June 29, 2016

The Brexit Aftermath: Impact On Global Growth And Strategy

- Brexit is a credible threat to the global economy. The U.K. economy on its own does not matter much to the globe, but the potential contagion risks are substantial.
- The U.K. is headed toward recession. The BoE will try to stimulate, but is somewhat impotent to defend against the current crisis. Fiscal support is required, but limited by the collapse of the government. Instead, an ongoing devaluation and/or deflationary adjustment is probable.
- The euro area is material within the global economy and has become the key swing factor. There is a risk that business sentiment sours and derails the improving but still tepid recovery. Policymakers need to respond fast to shore up confidence and build a credible firewall.
- The euro area economy is more durable than in 2011-2012, but if it were to weaken, the world would have a harder time providing an offset. The U.S. has stronger floorboards now, but commodity markets are weak and China is expanding at a much slower pace.
- Policymakers outside of Europe may also need to provide stimulus if U.K. housing topples and/or global financial system stresses develop. At a minimum, the Fed and Chinese policymakers will be sidelined in terms of any tightening while they monitor the fallout.
- The policy response in the weeks ahead and how well euro area economic confidence holds up in the face of Brexit will dictate the 6-12 month outlook for global financial markets. We recommend a more cautious stance in the near run until there is some clarity.

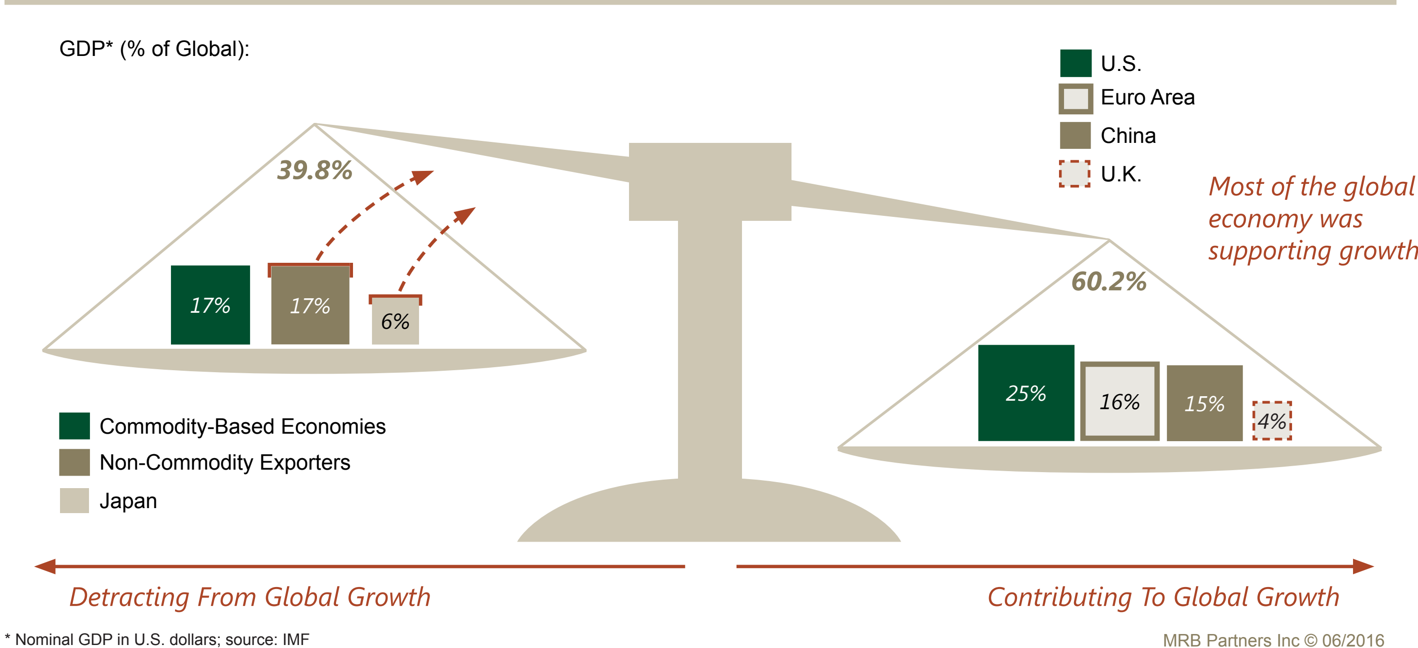
The U.K. vote last week to "leave" the European Union (EU) has rocked financial markets. Investors across the globe are grappling with the news and attempting to sort out the impact for the global economy and asset markets. The U.K. is a relatively small part of the world economy, but has significant trade links and a huge financial sector. In turn, the potential for destabilizing contagion is heightened.

Although we were not expecting a Brexit, we published an **MRB *U.K. Research Highlight***[1] last week prior to the referendum vote outlining the threats associated with a decision to leave the EU. The report focused on four major risk factors for the U.K. economy and the likelihood of a painful fallout. The primary focus was not the global ramifications. However, a regular theme in our work on future risk factors has been the potential for global contagion to spread from any downturn in the U.K. economy that threatens to burst the domestic housing and credit bubble.

Today's report utilizes a simple framework to focus on the global implications of Brexit. We conclude that the fallout in the U.K. will be manageable if it occurs in isolation. However, the potential contagion (particularly for the euro area) is enough to tilt global growth from strengthening to weakening. Global policymakers will need to provide offsetting reflation to limit financial contagion and ensure that business and consumer confidence is not impaired in a lasting fashion. It is prudent to be cautious in the near run, but the policy response and resilience of the euro area economy will determine if investors should tilt back to pro-growth or stay defensive.

