



Brexit wins – implications for the world, Australia and investors

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Key points

- > The vote by Britain to leave the European Union poses risks for UK, European and global financial and economic stability that may linger for a while.
- > However, it needs to be kept in perspective and is unlikely to plunge the global economy into recession.
- > The Leave victory is unlikely to have a major direct impact on Australia but could have an indirect bearing via financial market volatility and confidence.
- > The key for investors is to look for opportunities that Brexit driven volatility throws up.

Introduction

In a shock for financial markets which had been increasingly confident that Britain would vote to Remain in the European Union, a victory for the Leave outcome by 52% to 48% triggered an abrupt bout of “risk off” in financial markets late last week. I suspect it was probably also a shock to many Brits themselves some of whom seem to be going through a bit of Bregret (thinking they were just delivering a protest vote against the establishment and assumed that Remain would win anyway). Of course, it wasn't a good week for Europe either. This note tries to put it all in perspective.

Risks and uncertainties

The vote to Leave poses several risks.

- For the UK economy its bad news. According to estimates from the UK Treasury and the OECD the impact on trade, the financial sector and labour mobility could leave the UK economy 5% or so smaller than otherwise in 15 years' time. But in the short term there is a risk of recession given the blow to business confidence as UK businesses will be uncertain about their continued access to the EU. Some financial institutions and foreign companies may also consider relocating their operations to other EU countries given this uncertainty. Of course the negative impact on the UK economy will be partly offset by a weaker British pound, making UK businesses more competitive, and easier than otherwise Bank of England monetary policy. But political uncertainty won't help with Prime Minister Cameron to step down by October, uncertainty over the leader of the opposition Labour Party, pro-EU Scotland pushing for another independence referendum and some in Northern Ireland pushing for integration with Ireland.
- For Europe it will help fuel fears that some Eurozone countries may seek to follow the UK, setting off a domino effect, much as had been feared regarding a Grexit (or Greek exit from the Eurozone) over the last few years. This

could see a tightening in financial conditions as investors fear a break up in the Euro and start to require a premium to lend to countries like Italy or Spain fearing that they may not get paid back in Euro's, but in depreciated liras or pesetas.

- Renewed uncertainty regarding Europe in turn poses risks to global growth, much as we saw through the Eurozone debt crisis of 2010-2012. This risk in the short term could simply come via tighter financial conditions in Europe and if we see a flight to safety out of the Euro into the \$US which in turn will weigh on the Renminbi (sparking new fears of capital outflows from China), commodity prices (sparking new concerns about say oil producers defaulting on their debts) and emerging countries (with fears they may not be able to service their US dollar denominated debt) taking us back to the global growth fears we saw earlier this year.
- The Brexit vote also highlights and threatens to add momentum to a backlash against establishment economic policies and specifically to a move away from economic rationalist policies in favour of populism and a reversal of globalisation which would be a negative for long term global economic growth. The shift away from globalisation could also add to geopolitical instability (note: Russian President Putin was a supporter of Brexit – with many speculating he is hoping for a less united and weaker Europe)...but of course the world has a long way to go down that path.

Market reaction

Reflecting the worries about the impact on the UK and more significantly Europe, financial markets reacted sharply in “risk off” fashion on Friday with the British pound (-8.1%), British shares (-3.1%), the Euro (-2.4%) and Eurozone shares (-8.6%) down sharply and this seeing global share markets down generally along with the \$A. Safe haven assets such as bonds, the \$US, Yen and gold have all benefitted. This could have further to go in the short term until some of the dust settles.

Some perspective

However, it's worth putting all of this in perspective. First, the moves in some markets were exaggerated because those that occurred during the first four days of the last week when markets thought Remain would win had to be reversed. So, for example, while Eurozone shares fell 8.6% on Friday they only fell 2.6% over the last week. Over the week as a whole US shares lost 1.6%, Japanese shares lost 4.2%, Chinese shares fell 1.1% and Australian shares fell 1%. Bad but not monumental. The British share market actually rose 2% over the last week. While the British pound fell 8.1% on Friday it only fell 4.7% over the week as a whole and the \$A actually rose 1% last week. It was similar with bonds and oil – big moves on Friday but only modest moves over the week.

Second, Britain has only started down a process to exit and has a long way to go yet. At this stage it still has all the benefits (free trade) and obligations (free movement of people) of a full EU member. It will first need a new PM, then formally notify its intent to exit which will then kick off a negotiation process that will take up to two years. This will determine the ultimate impact on the UK economy – either it will retain free trade access to the EU but have to continue to allow the free movement of people, agree to EU rules and regulations and contribute to its budget (like Norway) or forgo free trade.

At this stage it's hard to see which way this will go, although I suspect that having seen the turmoil the Brexit vote has unleashed that the UK will opt for the least disruptive option, which may out of interest involve another referendum before it's all over. But the point is that for some time the UK will still be in the EU. In any case it should be noted that while the UK economy is big it's only 2.5% or so of world GDP so a recession in the UK will not be a huge drag on global growth on its own.

