Q&A

Brexit

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24 Years Experience

Western Asset Management Company Limited
Head of Investment Management, London, 2009–

BlackRock Investment Management
Managing Director, Head of Sterling Fixed Income, 2004–2009

M&G Investment Management
Director, Institutional Fixed Income, 2003–2004

Baring Asset Management
Director, Global Fixed Income and Currency, 1999–2003

Gartmore Investment Management
Senior Investment Manager, Global Fixed Income, 1995–1999

Whittingdale Investment Management
Economist, Investment Manager, 1992–1995

University of York, Ph.D.

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In this Q&A, Andrew Belshaw, Head of Investment Management, London, discusses the short-term and long-term impacts that Brexit, the UK's decision to leave the EU, will have on the UK, the eurozone and global financial markets.

Q: What is the likely short-term and long-term impact to UK GDP growth?

Short-Term Impact

The uncertainty over the UK's future trading relationship with the EU and the rest of the world is likely to persist for a number of months, if not years. Combined with the current lack of political direction, the immediate prospect for the UK economy is one of slowdown. Business sentiment and thus investment had already turned down in recent months. This is likely to continue, with investment plans being further postponed if not cancelled. Consumer sentiment is likely to be hit, with negative effects for the UK housing market, at least over the next few quarters. This suggests a slowdown in UK GDP over the rest of 2016 and into 2017. We anticipate growth now of 1.25% for 2016 and 1% for 2017, assuming the Bank of England (BoE) and the government respond to the new outlook with interest rate cuts, quantitative easing (QE) and a degree of fiscal easing. As opposed to some commentators, we believe if the right policy environment is adopted, the UK should avoid recession.

The main risk in the short term is that Brexit leads to a currency crisis. The UK has run a deficit on its current account for a prolonged period but the position has deteriorated to record levels in the last 24 months (-7% of GDP in 4Q15). The ability to finance this deficit is paramount in ensuring currency and economic stability. If overseas investors not only stop investing in the UK but begin to withdraw capital, the funding crisis that would ensue would be particularly problematic for the BoE. On the horns of a dilemma, do they deflate the economy by tightening policy, pushing the UK into recession and deflation, or do they let the currency depreciate further and fund the deficit through QE?

Long-Term Impact

In the very long term the UK economy will grow in line with fundamentals—labour force and productivity—which for the UK have tended to average around 2%–2.5% per annum (pa). As we do not think Brexit will materially affect the UK economy, we believe this average should continue to hold true.

Over the next 2 to 5 years, the outlook for the economy will largely depend on 1) the policy action by the UK authorities, 2) trade agreements with the EU and the rest of the world and 3) the global economic backdrop. We believe the global economy will continue to expand at a moderate rate and that the BoE will pursue a more expansionary policy as outlined above, providing a reasonable basis for 2%+ economic growth in the UK over the long term. This growth will be tempered if the UK is unable or unwilling to reach a free-trade deal with the EU and effective deals with non-EU countries. We believe some trade deal will be reached as it is in all partys' interests to do so. Even in the worst case scenario of a reversion to World Trade Organization rules it is difficult to see the impact of Brexit knocking more than 0.2 percentage points off of annual GDP growth over the longer term.

Q: What is the likely short-term and long-term impact on UK inflation?

Short-Term Impact

The 16% depreciation in trade-weighted sterling over the past year will obviously have a sharp upward impact on import prices, and a corresponding upward bias to consumer prices. The degree of increase will be determined by other factors in the economy, as increased uncertainty bears down on consumers and corporations, limiting the degree of potential pass-through. The result of similar-sized sterling depreciations in 1992 and 2008 was a very short-term upward bias to prices before inflation began to fall. We expect something similar to occur on this occasion.

Long-Term Impact

The longer-term impact of Brexit on the UK's inflation outlook will depend upon two things: 1) the nature of the UK's future trading relationship with the EU and the rest of the world, and 2) the monetary response of the BoE and the fiscal response of the government.