[1] **MRB *U.K. Research Highlight***, "*U.K. Brexit: Watch The Tail Risks*", June 22, 2016

Chart 1 **Global Growth Scale: Pre-Brexit**



* Nominal GDP in U.S. dollars; source: IMF

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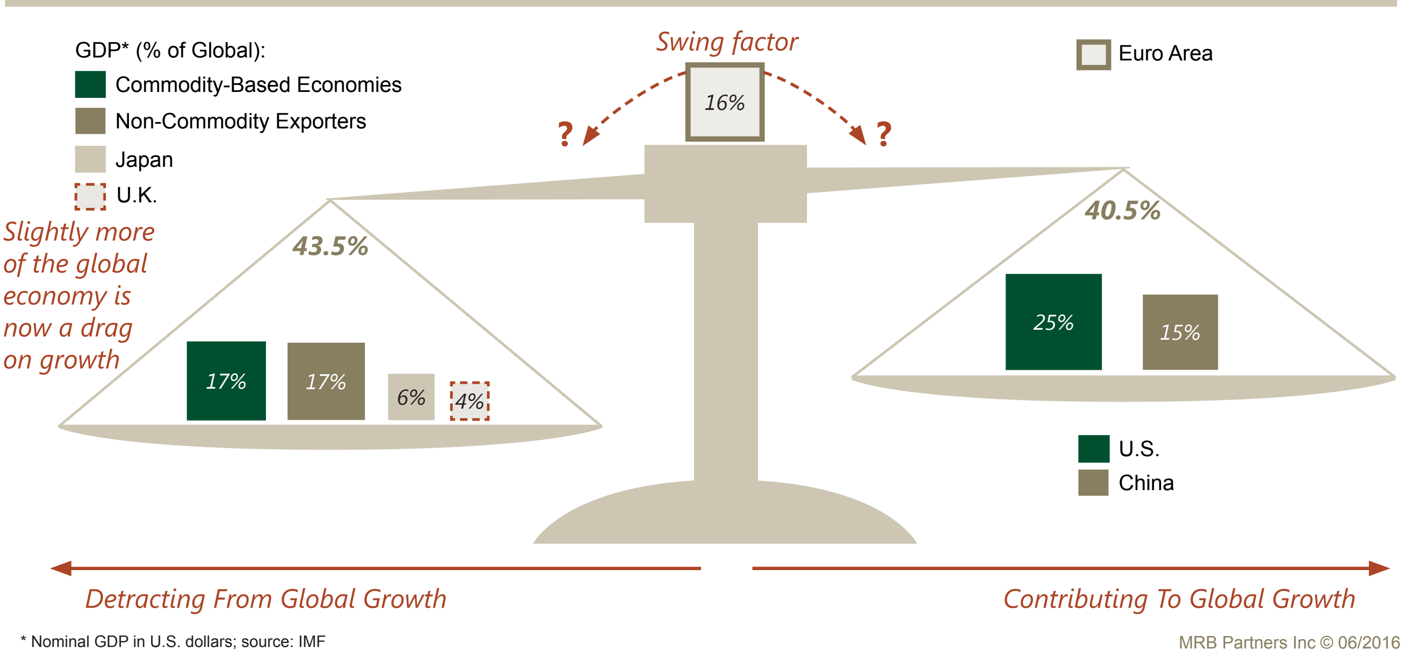
Chart 2 **Global Growth Scale: Brexit (Current Situation)**



* Nominal GDP in U.S. dollars; source: IMF

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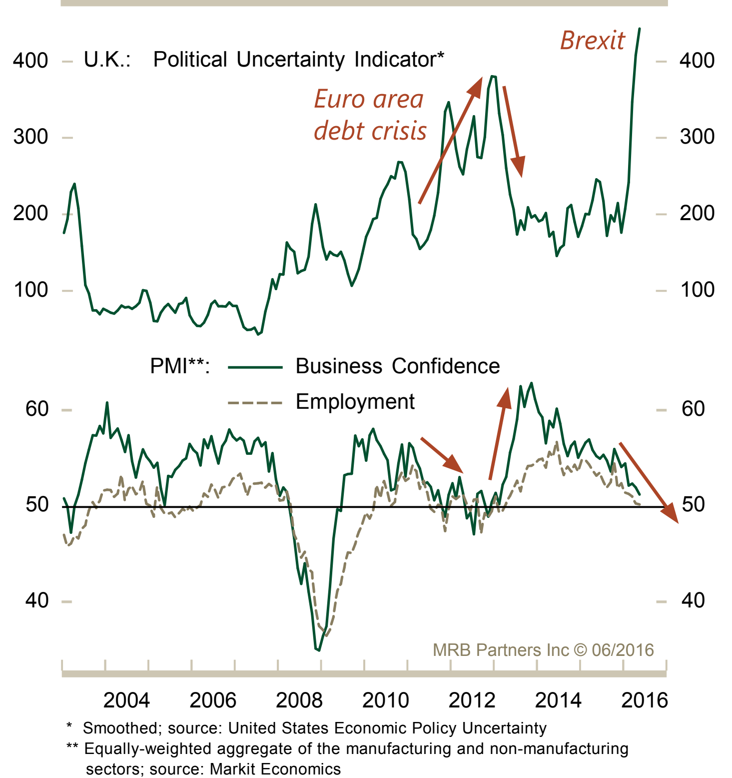
Brexit Alters The Pulse Of Global Growth

Prior to the referendum vote a modest majority of economies around the globe were contributing to stronger growth conditions (**chart 1**). There were weak links, but some of these were expected to be slowly lifted and help reinforce/accelerate the global expansion. Instead, Brexit has provided an adverse macro shock to the global economy and tilted the balance of aggregate growth slightly towards weakening conditions (**chart 2**).

U.K. (3.7% of Global GDP)

Chart 3 U.K.: Heading For Recession



* Smoothed; source: United States Economic Policy Uncertainty
** Equally-weighted aggregate of the manufacturing and non-manufacturing sectors; source: Markit Economics

The U.K. had been making a net positive contribution to global economic growth. Forceful BoE reflation curtailed deleveraging pressures during the Great Recession and led to a relatively steady cyclical expansion in recent years (albeit in part by tolerating a further increase in domestic imbalances). Consumer and business confidence soured somewhat heading into the referendum, in a similar fashion to the euro area during the 2011-2012 sovereign debt crisis (**chart 3**). That said, there would likely have been a boost in U.K. domestic activity if the vote had been to "remain" within the EU, as businesses would have unleashed pent up demand. This was the outcome previously in the euro area, when sentiment and corporate activity surged once policymakers halted the regional fallout.

