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MARKET INSIGHTS ALERT

Beyond Brexit

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Last night's Brexit vote reiterated just how out of touch financial and political elites in the UK are with the mass population. Fears of similar class polarization now cast their gaze on the recent rise of similar isolationist political movements elsewhere in Europe and the US with newfound gravity. While the short and intermediate impact could tip the UK into a recession, the most likely second order effect will be to hike premiums demanded for European risk assets under fear of rising Euroscepticism. Euro area capital investment, which had just begun to show some sign of life would likely be also be discouraged by exit risk uncertainty. US stocks will probably act as a safe haven for equity investors due to the safety of the dollar, a lower likelihood of US rate hikes and the prospect that earnings will fall less than in other economies. Additionally, exports to the UK and the Eurozone account for only 0.4% and 1.6% of US GDP respectively and the US dollar has risen by only 1.4% against the euro. That's not going to make a huge difference on its own, though we have to expect a serious drop in business and consumer confidence across Europe, so demand for US exports (14% of total US exports) will fall. Absent aggressive BOJ action, yen strength will continue to challenge Japanese equities. Emerging markets may end up benefiting from a gentler pace of rate rises by the Fed, but they could suffer if the dollar continues to climb.

While the Brexit event was historical in its initial market impact, it has not thus far been as disruptive as prior risk off triggers, such as the 2008 GFC or even the August 2015 RMB devaluation or January of this year. The hits to oil, EM and US equities and the move higher in the dollar index have been notable, but not dislocative, and have mostly pulled back to within recent ranges. It is possible that this initial shock may amount to an asset price adjustment to new realities including higher inflation and weaker growth in the UK, a period of potentially prolonged uncertainty that is negative for sentiment and capex until there is greater political clarity on whether the UK takes a hard or a soft exit path, some pressure on European peripherals amid heightened focus on European political dynamics, etc. Key drivers for risk appetite in the coming weeks will pertain to UK and broader European political dynamics, how the Bank of Japan copes with further unwanted yen strength and whether the recent stability in both oil and Chinese economic data hold. For now, fundamentals are out the window. When such tail risks crystallize, nothing is certain except uncertainty. Whether the pound or other assets will enjoy some kind of technical rebound or plunge further, and the longer term impact on financial markets and the world economy, will depend on central banks' effectiveness in in deploying liquidity facilities as well as a host of political developments in Britain, the rest of Europe and other countries. By definition these political events will be as unpredictable as the referendum itself.

Rather than trying to base a strategic response to this earthquake on purely speculative assumptions about British or European politics, trade negotiations or monetary policy, this is a time to behave tactically. Here are touchpoints that will determine future price action:

1. REDO, QUICK EXIT OR PROLONGED AND MESSY DIVORCE?

With David Cameron's announced resignation, until a new prime minister is in place, the government will not trigger Article 50 of the Treaty on European Union, which starts a two-year countdown to withdrawal unless the remaining 27 EU states agree unanimously to extend the process. Depending on who wins the party contest, the new premier could technically choose to announce a snap election to win a new mandate for exit since the current House of Commons is dominated by MPs who support continued EU membership. Popular referendums have gone against European integration before, only to have a re-run that went in favor of integration, as with Denmark rejecting the Maastricht Treaty in 1992, Ireland rejecting the Treaty of Nice in 2001, and Ireland (again) rejecting the Treaty of Lisbon in 2008. If this extended period of policy uncertainty is against a backdrop of depreciating assets, a falling currency and continued deferred investment and recruitment decisions, pressure may grow for the new government to opt for membership of the European Economic Area. However, the difference is that these prior referendums were already part of the European Economic Community and EU respectively, and were voting on whether to accept a new governing treaty. The treaty was altered to meet their demands, and the following year they voted to accept it. Brexit is different. Voters will have rejected a known status quo. Cameron has already renegotiated the relationship, so a Brexit vote repudiates that option. And it will be difficult for the EU to grant bigger concessions to get a second referendum, since that would both weaken the union and encourage other states to follow in the UK's footsteps.

Moreover, even though the referendum was not binding, ignoring the will of the people without a significant change in mass sentiment would amount to political suicide. The trickiest part of the exit agreement will be U.K's access to the common market. The UK has various models to follow – Swiss, Norwegian, Icelandic, Canadian, etc – to maintain a trade relationship with the EU. Brexit would involve various other negotiations, from the short-term settlement of accounts to the long-term initiatives to integrate EU laws into British law and renegotiate trade agreements with third parties. This would mean swapping the tariff-free area with the EU and establishing customs and border posts between Northern Ireland and the Republic. The two-year withdrawal negotiations would be followed by an exit relying only on the protections of the World Trade Organization that would not include auto parts and farm products. Crucially

for the UK, this form of exit would exclude London-based financial institutions from "passporting" rights that allow firms authorized anywhere in the EEA to carry on activities in any other state by exercising the right of establishment or providing cross-border services.