The UK economy should slow as the uncertainty generated by the Brexit vote negatively impacts confidence and thus consumer and business sentiment. However, we believe that the UK will avoid recession and continue to grow, with the slowdown putting a disinflationary bias into an already low inflation economy. In consequence, we expect the BoE to pursue a more expansionary monetary policy—cutting interest rates and embarking on more QE—with a degree of fiscal relaxation from the government. This should enable the UK economy to avoid deflation in the next 2–3 years, even if the UK does enter recession.

In terms of the trading relationships, the impact on inflation will depend on whether the UK adopts a tariff regime or not. Assuming the UK adopts a minimal tariff regime, in accordance with its historic biases, food prices, which comprise 15% of the consumer price index (CPI), should decline. Presently, the EU external tariff on some foodstuffs is between 20% and 40%. A removal of this tariff should allow the UK to source food from elsewhere in the world at more competitive rates. Goods prices, which comprise 40% of CPI, may also decline as tariff barriers are removed, mitigating some of the upward pressure from sterling's depreciation. Service prices, which tend to be more domestically generated, will depend more on domestic demand and the BoE's policy stance. The rise in the retail price index (RPI) will be less than that of CPI as lower house prices and mortgage interest payments will narrow the difference between the two.

Overall, we believe that inflation should be contained in the near term, with any deflationary bias offset by the BoE's monetary policy easing. Longer term, the effect of Brexit may be disinflationary at the margin, but it will not be the main determinant of UK inflation. As we have seen globally in developed world economies in recent years, the challenge of generating inflation in an environment of slowing longer term natural growth rates will persist.

Q: Where do you think long-dated real yields and gilt yields are trending in the short term and over the longer term (12 months' time)?

In the Short-Term

Both real and nominal yields should fall in response to lower economic growth outlook and the prospect of a much more accommodative monetary policy by the BoE. Yields should also be depressed as investors search for "safe haven" trades within the UK asset classes, i.e., away from banks and into gilts.

In the Long-Term

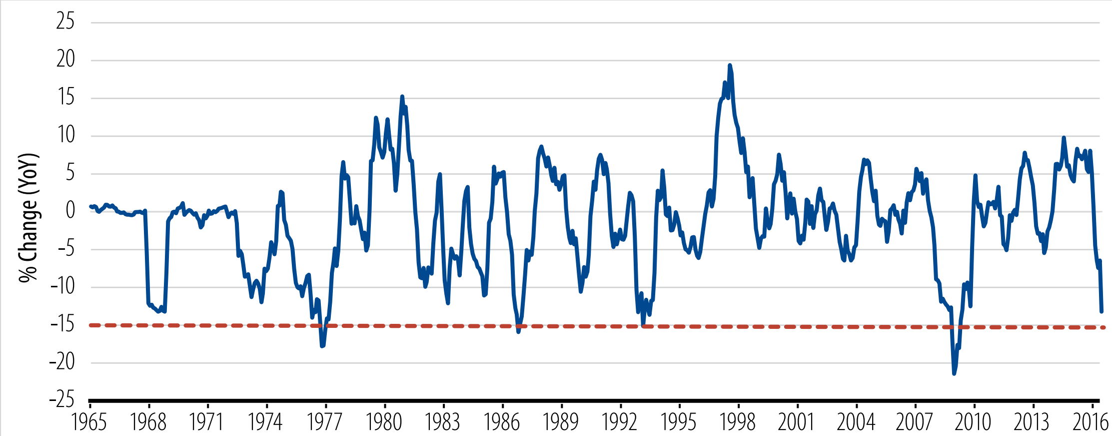
As the extent of the slowdown in economic growth becomes apparent, and if recession is avoided, then real and nominal yields should rise, with the yield curve steepening. We also expect breakeven inflation rates to begin to edge up in response to the stronger economy, easier policy and sterling depreciation.

Shorter-dated yields (less than 5 years maturity) will likely remain anchored as we do not anticipate any monetary policy tightening until well into the 2020s.

Q: Is sterling likely to weaken further?

On a trade-weighted basis, sterling has depreciated by 12% year-to-date and by 16% over the last 12 months. The annual decline is in line with past "negative shock" events that have hit the UK economy in the last 60 years (Exhibit 1).