Brexit Impact: The vote to "leave" will shift the U.K. economy from a positive to negative contribution to global growth. Brexit creates significant trade-related headwinds and heightened uncertainty for businesses and households. This will cause a further freezing or (in some cases) a permanent shelving of expansion plans and discretionary spending. There is a reasonable likelihood the U.K. will slide into recession. A major concern is that the U.K. economy is littered with excesses (including a housing and credit bubble) and cannot withstand much of an adverse shock (**chart 4**). These imbalances were destined to eventually erupt, but Brexit threatens to bring forward the day of reckoning if employment conditions weaken. The BoE will provide aggressive reflation as an offset, but has limited latitude given the level of current policy rates. The government does not have the fiscal latitude to provide a major bailout. For more details on risks associated with Brexit, see the June 22 **MRB *U.K. Research Highlight***[1] and the February 25 **MRB *U.K. Report***[2].

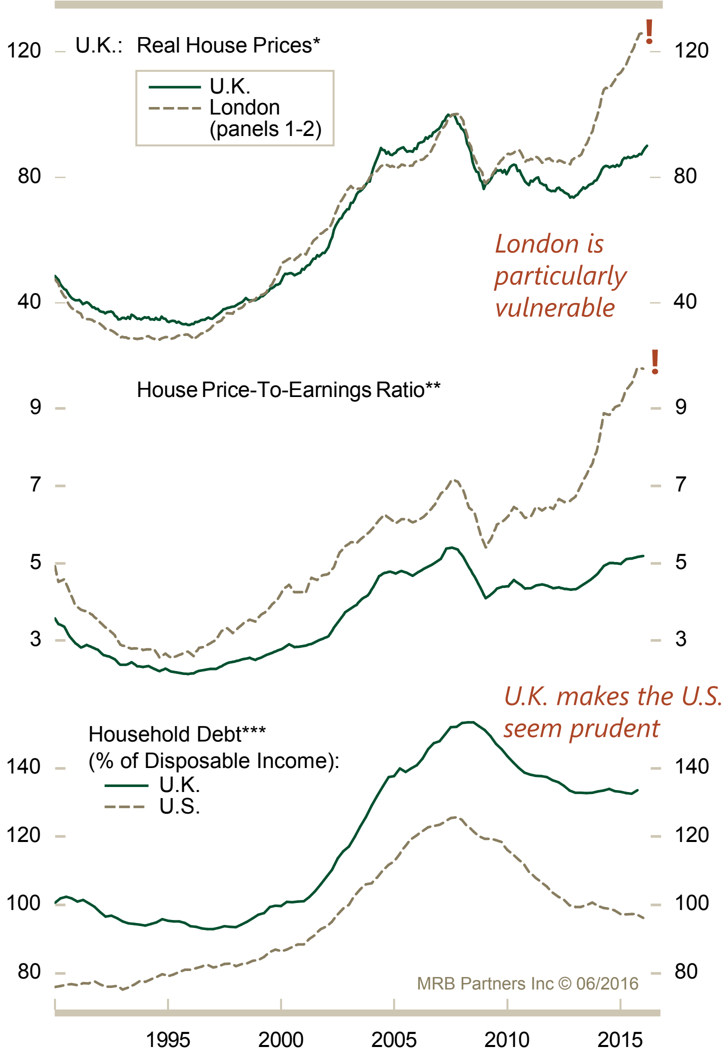
The U.K. economy will deteriorate markedly

Euro Area (16% of Global GDP)

The euro area has provided a modest contribution to global growth since the periphery debt crisis was halted in 2012. The ECB has managed to creatively work around policy rigidities and slowly reflate conditions (**chart 5**). In many ways the regional economic improvement was lagging the U.S. by 3-4 years. The expansion is fragile and needs aggressive ongoing ECB reflation, but (prior to this shock) had been on track to progressively transition into something more durable[3].

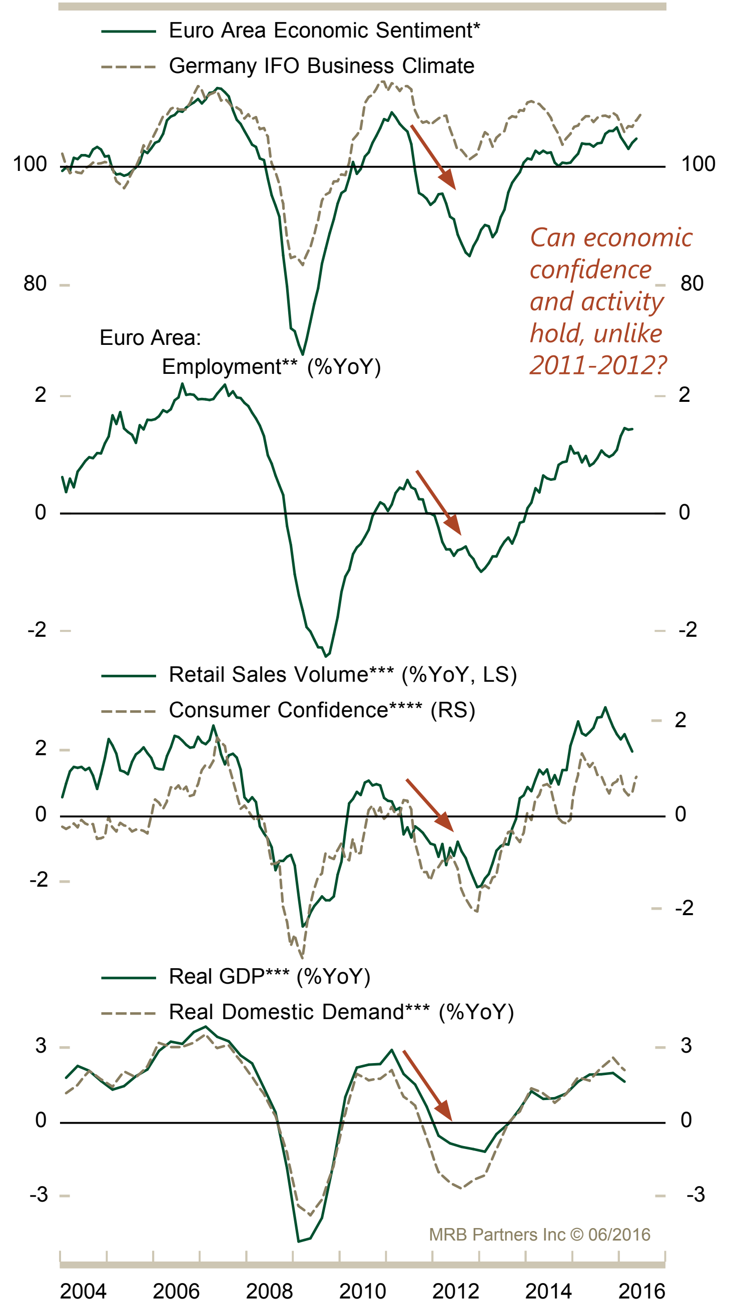
[2] **MRB *U.K. Report***, "***U.K.: Limited Room To Maneuver***", February 25, 2016
[3] **MRB *Theme Report***, "***Reflating A Deleveraging World (Part III): Regional Assessment***", June 15, 2016

