

THE BREXIT REACTION AND IMPLICATIONS

June 2016

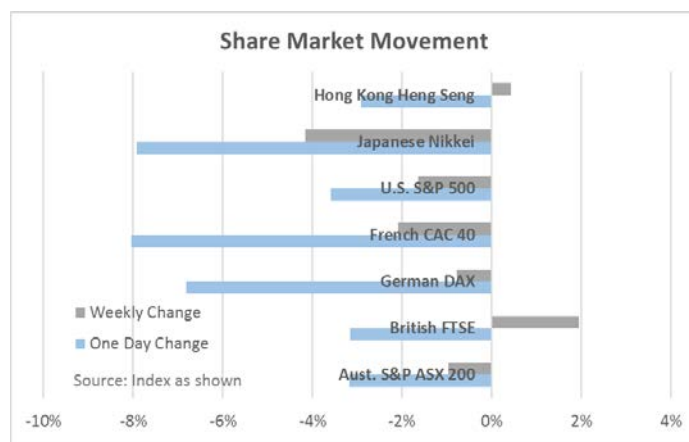
In isolation, the decision by the United Kingdom (UK) to leave the European Union should not be cause for any significant angst amongst Australian investors. Certainly, the ensuing reduction in free trade may lower the longer term economic growth rate of the UK, which in turn has an impact on global growth. However, this impact is very much at the margin and likely to be swamped in terms of magnitude by other more significant growth influences.

The preoccupation of financial markets with the UK's referendum in the lead up to the decision, and the subsequent market reaction following the "no" vote, suggests the potential impact of the decision is far wider than a few fractions of a percentage point off long term global economic growth. Financial markets do not deal well with uncertainty and the decision by the UK to exit the European Union creates heightened uncertainty, both in terms of the future structure of the UK economy and the ongoing operation of the European Union.

The market reaction

Before discussing the potential impact of UK's decision further, it is important to put the immediate market reaction in some perspective. Although opinion polls were indicating a close result, the "no" vote decision was not the outcome financial markets were expecting. The surprise result led to a sharp fall in equity market values and a rise in bond prices (fall in yields). Commodity prices also fell significantly (with the exception of gold, which rallied strongly), which is consistent with a scenario of a lowering in the outlook for economic growth. There were also some large adjustments on currency markets, with the British pound being sold off heavily and "safe haven" currencies, such as the \$US, being well supported. Against the \$US, the UK pound is currently trading 8% below its immediate pre-vote level.

Although all major equity markets fell in response to the referendum result, there was a degree of inconsistency in the magnitude of the falls. Somewhat ironically, the 3.15% decline in the British FTSE Index on the 24th of June was marginally better than the 3.17% fall in the Australian S&P ASX 200 Index. It would appear that the materially lower UK exchange rate helped stabilise their share market; whereas lower commodity prices weighed heavily on the local Australian market.



Notwithstanding the magnitude of some of the share market falls, the immediate market reaction did not appear to be one of panic. In fact, the majority of equity market falls could be considered to be quite moderate given the rally in prices that took place in the days just prior to the referendum. The accompanying chart shows the percentage change in some major equity markets on the day following referendum as well as the movement over the whole week of the referendum. It can be seen that the majority of movements over the past week have been modest. **Perhaps the most surprising result is that the British FTSE finished the week above its opening level.**

The future impact of the UK exit

In the shorter term, there may be very little fundamental change in the UK's arrangements with the EU. The Prime Minister has suggested that formal proceedings won't commence until a new UK leader is appointed in 3 months. It is expected that it will take approximately two years for the logistics of the exit to be completed. Over this time, the UK will seek to establish new trade agreements with the EU and other nations.

Generally, in any trade negotiation, it is in the interests of both parties to pursue free trade and minimise the imposition of barriers to trade – such as tariffs and quotas. A scenario whereby the UK successfully negotiates its way out of the EU and into new trade agreements with minimal impact to its longer term economic prospects is a high possibility. As Switzerland and Norway have shown, it is possible



to be heavily economically integrated into Europe without having full EU membership. The accompanying chart highlights that over the past decade, both Norway and Switzerland have enjoyed a higher rate of economic growth than the EU region.

However, whilst the UK may be able to successfully manage its EU exit and develop adequate longer term trade arrangements, there is concern that the UK's decision to leave will destabilise the EU more generally. Sentiment supporting national sovereignty and dissatisfaction with the free mobility of labour (i.e. the right of EU workers to work and reside with their families in any EU Member State) appears to be on the rise in other European nations. The UK decision, therefore, could be a catalyst for greater momentum to political opponents of EU membership in various other countries.

There is also a risk that the result of the referendum may create future instability within the UK. Support for independence within Scotland and Northern Ireland could grow with the narrowness of the overall vote suggesting the issues surrounding European integration will remain divisive in UK politics for some time to come.

Implications for investors

On balance, the economic implications of the UK exit from the EU are unlikely to be significant enough to materially change the outlook for global economic growth or the longer term returns from equity markets. Whilst the political implications may be more significant, relevant developments (e.g. further fracturing of the EU via other exits) will take a long time to play out. As such, leadership of the EU has time to shore up its support and make changes to minimise the potential for further departures. Of all the Member States, the UK has typically had a higher level of internal scepticism around the merits of the EU and was arguably less compatible with the EU in terms of legal structure and culture.

In the shorter term, the uncertainty caused by the UK exit decision will inevitably trigger a period of higher volatility and make equity markets more vulnerable to downward movement in response to bad news. To date, equity markets have not fallen far enough to create obvious buying opportunities and there could be an absence of buyers in further periods of market weakness.

However, central bank willingness to accommodate general financial market stability remains high and this should provide an important support mechanism in the months ahead. This implies the period of excessively low interest rates has become further entrenched and the expected program of monetary policy tightening in the United States will be delayed further. In this environment, the earnings yield available on equity markets continues to justify a benchmark allocation with potential buying opportunities emerging should shorter term volatility push valuations materially lower.