Exhibit 1
Trade-Weighted Sterling

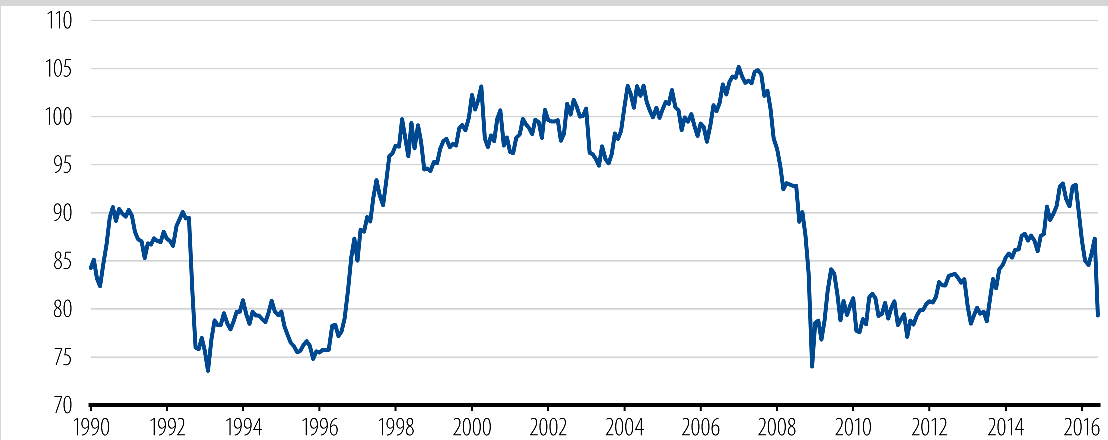


Source: BIS, Western Asset. As of 30 Jun 16

As can be seen, the nominal effective exchange rate adjustment that occurred after the crises of 1967, 1976, 1986 and 1992, was approximately -15% year-over-year (YoY). This is approximately the size of the adjustment that has already occurred to sterling as a result of the Brexit vote. Only in 2008, at the height of the financial crisis, did sterling suffer a more protracted decline, falling by just over 20%.

Consequently, the majority of the adjustment in sterling's valuation is behind us, in our opinion. Further weakening may occur as the BoE eases policy but from current levels we believe this should be limited. Exhibit 2 highlights the trade-weighted sterling index over the last 26 years, suggesting a move of -5% would take us to the all-time low index levels seen post sterling's exit from the European Exchange Rate Mechanism in 1992 and at the height of the financial crisis.

Exhibit 2
Trade-Weighted Sterling Index



Source: BIS, Western Asset. As of 30 Jun 16

To take us meaningfully below these levels, as discussed above, would involve a current account crisis, and decision by the BoE to let the pound find a new equilibrium level rather than tighten policy and risk deflating the economy.

Q: What is the outlook for the UK's credit rating?

The UK's credit rating has been downgraded and/or put on negative outlook by the main credit rating agencies. Is this justifiable? Not really, in our opinion. The UK growth outlook has deteriorated but, in our view, not dramatically so. Similarly, for debt reduction, it is not new news that the UK is well behind in its fiscal consolidation plans and likely to slip further. Brexit is likely to involve a fiscal expansion that will worsen the debt dynamics, but, unlike the eurozone economies that do not have the means to print money at times of distress, the UK does have that ability. That is not to say what the real value of the money printed will be in x years' time, but, in nominal terms, it does not matter as the debt can still be paid back. Despite Brexit, the UK still has a sound and independent legal system based on property rights and English common law as well as several hundred years of political independence and sovereignty. While these are all "soft" issues, we believe they should weigh heavily in any calculation of sovereign credit worthiness and are unlikely to change post-Brexit.

Q: What is the likely short-term and long-term impact to European GDP Growth?