Chart 4 **U.K. Housing And Credit Bubble**



* Rebased to pre-crisis peak; deflated by headline CPI; source: Nationwide Building Society
** First-time homebuyer; source: Nationwide Building Society
*** Sources: Bank for International Settlements and national sources

Chart 5 **Euro Area Needs To Stay Resilient**



* Source: Directorate General for Economic and Financial Affairs
** Implied monthly series; MRB calculation using Eurostat data
*** Source: Eurostat
**** Standardized; source: European Commission

Brexit Impact: The outlook for the euro area is much more significant to the balance of global growth than the direct U.K. impact. Unfortunately, the euro area expansion is still subdued. Reduced trade, along with potential financial system strains and greater political uncertainty, could severely dent regional business confidence. Employment growth has been solid within the euro area, but could deteriorate meaningfully as was the case during the debt crisis (even for the healthier countries). In short, the euro area economic recovery has been jeopardized by Brexit. There is a possibility that ongoing economic traction and recent ECB reflation will allow the economy to hold up in the face of the Brexit shock. However, it is likely that regional policymakers (which are also the heavyweights of the remaining EU) will need to move quickly and provide a reflationary commitment in order to shore-up confidence (discussed below).

> The euro area is more important than the U.K. for global growth

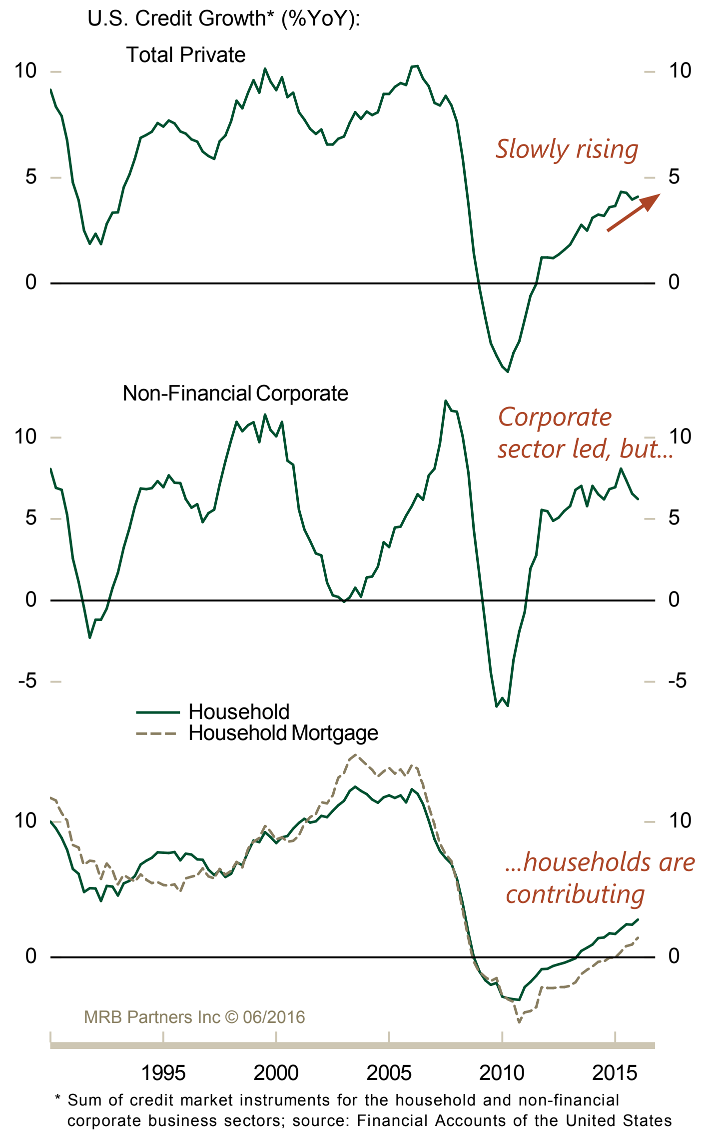
In **chart 2**, we downshifted the euro area influence on aggregate global growth to neutral, but acknowledge that the economy will soon tilt one way or the other depending on the policy response and which way economic sentiment breaks.

U.S. (25% of Global GDP)

The U.S. has been undergoing a self-reinforcing economic expansion for several years and deleveraging pressures are now fading, which will add to underlying strength of domestic growth conditions (**chart 6**). The economy provides a much more durable contribution to the global economy than investors acknowledge, and would not have been threatened by continuation of Fed tightening.