The broader concern is that this process prolongs business uncertainty about the future over a minimum of two years when the UK runs a current-account deficit worth 5% GDP. Until the campaign got underway, the core "exit" vote was around 35%. A drawn-out economic slowdown, asset-price depreciation and even – depending on what the Bank of England needs to do to prop up the exchange rate and finance the current-account deficit – higher interest rates would test the patience of softer Brexit voters.

The bottom line is that the two-year negotiation period is likely to be a messy affair. European policymakers – including Anglophiles like German finance minister Wolfgang Schäuble – threatened that the UK will not gain access to the common market after a Brexit. Whether these were mere threats intended to sway the vote, or real policy positions forged by the need to prevent further exit referendums, is unclear. Additionally, UK political limbo and Tory politics point to substantial uncertainty over the coming months, and until a new administration is in place and the exit path more clearly known, we see scope for USD assets to broadly outperform the UK and Europe. This of course poses a conundrum for the Fed, where officials are focused on the countervailing effects of a stronger dollar and lower yields on financial conditions as well as on potential real economy impacts, and will reinforce dovish caution.

2. CENTRAL BANKS RESPONSES

The G7 will likely have to address the instability in the currency markets. Central banks are set to employ liquidity facilities. The rhetoric of pro-Remain policymakers has changed from "Project Fear" to "Project Reassure". The Governor of the Bank of England has emphasized both the health of the UK's financial system and the Bank's willingness to provide support where needed and it has dawned on investors that a long period of negotiation, rather than sudden upheaval, now lies ahead. In the Eurozone, there was a marked spike in peripheral sovereign yields (See CHART 1).

OIS rates now reflect greater expectations of further ECB action, fueling a rally further out the curve. Additionally, another 10bp depo rate cut by is fully priced by EONIA forwards by Q4 with more into the turn of the year. A further acceleration in the pace of purchases – perhaps from the current €80bn per month to €90bn or€100bn – now seems likely.

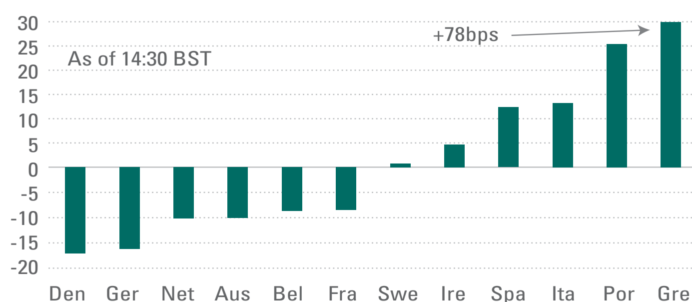
In the U.S., the chaos likely pushes back the timing of the recovery in payroll growth after the sharp May slowdown, rendering a September hike less likely. Survey-based measures of hiring intentions dropped after the S&P500 fell by 12% between late December and mid- February, and we can't rule out a similar decline over the next few weeks, following an initial plunge today.

In Japan, Finance Minister Taro Aso held an emergency press conference to say he was "very concerned" after the yen's initial surge to around 99 against the dollar (though the JPY trimmed its gains to around 102.30), but there was no sign the BOJ will hold an emergency policy meeting (Kuroda is in

Europe for a BIS meeting through June 28) and Aso has said concerted action is premature. Further accommodation would most likely be triggered if the Q2 Tankan and CPI data exhibit weakening momentum and price pressures.

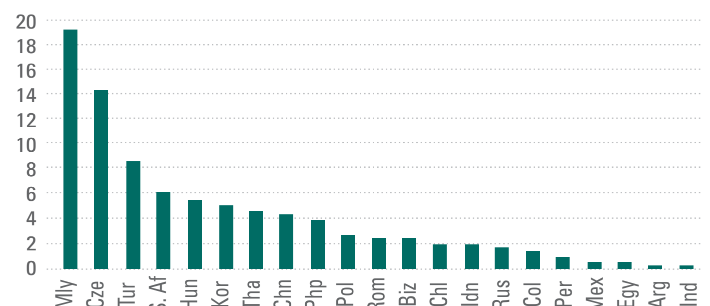
While the direct economic impact on EMs could be surprisingly small, the political ramifications for EMs in the EU could be significant as populists in CEE will be emboldened by the vote. A sharp rise in the Chinese RMB with a sustained appreciation of the USD would also be deflationary. However, the RMB's trade-weighted weakening over the past 12 months gives the People's Bank some leeway to allow the currency to track the dollar higher if necessary in order to avoid a repeat of the panic seen earlier this year. Finally, an additional area of vulnerability included banks that rely heavily on external wholesale markets. A decent proxy for this is banks' short-term external debt (see CHART 2). On this measure, banks in CEE, Turkey, South Africa and Malaysia look exposed. Finally, in the event that the Chinese RMB weakens against a globally strong dollar following the vote, this could rekindle devaluation fears.