Short-Term Impact

Uncertainty is never good for the economic outlook, and we expect the increased uncertainty over future trading arrangements within Europe will be a drag on European growth. However, so long as confidence holds up, we believe the fallout will be limited. Our pre-Brexit positive view on the continental European growth outlook was predicted on domestic demand in core economies strengthening. With European Central Bank (ECB) monetary support likely to be expanded, this should continue to be so. The UK is an important market for EU goods exports (16% of total exports), so with a slowing UK economy some decline in net exports is likely to be a drag on European growth. However, we see this being only 0.2% GDP in 2016 and 2017, taking our growth forecast down to 1.75% for both years, which is still above consensus expectations. The main downside risk is that Brexit continues to exert pressure on European banking systems, particularly in Italy, and that further deleveraging depresses credit creation, raises risk premiums and impacts growth.

Long-Term Impact

The long-term outlook will be determined by 1) ECB policy 2) global growth 3) negotiations with the UK and 4) any further political splintering in the EU. We expect the global economy to expand at a moderate rate over the medium term and for ECB policy to remain very accommodative. Trade negotiations with the UK are hard to predict, but given exports to the UK are only 3% of GDP (the eurozone trade surplus is 0.7% of GDP), in the worst case scenario the hit to EU growth should be manageable. In our opinion, growth in the long term should be in line with long-term fundamentals at around 1%–1.5%.

However, the risk to the longer-term outlook is political risk and further fragmentation of the EU. With an Italian referendum on Senate reform in October, a French Presidential election in April 2017 and a German Federal election in October 2017, the chances of a more Eurosceptic trend developing in other EU countries, in our view, is high. If this trend develops, risk premiums would rise in those countries deemed most likely to leave, while the growing uncertainty and tightening of credit conditions would negatively impact EU growth.

Q: What is the likely short-term and long-term impact on eurozone inflation?

Short-Term Impact

A slower economy and an appreciating trade-weighted euro (up against sterling and many emerging market currencies recently) should lower inflation and inflation expectations, increasing the need for the ECB to act. A disinflationary bias will be tempered if domestic demand continues to expand as we expect. Downside risks come from any Brexit-induced banking crisis, although ECB President Mario Draghi's "whatever it takes" mantra should ensure against this.

Long-Term Impact

We expect the ECB to expand monetary accommodation in the latter part of this year and the economy to weather the Brexit shock. This should mitigate the immediate deflationary shock in the long term. As domestic demand in core economies continues to improve and as the euro weakens, the impulse will be towards moderately higher inflation, around 1%–1.5% pa.

Q: Where do you see long-dated real yields and German bund yields trending in the short term and over the longer term (12 months' time)?

In the Short-Term

We expect German bunds will continue to benefit from a safe haven bid and an ECB-induced rally, with the whole yield curve going potentially negative by year end. Real yields will decline, but at a slower rate, taking breakeven inflation rates lower. The German bund curve will continue to flatten as more yields converge on the -0.40% deposit facility rate level, the current floor for eurozone national central bank buying.

In the Long-Term

We expect German bund yields will remain low as we do not anticipate any tightening of ECB monetary policy until the early 2020s at best. Yields should begin to drift higher as the worst fears over a Brexit-induced slowdown are not realized and inflation expectations stabilize and turn up.

Real yields should remain well supported and should begin to outperform nominal yields over the long term.

Q: What is the likely impact of Brexit to peripheral Europe?

Short-Term Impact

We believe the periphery is "back-stopped" by the ECB. We believe the sovereign asset purchase program will ensure spread widening is contained in a risk-aversion environment. As we have seen, ECB President Mario Draghi truly meant what he said in 2012, that "the ECB is ready to do whatever it takes to preserve the euro."

However, risks do remain, and primary among those is a further deterioration in the Italian banking system, leading to a widening periphery credit and sovereign crisis. While the ECB can mitigate the liquidity aspects of this via Targeted Longer-Term Refinancing Operations, etc., the underlying capital issue can only be resolved by the banks themselves.

Long-Term Impact

Political instability is the main risk. The Italian Senate reform referendum in October is a potential destabilizer, especially given the recent success of the eurosceptic Five Star Movement in the mayoral elections. Rejection of these reforms will likely lead Prime Minister Matteo Renzi to quit. A general election is unlikely in the short term given the recent Lower House reforms, but, political instability would likely ensue and provide ground for the further advance of eurosceptic parties.

Q: Is the eurozone likely to face an existential crisis? What are some signposts that you are looking for to assess the situation?

