Special edition – Brexit

June 2016

UK referendum: 'Leave' wins the day

What next?

Against the run of the opinion polls and the betting markets in the final few days before the vote, the people of the United Kingdom (UK) have voted to 'Leave' the European Union (EU).

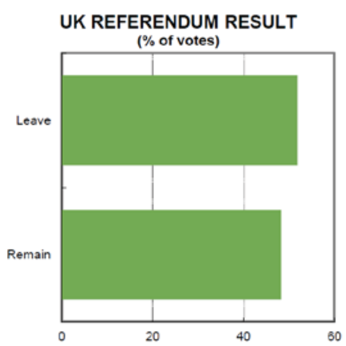
The official tally of the referendum showed the 'Leave' camp received 17,410,742 votes, which was approximately 51.9% of the total. 'Remain' took 16,141,241 votes, 48.1% of the total. Voter turnout was a very high at 72%, above the 66% seen in the 2015 General Election.

The process to 'Leave' the EU is likely to take at least two years, once the UK Parliament invokes Article 50 of the Lisbon Treaty (the Treaty of the European Union). However, the timing of this is uncertain, with the 'Leave' campaign suggesting that that they would begin informal negotiations before activating Article 50 and MP Boris Johnson stating that there would be "no need for haste" in negotiating Britain's exit.

In addition to negotiating their withdrawal, the UK would also need to negotiate post-exit arrangements with the EU on issues such as trade, regulation and immigration. When taking into account the complexity of this negotiation process and the involvement of all 27 remaining EU Member States, the two-year period appears limited.

While it is true that the period can be extended, this would require the agreement of all 27 remaining EU Member States and there is a high probability that this would not be forthcoming. At the end of the two-year period, the UK will cease to be a member of the EU and all related treaties and agreements will halt whether or not replacement agreements or treaties are in place.

This uncertainty is one of the key risks around the 'Brexit', as it is not clear what the arrangements would look like post-exit, or if indeed any will be agreed before the UK formally leaves the Union.



Short-term

Financial markets have responded with significant volatility post the result. In the Australian time zone on Friday, as the results came through, the GBP/USD exchange rate (cable) traded from 1.50 at the open to a low of 1.3229 on the day. Since then cable has traded in a 1.34-1.40 range and this morning is trading at 1.3420. Through this period, the GBP traded at its weakest level since 1985.

The UK looks like it will imminently lose its AAA/Aaa credit rating. Moody's has lowered the UK's credit rating outlook to 'negative' from 'stable', while S&P has stated that the UK's AAA credit rating was "untenable under the circumstances".

The outlook for the GBP over coming months now looks to be (much) weaker than previously anticipated. Apart from the weaker economy, easier monetary policy and greater uncertainty that is now expected to flow from the UK's decision to 'Leave' the EU, the GBP is also likely to be weighed down by the need for the UK to fund its ongoing current account deficit – which stands at around 5% of GDP.

The weakness of the GBP has also seen a strong 'flight to quality' rally for the US dollar (USD) and Japanese Yen (JPY).

Global equity markets reacted very negatively to the 'Leave' vote. In trading on Friday, as the vote counting continued, the Australian equity market dropped 3.2%, while the Japanese market was down a very large 7.9%. During trading on Friday, after the 'Leave' vote was declared the winner, UK markets were significantly weaker with the internationally focused FTSE100 down 3.15%, the domestically focused FTSE250 down 7.2% and the FTSE Banks index down 9.77%. Equities in Europe were also weaker with the Euro Stoxx down 6.9%, led by falls in the Spain (-12.35%) and Italy (-12.48%) while the French market was down 8% and the German market was down 6.8%. In the US, the Dow ended down 3.4%, while the S&P500 was down 3.6%.

Global equity markets are likely to remain under near-term downward pressure as investors come to grips with the implications for the UK, EU and global economy and how policy makers and central banks respond to these developments.

Global bond markets rallied hard on Friday in response to the 'risk off' developments. US 10 year bond yields were down 19bp to 1.56%, while UK 10yr gilt yields were down 29bp at just 1.08%. German 10yr bund yields traded back into negative territory, to be at -0.047%. Japanese 10yr yields ended Friday at -0.185%, while Australian 10yr yields rallied by 24bp to 2.0%.

With global monetary policy set to be eased again in coming months and global economic growth likely to remain subdued, further downward pressure on global bond yields could be expected.

In response to these developments and on concerns that the UK economy will suffer a significant loss of economic momentum, the Bank of England (BoE) has quickly stepped in to support markets. BoE Governor Mark Carney issued a statement after the vote, stating that “as a backstop, and to support the functioning of markets, the Bank of England stands ready to provide more than £250 billion of additional funds through its normal facilities”. He also stated that "the BoE is also able to provide substantial liquidity in foreign currency, if required.”

The European Central Bank (ECB) also responded to the UK vote to ‘Leave’ by stating that “following the outcome of the UK referendum, the ECB is closely monitoring financial markets and is in close contact with other central banks. The ECB stands ready to provide additional liquidity, if needed, in euro and foreign currencies."

The outlook

The UK economy was already slowing into the Brexit vote, with Q1 16 GDP at 2%/yr. The risks now are that the uncertainties created by the ‘Leave’ vote see a substantial downturn in economic activity, including consumption, business investment and trade flows (especially services) and push the UK economy into recession.

In response the BoE is likely to be compelled to ease monetary policy further. With the base rate currently at just 0.5%, this is likely to involve both a small interest rate cut (but probably not into negative territory) and more quantitative easing (ie asset purchases). A bank funding-for-lending program is also likely to be in the BoE’s tool kit.

Some fiscal policy expansion by the Government could also be on the cards – although the political uncertainties created by the ‘Leave’ vote could complicate this.

Elsewhere, further policy easing from the BoE and a weaker UK economy has policy implications more broadly.

The strength of the USD and JPY also likely will impact both the US Fed and the Bank of Japan (BoJ). At this stage we continue to expect one rate hike from the US Fed in September, but prolonged weakness/volatility in global financial markets could delay the Fed even further.

The strength of the JPY since the Brexit vote just reinforces our view that the BoJ will ease monetary policy further – including a move deeper into negative rate territory and an increase in the BoJ’s QQE program.

Locally, a weaker global economy will add to the pressure on both the Reserve Bank of Australia (RBA) and Reserve Bank of New Zealand (RBNZ) to ease monetary policy further in coming months. Indeed, we expect further rate cuts from both the RBA and RBNZ in the near-term.

The positives

From an economic and financial market perspective the decision to the ‘Leave’ the EU might be a difficult one to understand, and financial markets have certainly had this response. However, it must be accepted that a majority of the people in the UK evidently see positives in leaving the EU.

The overall argument for leaving centres on returning sovereignty to the UK, but there are also some more specific potential positives.

- Membership fee – Last year the UK paid £13bn into the EU budget, but only received £4.5bn of spending, a net contribution of £8.5bn. However, while leaving the EU would appear to offer an immediate cost saving, it is unclear how much would be realised in practice as most nations with access to the single market must contribute in some way to the EU budget.
- Trade – Outside the EU, the UK will be free to establish its own free trade agreements without being bound by EU law in areas such as agriculture, justice and home affairs.
- Regulation – Free from compliance with EU legislation, the UK would be free to set its own regulation without outside influence.
- Finance – Without EU membership the UK would be free to regulate financial services as it sees fit, protecting it from potentially burdensome EU regulations.
- Immigration – Leaving the EU will mean that the UK can resume control of immigration and limit the flow of EU migrants; as well as exclude them from in-work benefits.

Political implications

The most obvious political ramification of the ‘Leave’ vote has been the decision by British Prime Minister (PM) David Cameron to resign. PM Cameron has stated that “the British people have voted to leave the EU and their will must be respected. I do not think I can be the captain to take the country to its next destination.”

PM Cameron will likely leave office before the Conservative Party conference in October. Front runners to take over as Prime Minister include Boris Johnson (former London Mayor and leader of the ‘Leave’ campaign) and Theresa May (Home Secretary).

Despite his decision to resign, PM Cameron is under pressure from his EU colleagues to speed up the ‘divorce’ talks with the EU, after officials in Brussels said exit negotiations should start immediately. Significantly, EU head Jean-Claude Juncker said the UK leaving the EU would "not (be) an amicable divorce", but it was "not a deep love affair anyway". A sentiment echoed by Martin Schultz, the President of the European Parliament, who said that EU lawyers were studying whether it was possible to speed up the triggering of article 50 stating - “uncertainty is the opposite of what we need” and that it was difficult to accept that “a whole continent is taken hostage because of an internal fight in the Tory party.”

The ‘Leave’ vote by the UK has already seen calls from some in Scotland for a second referendum on Scottish independence, as Scotland has made it clear that they want to remain within the EU. The Brexit vote showed 62% of Scots in favour of Remain.

There has also been calls for discussions around the future of Ireland, with the Republic of Ireland to remain a member of the EU, but Northern Ireland now not – despite a 54% vote for Remain in Northern Ireland. Increased border regulation and control between the Republic and the North is unlikely to be a welcomed development.

Across the EU the risk now is that other countries, emboldened by the 'success' of the 'Leave' vote in the UK, could see an intensification of anti-EU sentiment. This might see other 'minority' parties in Sweden, Spain, France, Italy and even German, push a more nationalist agenda.

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