local one.

- The UK economy will slow sharply. Our best estimate is that growth will slow from an annualised pace of 1.6% to around 0.6% in the second half of 2016, with a similar growth rate achieved in 2017. We can expect inflation to jump to 3% or 4% by the second half of 2017, as a direct result of the decline in sterling. That compares with a previous forecast of around 1.7%.

- We expect the Bank of England (BoE) to look through the rise in inflation. Policy will surely be looser than it would have been under Bremain. The BoE will make clear its willingness to offer emergency liquidity to the market, but it may well wait to gauge its response to the slowdown in economic activity. We also expect it will think hard before intervening to defend the pound. The fall so far today has been dramatic, by any standard, with the pound at one point falling to its lowest level against the dollar in 30 years. But the scale of the fall has been exaggerated by the rally preceding the vote. Arguably, a double digit decline in the currency is not an over-reaction to a policy change of this magnitude.

- The interplay of domestic and global factors is highlighted by the UK Gilt market, where long-term government bond yields barely moved in early trading. This may have been because domestic "risk-off" flows into bonds were being offset by foreign sales of Gilts. But Gilt yields moved sharply lower after the prime minister, David Cameron, announced his resignation. We would expect Gilt yields to be lower, over time, than if voters had opted to remain in the EU, given the "lower for longer" view on short-term rates outlined above. Put another way, we do not think question marks about sterling will turn into questions about the creditworthiness of the UK government.

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- Further afield, growth in the eurozone will be dented, possibly strengthening the case for the European Central Bank to expand its quantitative easing – bond purchases – in the autumn. If there is a prolonged decline in global market confidence, the US central bank could find it more difficult to move forward with higher interest rates in the second half of 2017. Central banks in countries with "safe haven" currencies, notably the Japanese yen and the Swiss franc, may also come under pressure to ease policy to prevent these currencies rising a lot further.

These are significant consequences. But right now we do not think the Brexit shock poses an immediate threat to the global recovery. Over time, we would expect this reality to be reflected in asset markets outside the UK, particularly in the US, where the stock market has reacted sharply to a result which would be expected to have only modest direct consequences for the US economy. However, it could take some time before the dust settles and investors should expect plenty of volatility, as UK policymakers and the wider world come to grips with the consequences of this historic vote.

This immense shock for the UK will have an economic and financial impact on the rest of the world, but we believe that the fallout should be manageable, if policymakers respond appropriately and investors keep their heads. Whether the political implications will also be containable, particularly in Europe, is another matter.

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