No, we think this is unlikely, unless we see a political crisis in Italy and a banking crisis (as discussed previously).

Things to look out for are:

1. Opinion polling on the Italian October Senate reform referendum
2. Data showing a slowing economy, increasing unemployment
3. ECB TARGET2 liquidity provision or capital raising for the banks
4. How the People's Party performs as a minority government in Spain
5. Peripheral bond spread widening, particularly at front end of yield curve

Q: What is the likely short-term and long-term impact to US GDP growth?

In our opinion, the Federal Reserve (Fed) is now unlikely to raise rates this year. The Fed will be concerned about the potential negative impact on global growth from Brexit and any tightening of financial conditions from a stronger US dollar or weaker equity markets. We therefore expect the Fed to maintain a cautious, risk-management-focused approach, absent a much stronger signal from the economic data or from markets. Our base case expectation for US economic trend growth is still around 1.5%. We will continue to monitor developments but until we see further evidence to the contrary, our current outlook is that the US economy will experience moderate growth in the short term, even as the manufacturing sector remain challenged.

Q: What is the likely reaction of global central banks to Brexit, do you see any further easing from any major central banks?

We expect the BoE, ECB and Bank of Japan (BoJ) to provide further policy accommodation over the coming months, and for the Federal Reserve (Fed) to retain its "data dependent" bias:

BoE: Bank Rate cut to zero, QE restarted (£100 billion+). Credit easing.

ECB: Depo and Refi rate cuts in 4Q16. QE expanded and extended.

Fed: The Fed is now unlikely to raise rates this year.

BoJ: More QE, but with a greater focus on "quantity" by buying bonds other than Japanese Government Bonds like local government, government agency bonds and residential mortgage-backed securities.

Q: To what extent has Brexit changed your view of global GDP growth?

Global growth and inflation risks are clearly skewed further to the downside in our opinion. However, our view remains that the global recovery, though fragile, will be positive and sustainable as policy accommodation from central banks around the world ultimately succeeds in underpinning growth.

Q: What is your outlook for global credit spreads post the Brexit vote?

Although global corporate earnings may weaken modestly in the near term, the technical tailwinds remain very positive for US and European credit in our opinion. Strong investor flows into US credit in search of higher-yielding assets and ECB corporate bond purchases are expected to see global corporate bonds outperform government bonds over the rest of the year.

Q: How have UK credit markets responded and what is your outlook?

We have been surprised by the overall resilience of UK credit post the Brexit vote. Other than sharply wider spreads for UK financial and some real-estate related issuers, dispersion across the subsectors has been limited despite significant differences in UK equity prices. This is most likely due to expectations of an imminent resumption of BoE QE including the purchase of UK corporate bonds. In the near term, we adopt a cautious approach given current valuations and weak UK market liquidity. Where permitted, we prefer greater name diversification, liquidity and valuations available in US corporates.

Q: What is the outlook for UK bank and insurance companies?

Post the Brexit vote, the markets have punished banks and insurance companies, with equity prices down substantially and credit spreads sharply wider. However, the BoE has made it clear it will provide all necessary liquidity to the banking system in both sterling and other currencies. This comes on top of the UK banks' strong existing liquidity positions. Over the longer term, any rise in UK unemployment and a likely spill over into the UK housing market would put some pressure on the UK bank's domestic asset quality, but any deterioration would be from very strong current levels. The UK banks' capital buffers, built up since the 2007–08 crisis, should be able to absorb this comfortably. Earnings will come under further pressure as loan volumes stagnate at best, transaction volumes reduce and lower-for-longer interest rates keep interest margins under pressure. Any change to the status of London as a global financial centre will only play out over an extended timeframe, if at all. In any case, several of the major UK banks have substantially reduced their investment banking footprint, so are scarcely reliant on City financial markets business as they pursue an almost exclusively domestic retail/commercial strategy. Solvency II capital ratios for the UK's major insurance companies are expected to remain high despite further pressure on investment income and increased market volatility. While the headwinds for the UK bank and insurance sector have clearly increased post the Brexit vote, and we expect further pressure on profitability, capital ratios remain solid and we remain comfortable with the institutions we hold.