Third, while the Brexit vote will likely trigger a guessing game as to which Eurozone country will try and follow the UK's lead and ask for a similar referendum it's doubtful that Eurozone countries will actually seek/vote to leave because the hurdle to leave the Eurozone is higher than Britain leaving the EU as it will mean adopting a new currency, paying higher interest rates, etc. Just think of Greece despite its woes over the last few years consistently deciding to stay in the Eurozone. Britain has always identified itself as being less European than other European countries. And it's notable that people in the rest of Europe see the EU/Eurozone as a source of strength and force for peace and less as a driver of economic prosperity. It's also worth noting that Sunday's Spanish election actually saw support for the governing People's Party increase with no gain for anti-establishment Podemos suggesting that the Brexit mayhem may have seen voters opt for stability. A key country to watch is Italy following the recent success in municipal elections of the Eurosceptic Five Star Movement. Of course the mere agitation for, and reality of, any referendums on the issue of exit by Eurozone countries will cause periodic market jitters even if they vote to remain as I expect.

Fourth, the Brexit vote is unlikely to be akin to a Lehman moment because conditions are radically different. Lehman came after a long period of global strength and a credit boom where liabilities and exposures were opaque. That is not the case now and Brexit has been talked about endlessly so is not the surprise Lehman was.

Finally, central banks have quickly adopted a "whatever is necessary" stance to provide liquidity to markets and support their economies, notably the Bank of England which is already providing £250bn. The ECB is monitoring the situation but its liquidity measures (eg, TLTRO and quantitative easing) are probably more than enough at present, although they may be extended. The more important point is that global monetary policy will remain easier for longer. The Fed certainly will be slowed further in raising rates because it won't want to put more upwards pressure on the \$US which is being boosted by safe haven demand. A G7 Statement decrying excessive currency volatility has arguably given Japan close to a green light to intervene to stop the Yen rising much further. Expect more Bank of Japan easing soon which should help Japanese shares.

The bottom line is that Brexit is unlikely to knock the global economy into recession and we see little reason at this stage to change our expectation for continued moderate global growth.

Short term opportunities

I am not so confident about British assets given the long period of uncertainty the UK will now face both economically and

politically. So while the pound is undervalued and oversold the risks remain down until the nature of Brexit is sorted out.

However, the global bout of "risk off" that we have seen is likely to provide a buying opportunity as Europe is ultimately likely to hang together, global monetary policy is likely to be even easier than previously thought and the global economy is likely to continue to see modest growth.

What about the impact on Australia?

Given that only 2.7% of Australian exports go to the UK and that the Leave victory is unlikely to plunge Europe into an immediate recession, the main impact on Australia will be on financial markets. This could affect short term confidence and may add to the case for the RBA to cut interest rates again particularly if banks increase their mortgage rates out of cycle due to higher funding costs flowing from an increase in lender caution and if the \$A is pushed higher due to an ongoing delay in the Fed raising interest rates. That said, we expect the RBA to cut rates again anyway and a falling \$A will ultimately provide a shock absorber for the Australian economy if the global economy and financial system really gets hit. Overall, Brexit barely changes the risk of recession in Australia which is low.

What to watch?

Key indicators for investors to watch include the following:

- The EU leaders' summit this week – this is unlikely to see big increase in European integration but will likely see more statements pointing in that direction. An increased focus on border control to prevent a repeat of last year's immigration crisis given that immigration played a major role in the Brexit vote is also likely.
- Geopolitical events in Europe – the key event in the short term is the Italian referendum on Senate reforms to be held by October. This is necessary for economic reform to succeed in Italy. Next year will also see a Dutch general election and French presidential election (although it's interesting that support for Marine Le Pen in France appears to be falling).
- If the "who's next" guessing game really heats up then Italian and Spanish bond yields will start to surge higher again as investors start to demand a greater Euro break up premium. Ten year bond yields did spike in Italy and Spain last week but only to 1.55% and 1.62% respectively which is well below the 7% plus levels reached in 2011-12. I suspect the ECB's "whatever it takes" to preserve the Euro commitment may limit any blowout here.
- Eurozone bank share prices are also worth watching given this is where financial stress will show up in Europe.
- The nature of the Brexit - a minimalist Brexit (ie, like Norway's arrangement) would send a strong signal dissuading other Eurozone countries from doing the same.
- A renewed surge in the value of the \$US – this would be bad for the global economy and signal problems in China, commodities and the emerging world. Further Fed delays in hiking rates may dampen the \$US though. It's noteworthy that the US money market now sees a greater chance of rate cuts (albeit 10-14%) than of rate hikes (zero chance) at the July and September Fed meetings and sees only a 15% chance of a hike by year end.

Concluding comment

We are now going through what is traditionally a rough time of the year for investors ("sell in May and go away..."), and the Brexit vote is contributing to that this year. The key for investors is to either look through the short term noise caused by the Brexit decision or look for investment opportunities that it throws up as investment markets become oversold.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital