Beyond Brexit: What happens next?

National politics matters as much as global growth

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The UK has voted to leave the European Union (EU) by a majority of 51.9% to 48.1%, and UK Prime Minister David Cameron has tendered his resignation on the back of the result.[1] Voter turnout was very high at around 72%.[1] While a high turnout was expected to benefit the "remain" camp, the reality appears to have been different.

Global financial markets were wrong-footed by the decision - they had been rallying in the days running up to the vote, apparently anticipating that the UK would choose to remain in the EU. However, they gapped down sharply on the news, given the enormous asymmetry in which Brexit risk had been largely priced out going into the vote - polls and betting odds had gotten it wrong. On June 24, the day after the vote, markets have already recovered somewhat from their initial reactions, but are left facing much economic and political uncertainty ahead.

What happens next?

Various scenarios could unfold in the coming weeks, in terms of the direction of the UK's political leadership, the markets' response and ripple effects in other European countries- Spain holds its general election this weekend and it will be interesting to see if Euro skepticism resonates.

At Invesco Fixed Income, we see the major risks in the aftermath of the vote to be surrounding growth - in the UK, the EU and globally. We believe the resulting uncertainty is likely to put a damper on investment, especially in the UK, but in the EU as well, and perhaps elsewhere, until the outcome of the complicated exit negotiations can clarify the overall trade and business landscape of the separated blocs.

Political uncertainty is also likely to be heightened post-referendum, especially in the UK, but also in the EU and eurozone, and even in the United States. For the UK, the focus is already on the leadership of the Conservative Party, following Cameron's resignation, which will be effective in October 2016. There is much talk of an early general election, not due until 2020, which would complicate EU exit discussions and other trade negotiation. However, we believe this is not a central scenario, because the House of Commons (the lower house) would have to pass a vote of no-confidence in the current government, or a two-thirds majority would have to call an early election. The Conservative Party with its parliamentary majority is in a position to prevent either outcome, and would probably prefer an internal succession process rather than a new general election. If so, the political uncertainty could be contained, and a transition in the next few months could pave the way for negotiations about the future of the UK and EU.

The new prime minister will have his or her hands full not just with the EU but also with the integrity of the UK itself. Scotland voted overwhelmingly to remain in the EU by a margin of 24%, whereas England and Wales voted to leave by 6.8% and 5.1% respectively. [1] This contradiction has already prompted calls for a second Scottish independence referendum. Northern Ireland voted by an 11.5% margin to remain, also significantly more than the overall UK 2.8% margin for leave. [1] Senior Northern Ireland politicians have called for a referendum on the reunification of Ireland.

The EU and eurozone will need to address the risks of copycat exit referenda in other member states as other countries within Europe potentially consider their EU membership.

A potential eventual course of action is to try to "federalize," or more closely join, the eurozone, but this would likely take a lot of time and negotiation, during which Euroskeptic countries may well wish to exit based on their own referenda. The countries that should be most closely watched on this front are Finland, Netherlands and Denmark. National elections in Spain (upcoming), France and Germany (2017-2018), as well as mayoral elections in Italy (ongoing) will also provide useful political signals.

Amid all of this uncertainty, financial market reaction, while very negative, has been more constrained than might have been expected. Credibility around central bank support may be an underpinning. Bank of England (BoE) Governor Mark Carney, for example, announced that the BoE stands ready to provide GBP250 billion of extra funds and won't hesitate to take additional measures, if necessary. And while not a coordinated measure, the US Federal Reserve (Fed) will very likely hold rates steady in July; in fact the markets have almost completely priced out a Fed hike for the rest of this year, in our view.

That said, we do not think that direct central bank action would be required unless there are significant market dislocations. So far, financial assets geared to growth, like financial and corporate stocks with UK and European exposures, have suffered, and yields on so-called "safe-harbor" government bonds have fallen. But there is no sign of a liquidity or credit problem in the capital markets or the banking systems of Europe or the wider world. We interpret this as the markets pricing in lower growth and inflation in the UK, Europe and the world - including the United States - rather than a financial crisis or shock.

Also of note, European stock markets lost more ground than UK or US stocks on June 24, which likely reflects the market adjusting to reflect downward revisions on the outlook for growth and inflation in the EU and eurozone as a result of Brexit.

Longer-term view

The coming weeks will pave the way for months of national political decisions and years of international negotiations. We believe the UK's decision could unfold into two possible scenarios: positive Brexit or negative Brexit. It will be critical to monitor political signals as much or even more than the economic data and behavior of financial markets, which may now be as much or more influenced by prominent politicians as by central banks.

- In a negative Brexit scenario, UK growth could slow significantly; recession would be a distinct possibility. Lower UK-EU trade could cause a new deflationary demand shock in Europe, where peripheral European countries could bear the brunt of such a slowdown. The EU's new emerging market member-states, such as Poland and Hungary, are also likely to suffer weaker growth, in our view. By threatening their catch-up in terms of prosperity and living standards to richer EU neighbors, the risk of social and political tensions could rise.
- A positive Brexit scenario could involve the UK and EU engaging in constructive negotiations about exit and about maintaining open borders to trade and investment. Such a scenario could also entail the post-Brexit UK stepping up to the plate as an independent trading force and voice apart from the EU. In this scenario, we believe the UK's recent growth slowdown would likely continue, but downside risks would be contained by constructive engagement among the UK, EU and global trading partners, including the United States.

Conclusion

Both the European and global economy and markets face substantial uncertainty, arising from political shifts as much or more than from more fundamentally economic or financial challenges and opportunities.

The risk is that we get a negative Brexit in which the UK, EU and eurozone turn inward to maintain internal integrity. However, we hope that the part of the Brexit campaign that was about opening up further to the rest of the world helps render a positive Brexit. Correspondingly, that hope would be supported by a Europe that remains open to the UK and the wider world, despite its need to integrate to sustain the euro and despite the challenge of political forces that are skeptical to that integration.

[1] Source: Bloomberg L.P., June 24, 2016

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