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UK economy

Referendum on EU membership – the UK votes to leave the European Union

Chief Investment Office WM I **24 June 2016**
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- The UK has decided to leave the EU. The final count is expected to be in the region of 48% Remain, 52% Leave.
- Markets had largely positioned for the UK to remain before the vote. Thus the reaction in currency markets has been hugely negative. We expect sterling to be volatile, and UK equities will again come under pressure, especially those linked to the domestic economy.
- Uncertainty is likely to increase for both business and households in the UK, potentially leading to a demand shock for the economy. Our initial assessment is that growth in the second half of this year will slow further. The Bank of England will at the very least keep interest rates on hold, but a cut is very likely. Other forms of stimulus are also possible. We will be formally reviewing our forecasts in due course.

Source: istock

The UK public votes to leave the European Union.
The UK public has voted to leave the EU. The final count is expected to show that 48% of the public voted in favour of remaining a member of the EU, 52% preferred to leave.

What next?
There is a great deal of uncertainty ahead as questions will now be raised about the timeline and process from here. Indeed it is still far from clear that today's vote will actually lead to the UK exiting the European Union. Before we move on to the many questions facing the UK in the weeks and months ahead, it makes sense to start this note with the facts that we do know.

- The UK is for now still a member of the EU.
- The UK will remain a member of the EU until the date it formally notifies the EU that is wishes to leave (so called triggering Article 50 of the Treaty of Lisbon), and for at least two years beyond this.
- Until the UK leaves, its companies will retain free and unfettered access to the single market, and all EU laws and regulations will continue to apply.
- Thus, business in the UK will continue, and trade with the rest of the world will carry-on on the same terms as before.

As for the list of uncertainties, these are many, including

- How long will David Cameron remain as prime minister, and who is likely to succeed him?

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- Will the government trigger Article 50 immediately or will it look to wait?
- Will the UK government look to renegotiate its membership with a view to holding a second referendum?
- How will EU countries react to this decision?
- If the UK does pursue the exit path, how long will it take to agree a new trade deal with the EU and the 53 other countries covered by its current membership?
- Will any new trade deal cover services?
- How will overseas investors now perceive the UK?
- Will a new independence referendum for Scotland be called within the current Scottish parliamentary cycle?

With these and countless other questions to be answered, our sense is that the already tangible slowdown in business confidence in the UK will accelerate in the short term. This will likely see investment and hiring placed on hold until such questions and uncertainties are resolved. Additionally, consumer confidence is like to slip as uncertainty about the prospect for future incomes and employment grows.

In our mind, this points to flat to meagre growth for the economy in the second half of this year, which is likely to be met with further loosening of monetary policy in the months ahead. We are in the process of formally revising our growth numbers and outlook for interest rates, and will update readers in due course.

Markets – the only certainty is more uncertainty, but there are still pockets of resilience

The reaction in the currency markets thus far, with sterling falling by 9% in early trading, is likely a good indication of the trend for the coming days. We expect to see significant volatility in currencies and equities until a greater understanding of the consequences of the UK's decision is gained.

In our view, it is reasonable to expect that sterling will settle in the mid 1.30s level against the US dollar until some clarity emerges. Beyond this level, we would note that sterling would be significantly undervalued and markets would probably be reluctant to sell.

For the FTSE 100, we expect the falls to be cushioned by a decline in sterling. The FTSE 100 futures market is currently showing a fall of around 7%. In the run up to the referendum, we identified that on a vote to leave the FTSE 100 could move below 5,600 (more than 10% fall) over a 12-month period.

In our view, companies and sectors most leveraged to the UK economy could therefore be expected to continue some of their pre-referendum underperformance. This includes sectors such as the financials, consumer discretionary, and the FTSE 250 Mid Cap Index. Meanwhile we would expect defensive and international segments of the market to outperform, as they have less exposure to the UK economy and should be supported by a weaker pound.

For the gilt market, it is likely that yields will fall as investors digest the prospect of weaker GDP growth, the prospect of interest rate cuts, and the potential for further quantitative easing by the Bank of England. In the credit markets, the stability in credit spreads is unlikely to persist as risk premiums rise.

There will likely be numerous statements and actions from policy makers and central bankers in the coming hours and days, with the aim to calm the markets and reassure their nations' citizens. These may go some way in assuaging concerns in the very near term, but a close eye needs to be kept on the wider political ramifications of today's decision. With an election in Spain at the weekend, and signs of increasing support for anti-establishment parties in other European countries, questions may arise about the glue that currently binds the European project together.

However, we should not be too fatalistic, as there are many areas of strength in the global economy that will help to stabilise the situation. Low inflation meanwhile offers central banks the scope to respond aggressively if need be. In particular, the US economy is unlikely to be derailed. In Europe, after a strong performance in the first quarter, the foundations are in place for expansion to continue in the face of any disruptions caused by the UK's decision. And in Asia, the ongoing stabilisation of the Chinese economy should continue to support activity across the region.

The days ahead will likely be challenging for investors to navigate, but maintaining a global portfolio diversified across regions and assets is the best way to shelter from the biggest pitfalls, and gain exposure to the greatest opportunities.

Appendix

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