Brexit Impact: Brexit does not directly impact the U.S. macro backdrop, other than sidelining the Fed. U.K. economic weakness will not be a material drag on U.S. growth, unless conditions spiral into a global financial crisis. There is a non-trivial ***eventual*** risk of the latter, but it will not be imminent. The U.K. housing market would need to be headed toward a crash and crunch domestic banks first, which (if this occurs) will not likely be a 2016 story. Nonetheless, the Fed will be prudent and shelve its tightening campaign until after it is clear that EU policymakers are curtailing global contagion.

Chart 6 **U.S. Deleveraging Is Fading And Makes Growth More Robust**



* Sum of credit market instruments for the household and non-financial corporate business sectors; source: Financial Accounts of the United States

China (15% of Global GDP)

The Chinese economy was a drag on economic growth until earlier this year, but has since gained momentum and is now providing a contribution. Indeed, Chinese policy stimulus is working to lift domestic credit growth and boost the real estate market (**chart 7**). If anything, housing is becoming too hot and policymakers will need to progressively introduce macroprudential tightening later this year, albeit they will be hesitant until the impact of Brexit on global demand is better known.

Brexit Impact: Policy will stay accommodative and allow the Chinese economy to support global growth. Brexit will not materially impact China, provided that the contagion does not lead to a broader EU recession. That said, Chinese policymakers are likely to be cautious about tightening conditions to cool domestic housing and investment until the fallout in Europe and knock-on to global trade is better understood.

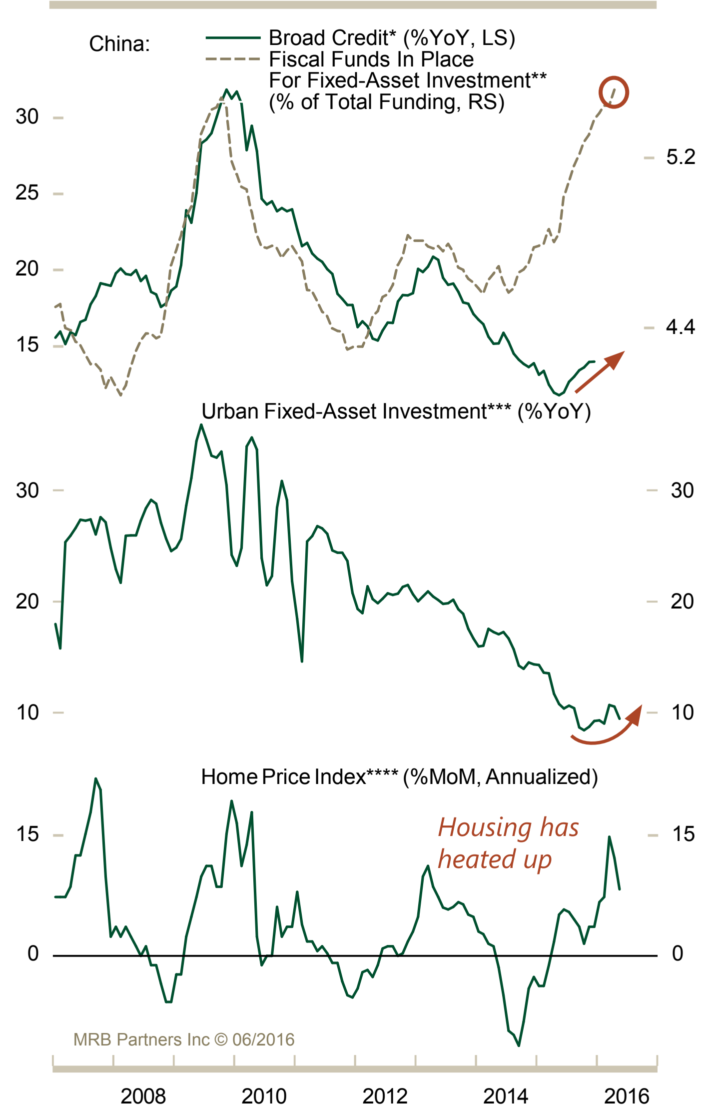
The U.S. and China should remain resilient and support global growth

Commodity-Based Economies (17% of Global GDP)

The deterioration in commodity-based economies has a long way to run and will represent an ongoing drag for the global economy. Natural resource demand remains firm and prices have rebounded off their lows, alleviating some of the contractionary headwinds facing these economies. However, unless commodity prices rise materially from current levels, substantial cutbacks in production and employment can be expected. Commodity sector headwinds are likely to spread to other parts of these economies, causing a broad-based fallout. Sizable housing and credit imbalances amplify the downside risks (**chart 8**). Indeed, an increasing number of these economies will head into recession and possibly experience a painful deflationary adjustment, at some point not too far down the road.

Brexit Impact: The U.K. referendum has a slight negative indirect impact on these economies, and will help ensure they stay in the weak camp. Specifically, Brexit pushes up the U.S. dollar and softens global demand, which will cap commodity prices.

Chart 7 Chinese Economy Is Firming



* Adjusted for municipal issuance from May 2015; sources: People's Bank of China and Chinabond
** State budgetary funds do not include local government financing vehicles; source: China National Bureau of Statistics
*** Smoothed
**** 70-city price index; MRB estimate from 2011 using population and transaction weights for each city; source: China National Bureau of Statistics

Non-Commodity Based Exporters (17% of Global GDP)

Aggregate economic conditions within these economies (which include much of emerging Asia, Singapore, Sweden and Switzerland) have weakened over the past year, largely due to a notable slowdown in global trade (**chart 9**). The import-intensive part of the Chinese economy downshifted substantially[4], and was not sufficiently offset by the U.S. and euro area. That said, we had expected export demand to gradually improve, driven by renewed strength in the Chinese and global economy. This, along with still very accommodative domestic monetary conditions, should support firmer growth in these non-commodity export economies.

Improvements in global trade have likely been postponed

Brexit Impact: Brexit is a mild negative by removing the modest tailwind needed to improve these economies and alleviate this drag for global growth. In particular, decisively weaker economic activity in the U.K. and (more importantly) the potential for a slowdown in the euro area postpones any improvement in global trade.

