

## **Brexit: What Does It Mean?**

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On Thursday the United Kingdom voted to exit the European Union in an advisory referendum. In the aftermath Prime Minister David Cameron tendered his resignation and the pound touched its lowest level against the US dollar since 1985. But there is more to the story than shock. The consequences of Brexit will remain unknown for some time, to say nothing of its implementation. We think investors will be best served by measured consideration of the actual impact of a country which accounts for ~2% of global growth leaving a political union. Below we pose and answer questions which we think better contextualize the historic vote.

### **What does the market response mean?**

As of 12:35p EST, the pound was down 8.3% against the dollar and down 6.2% versus the euro. The 10-year UK government bond yield fell 29 basis points to 1.08%, German 10-year Bunds dropped firmly into negative territory, falling from 0.09% to -0.05%, and the 10-year US Treasury yield fell 17 basis points to 1.57%. Some of the market response reflects frenzy (see European bank stocks, for example). Other developments we regard as more durable. In particular we expect the Brexit vote to keep interest rates lower than otherwise across the world and across maturities. The weakness of the pound and the euro also appear likely to persist. However, other sectors have performed comparatively well. Investment grade and high yield credit spreads have widened, but investment grade bond prices are roughly unchanged on the day, meaning that much of the spread widening in IG was offset by a drop in Treasury yields (except for Yankee banks and some lower quality investment grade issuers).

### **Britain voted to exit the EU but when will they actually “be out”?**

Brexit will be a long process. The official path out of the EU resides in Article 50 of the Lisbon Treaty—a treaty which reformed aspects of the original EU Maastricht Treaty. By the terms of Article 50, Britain must formally notify the EU of its intention to withdraw. The treaty also stipulates that the terms of Britain’s departure will be set by a majority vote of the EU’s 27 other members, without the UK’s input. Upon notification, a two-year clock begins ticking, after which EU treaties no longer apply. However, and this is a key point, David Cameron’s resignation means that the new Prime Minister will likely be the one to decide when to initiate the two-year countdown to official exit. It may also be the case that the EU agrees to extend the two-year exit clock in light of difficulties. The actual consummation of Brexit remains far off.

### **What are the economic implications?**

The most important channel to acknowledge is the movement of goods and services, and to some extent, people. Many know that roughly half of all of the UK’s trade is with Europe. Evaluating the UK’s trade position country by country shows a somewhat more nuanced story. The UK’s number one export destination is the United States. The UK exports around the same amount to France as it does to China. Just because Brexit has happened, Brits are not going to stop buying BMWs, and EU member states are not going to stop buying Jaguars or Aston Martins. After all, aside from Germany, Britain is a more important trading partner to the largest EU countries than those countries are to Britain (see chart below).

## In Terms of Trade, Brexit Hurts Most EU Countries More Than It Hurts Britain



Source: Thomson Datastream, Capital Economics

\*Data is goods trade for full year of 2014

### Beyond the uncertain political and legal future of Brexit, what are the consequences for central banks and monetary policy?

The UK was not part of the monetary or banking union. The Bank of England has always set monetary policy in Britain, and the ECB has had no role in the UK. If ever there were thoughts of a near-term rate hike in the UK, the chances are substantially diminished now. Perhaps more relevant for bond investors, due to the sharp devaluation of the pound, import prices will very likely increase, pushing inflation higher. Just as the Fed has repeated its mantra of “looking through” the effects of a stronger dollar in the last 18 months, so too would we expect the Bank of England to regard a jump in prices with skepticism. If the buzz around additional countries leaving the EU accelerates, we’d expect the ECB to confirm its existing policies, perhaps even enlarging the corporate sector purchase program. For the Fed, the biggest Brexit-related concern is the effect of the vote on global financial conditions. The pullback witnessed today in markets will certainly pique the Fed’s interest, but, unless it is sustained, and so long as the US economy continues producing new jobs and near 2% inflation, interest rate hikes are not necessarily done for ([click here for our views on the Fed after the June FOMC meeting](#)).

### Should the real worry be the contagion effects from Brexit?

On the heels of the UK vote many worry that other European countries will follow the UK out of the EU. In light of the existing debate around immigration, there is scope for the anti-EU sentiment to intensify after Brexit. Far-right party leaders in France, Italy and the Netherlands have already called for national referenda on EU membership in their respective countries. A survey conducted by the Pew Research Center makes clear that many Europeans share the British majority’s unfavorable views toward the EU; 71% of Greeks, 61% of French, and 49% of Germans and Spaniards hold unfavorable views towards the EU. Depending on the negotiated consequences of an exit, other nations may become more disposed to strike out on their own in the future.

### Implications for the rest of the world?

Aside from the obvious market impact, the economic fall-out from the UK’s decision to leave the EU should be muted. The UK accounts for only 2.3% of global output, and is expected to add only ~2% to global growth in the next year. The countries driving global growth—China, India, and the US—won’t see their economic trajectory changed much by today’s decision.

### **What if it goes badly?**

Britain is the first country to leave the EU. As a result history isn't much help in evaluating the benefits of the decision. Our highest conviction view is that the British economy is probably as likely to perform well outside of the EU as it was inside the EU. Once the dust settles (no matter how long it takes), it will be clear that Britain still trades with the rest of the world, immigrants still arrive on UK shores, and the competitive advantages of certain segments of the UK economy will remain intact. Changes to those variables, in our view, would be just as likely inside the EU as out. More technically, if Brexit does not go well, the UK is still allowed to re-apply for EU membership (a low probability to be sure). The Lisbon Treaty makes provisions for re-entry, but an absolute majority of EU member states would need to ratify any future British proposal to re-join.