CHART 1 Today's Change in 10-Year Government Bond Yields (bps)



Source: Capital Economics

CHART 2 Banks' Short-Term External Debt (% of GDP)



Source: Thomson Datastream, Capital Econimics

I'M MAD AS HELL AND I WON'T TAKE IT ANY MORE!

The Brexit referendum represents a global phenomenon: populist revolts against established political parties, predominantly by elderly, poor or under-educated voters angry enough to tear down existing institutions and defy the "elite" politicians and economic experts who warn against leaps into the unknown. The British referendum blew the cover off of an extremely fractured and polarized society—with huge majorities for Brexit among elderly and poor voters and in relatively under-developed rural regions vehemently opposed by almost equal majorities that supported EU membership among young and highly educated voters and in the prosperous cities—not only London, but also Manchester, Bristol, Newcastle and the whole of Scotland. As one investor cogently stated: "Put another way, if your house is cleaned by a Polish immigrant then you probably voted remain but if you perceive your job to be at threat from immigrants then you probably voted out."

This extreme polarization on a national issue of existential importance would raise risks of social and political tension even in benign economic conditions. If, as is likely, Britain now suffers some kind of financial crisis and recession, the people who voted for Brexit will discover that leaving the EU has not resolved any of the economic problems and social grievances that provoked their protest against the political establishment. If this happens, public anger will presumably intensify, rather than calm down.

More generally, rising income inequality and slow economic growth in many developed countries have triggered a backlash against globalization. This is already shaping up to be a key issue in November's US presidential election, with presumed Republican nominee Donald Trump threatening to start a trade war with China and to build a border wall with Mexico. We don't think the UK vote makes a Trump win in November any more likely but, given that the early polls a few months ago pointed to a remain win, it does demonstrate that opinions can change. Accordingly, we would be wary of reading too much into presumed Democratic nominee Hillary Clinton's current lead in the polls.

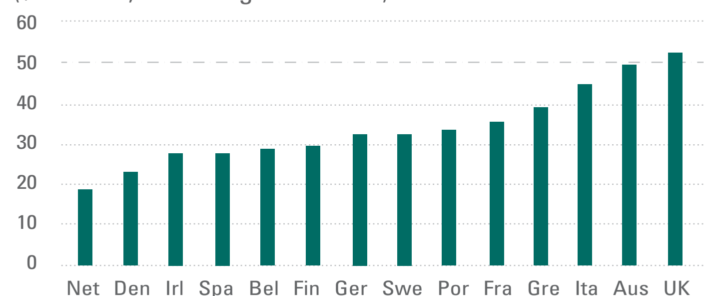
WHO'S NEXT?

The UK vote to leave the EU could, of course, have wider ramifications for the EU and global economy. Speculation will mount that the UK vote could set off a chain reaction of other EU countries leaving. This speculation is supported by growing skepticism among EU countries. The global financial system relies on the euro and the ECB and both rely on the cooperation of member currencies. If the exit of the UK, which was not a part of the currency union, led to a 10% swing in global risk assets, what would be the impact of such a referendum by a major member country? Given the ease with which capital can move such a referendum could significantly increase capital flight and threaten the country's banking system. As we saw in the debt crisis, this could breed contagion.

Support for a similar referendum exceeds 50% in both France (where the Euroskeptic Marine Le Pen has surpassed Hollande in the polls) and in Italy, where the 5 Star Movement gained significant momentum recently in municipal elections. **Opinion surveys are one way to identify where euro-scepticism is strong.** In May, polling firm Ipsos Mori asked respondents how they would vote if an EU referendum were held in their country. In that survey, the most euro-sceptic countries were Italy, France and Sweden. Yet even in the most Eurosceptic of the three, Italy, at 48% there would not quite be enough support for an "out" vote. The EC Eurobarometer survey carried out in November incorporated a broader array of countries and was in retrospect foresaw the outcome of the Brexit referendum. In response to whether respondents thought that their country could face the future better outside of the EU; excluding unknowns, 53% of respondents thought that the UK would fare better outside the EU. The response from Austrian and Italians was also high, at 50% and 45%, respectively. In contrast, in the Netherlands and Denmark less than 25% of respondents were optimistic on their countries prospects outside of the EU (see CHART 3).

This weekend's Spanish election suddenly becomes much more of a focus. A fragmented outcome, as is widely expected, may fuel uncertainty and contagion fears, maintaining upward pressure on peripheral spreads. But Podemos will likely come in second, which makes an alliance with the established socialists less likely. More "change" elections are expected for Germany (2017) and France (2017).

CHART 3 Would Your Country Fare Better Outside of the EU? (% of Total, Excluding Unknowns)



Source: European Commission

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