[4] **MRB *Theme Report***, "**[*How China's Economic Transition Is Reshaping The World*]**", May 5, 2016

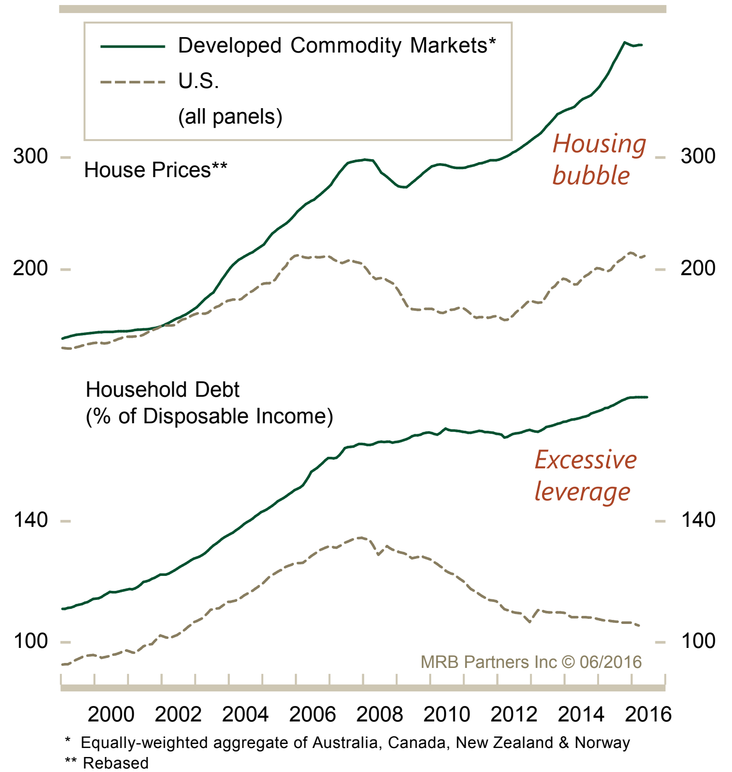
Japan (6% of Global GDP)

Abenomics has only had modest success and Japanese economy remains a drag on global growth[5] (**chart 10**). Policymakers will need to become much more creative to sustainably end deflationary pressures. While the BoJ has underwhelmed this year, our view has been that the central bank will soon surprise investors to the upside by trying another bold step forward (more along the lines of the ECB) to break the liquidity trap and weaken the currency. The government has already further delayed the VAT tax hike and will likely provide some sort of fiscal stimulus. These efforts, combined with our anticipation for a pickup in global trade, built the case for Japan no longer being a drag (and perhaps even mildly contributing) to global growth.

Brexit Impact: Although Japan's trade linkages with the U.K. are limited, Brexit has led to further appreciation of the yen, as well as weakened the outlook for global export demand. In this regard, the U.K. referendum has postponed (if not derailed) the prospects for an improvement in the Japanese economy.

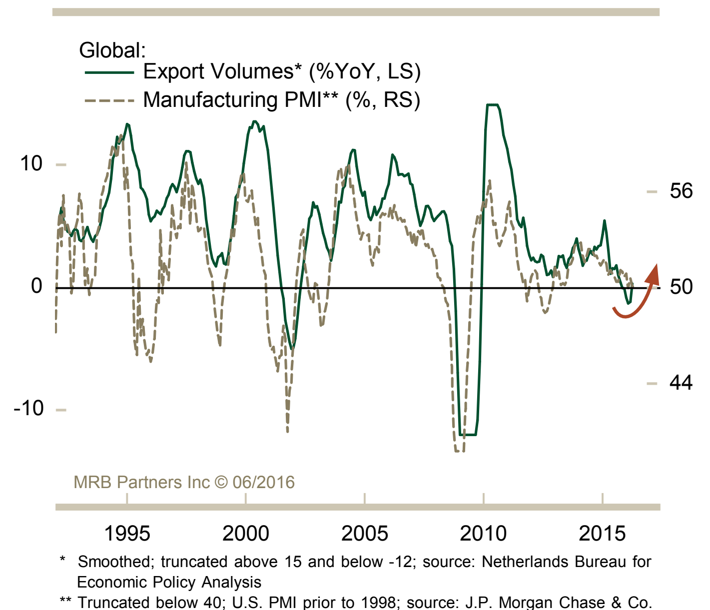
Final Word: *The pulse of the global economy is swinging from net strength towards weakness in response to the Brexit shock. The U.K. vote to leave the EU will likely result in a domestic recession. This presents only a mild direct drag for global growth conditions, given the limited size of the economy. However, the contagion risks are substantial. The most immediate concern is the euro area, where policymakers need to respond fast and aggressively (discussed below). Policymakers elsewhere may need to also provide stimulus if the U.K. housing market topples and/or global financial system stresses develop. There is a reasonable chance that global policymakers will provide preemptive support, given that most fear the fragility of economic sentiment in the post-Great Recession world. If so, this would be an encouraging step to reinforce the global economy and help it withstand the Brexit shock.*

Chart 8 Commodity Markets Have Sizable Imbalances



* Equally-weighted aggregate of Australia, Canada, New Zealand & Norway
** Rebased

