# Our Initial Thoughts on Brexit

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**KEY TAKEAWAYS**

- By a narrow margin, the UK has voted to leave the EU.
- We expect the UK and EU economies to slow as a result.
- Currency and market volatility will likely remain elevated.
- Central banks stand ready to provide liquidity.
- We encourage patience as the implications become clear.

The UK referendum on European Union membership saw 51.9% of voters favor leave, surprising a market that had become confident of a remain outcome over the last few days. Thus far, financial markets have not shown widespread panic, just weakness and increased volatility. We encourage patience as the implications become clear. Below we share our initial thoughts on the economic and financial impact of this historic vote.

## A Slow Upheaval for the United Kingdom

We expect the UK economy to slow toward recession in the second half of this year, and fiscal consolidation, about which we have always been skeptical, will likely not occur. Prime Minister Cameron has resigned and is expected to leave office by October. A new government will negotiate the terms of the UK's exit. UK politics will be tumultuous in the next six to eight weeks, and negotiating Brexit will take at least two years.

The Bank of England (BOE) may cut rates or increase quantitative easing. BOE Governor Carney has already promised £250 billion in liquidity if required. Markets expect a 25 basis point cut from the BOE by February 2017. As expected, Standard & Poor's has downgraded the UK in the wake of the vote, and other rating agencies are likely to follow suit.

The pound initially fell sharply Thursday night, and trading has been volatile, packing a year's worth of volatility into recent trading. Currency and market volatility will likely remain elevated.

## Concerns for the European Periphery

Uncertainty caused by Brexit will hit EU growth. Peripheral economies will remain pressured, and we expect intra-EU government bond spreads to widen. The ECB will seek to protect and defend the financial system and also stands ready to provide additional liquidity if needed.

Brexit could spark political and referendum contagion across the euro zone, which could increase downside risks. For example, Scottish First Minister Sturgeon has announced her intention to propose a new independence referendum. The Spanish elections on Sunday, June 26, ended in another stalemate, which could result in a weak coalition government and continued political uncertainty. Similarly, Italy has a referendum vote in October. We think anti-EU risks are rising in periphery politics.

## Ripple Effects in Global Markets

Risk aversion could increase further on the back of Brexit and drive up demand for the US dollar and Treasurys. Central banks, including the Fed, are generally in "wait and see" mode but ready to provide liquidity if needed. Markets have already pushed out additional Fed rate increases to the third quarter of 2018. We don't think the Fed will have to wait that long, though hikes could be off the table for 2016.

While Brexit may make the Fed move more slowly in hiking rates, it could speed up policy action in other countries. For example, if US dollar strength persists, we expect pressure to intensify on the Chinese renminbi. This could trigger a renewed wave of capital outflows and, together with weaker economic data, could spur a policy response. We think a response will involve various liquidity tools as authorities have been reluctant to signal aggressive monetary easing to prevent credit growth acceleration. In Japan, yen strength is a serious concern for the BOJ, which may hasten a policy response, but we expect a more measured approach after initial market turmoil subsides.

We have closely monitored Brexit since late 2015 and carefully considered the potential impact of both outcomes. We remain singularly focused on client portfolios, seeking opportunities amid market volatility.

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# Disclosure

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