Chart 9 Global Trade Was Finally Starting To Firm Before Brexit



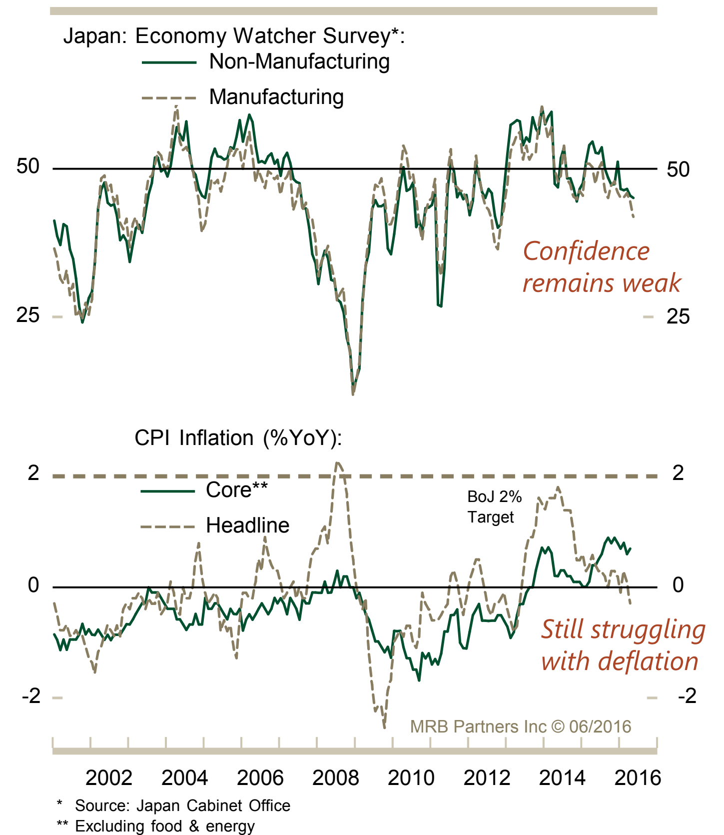
* Smoothed; truncated above 15 and below -12; source: Netherlands Bureau for Economic Policy Analysis
** Truncated below 40; U.S. PMI prior to 1998; source: J.P. Morgan Chase & Co.

[5] MRB *Japan Report*, "Is Abenomics Working?", April 7, 2015

Euro Area Is The Swing Factor

The world was already trying to absorb the commodity fallout and downshift in global trade, which had weakened nearly 40% of the world economy. There was a good chance that just over half of this group (i.e. the non-commodity exporters) would be lifted with some policy reflation and improvement in global export demand. At best, this has now been postponed.

Chart 10 Japanese Growth Conditions Have Slowed



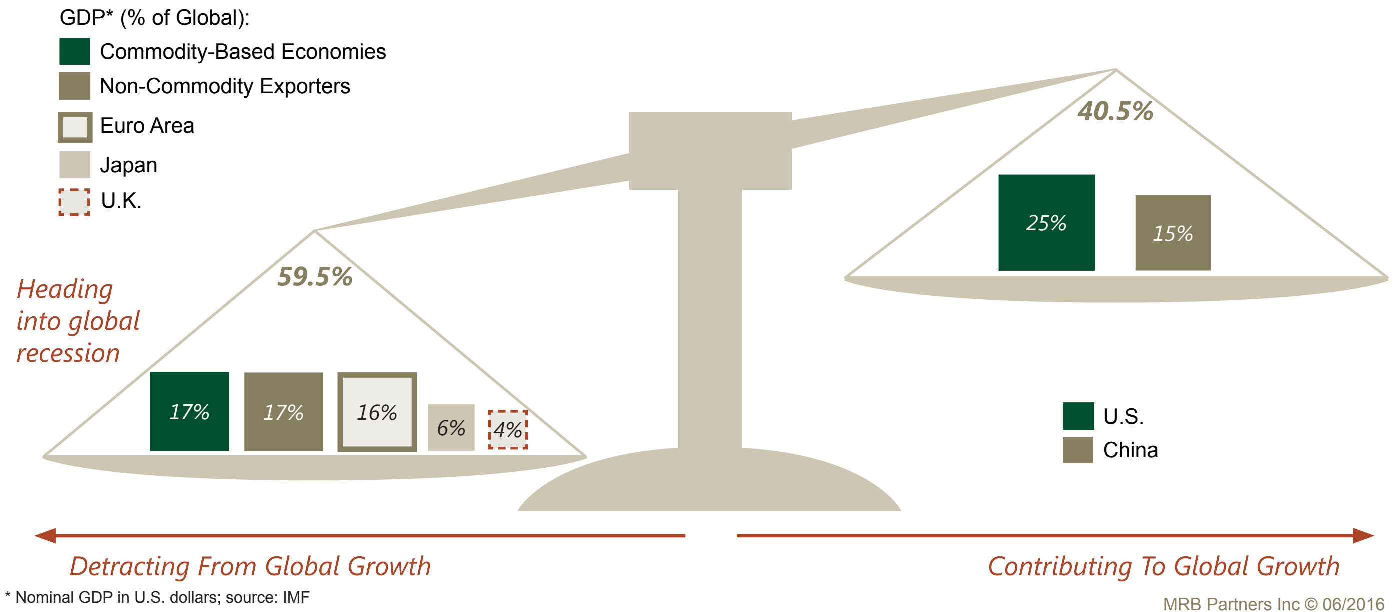
There is little that can be done to prevent the U.K. from shifting to a source of global weakness, as it heads towards recession. The BoE will try to stimulate, but monetary policy is somewhat impotent when faced with either the exiting of global businesses or domestic deleveraging pressures. Also, while U.K. mortgages are still largely linked to the short-end of the curve, the central bank has limited latitude with interest rates already depressed. A fiscal policy response is required, but is unlikely given the collapse of the government and still large fiscal deficit. Instead, an ongoing devaluation and/or deflationary adjustment is probable. That said, the U.K. only accounts for 3.7% of the world's GDP, so the direct global impact is limited.

Instead, the major concern related to Brexit is global contagion. The euro area (which accounts for 16% of global economy) faces the most immediate risk. There is a chance that the euro area economy holds up despite the Brexit shock. The regional economy has been gaining momentum and the ECB recently provided another shot of liquidity. However, the recovery is still somewhat fragile and without additional policy support or guarantees, economic confidence could weaken materially, leading to a freezing in business activity and/or credit growth. Thus, the response of regional policymakers will likely dictate the fate of the global economy:

The euro area will dictate the fate of the global economy

- There is a good chance that if the authorities in the euro area (or more likely the broader EU) fail to respond quickly and forcefully to build a firewall, their economies will weaken. If so, the portion of the global economy acting as a drag on aggregate growth in this scenario would increase to nearly 60%, making it extremely difficult for the U.S. and China to offset and prevent a global recession (**chart 11A**).
- Conversely, if policymakers move to provide a credible guarantee, it would go a long way to shore up confidence in the euro area and keep the regional economy on a recovery path. In this scenario the pulse would tilt back towards a mild global

Chart 11A **Global Growth Scale: Brexit (Downside Scenario)**



* Nominal GDP in U.S. dollars; source: IMF

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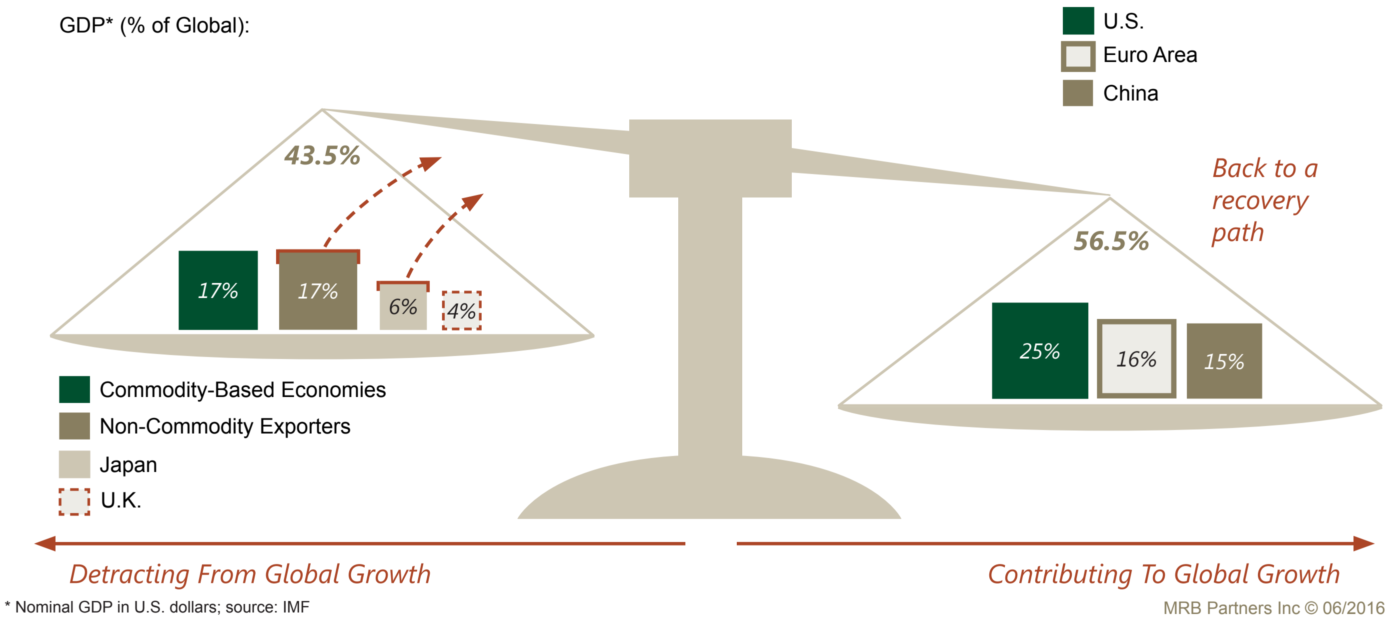
Chart 11B **Global Growth Scale: Brexit (Upside Scenario)**



* Nominal GDP in U.S. dollars; source: IMF

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expansion, with a moderate majority of the world economy providing support to aggregate growth (**chart 11B**). With a lag, global export demand may also pick up and help lift some of the weaker global links.

Europe needs to build a firewall to protect against the U.K. fallout

Without the UK government negotiating with the EU, the halting of contagion would not be via direct support as in the case of Greece. Instead, building a firewall would require the rest of the EU to recapitalize their own domestic banking systems as needed, and provide monetary and fiscal stimulus to shore up economic confidence. The European

Bank for Reconstruction and Development has some funds it could use without taxpayer approval to provide fiscal support. Further funds may no longer be as hard to obtain, given that the rest of Europe is determined to show strength and resilience, despite the exiting the U.K. economy. The ECB has also demonstrated creativity and forcefulness in recent years.

The U.K. will come up short in the negotiations

Final Word: *The euro area has become the swing factor for the globe. The regional economy has received an adverse shock that it will need to absorb. Without policy intervention there is a decent chance that regional conditions will deteriorate and drag down the globe. Although the world economy was able to withstand the euro area debt crisis and double-dip recession in 2012, at that point in time commodity markets were still in solid shape and China was expanding faster.*

That said, euro area policymakers learned a considerable amount from the debt crisis and last year's negotiations with Greece. They now understand the importance of a swift and unified response. The U.K. has a weak hand and will come up short in the negotiations (as did Greece), but there is likely to be a coordinated effort to ring-fence the remainder of the EU in order to demonstrate strength and resilience, even in the event of a member exiting. Also, a positive economic outcome would help prevent more referendums and bigger challenges for the euro area and EU. An encouraging sign is that the European Commission suggested that they will do whatever is needed to protect Italian banks against market turmoil.

Global policymakers may move preemptively, which would be encouraging

In the interim, the U.S. and China must remain strong and global policymakers may need to provide additional stimulus if global banking system strains emerge. As noted above, a preemptive move by policymakers outside of Europe to help provide offsetting reflation and build a global firewall would be an encouraging step to ensure that the global economy holds firm.

Investment Strategy

The global economy has been forced to absorb a number of shocks over the course of this investment cycle, causing anxiety to be elevated among market participants. Indeed, investors have demonstrated a preference to sell first and assess conditions later. This has again been the case over the past year with the risk of Grexit and fears of Chinese currency devaluation (**chart 12**). In both cases it took a shift in policy to halt the selloff. The Brexit outcome is sufficient to warrant scaling back risk exposure (at least temporarily), as a prudent measure while the macro shock is being absorbed. The following provides some additional rationale for our recent recommendation to de-risk:

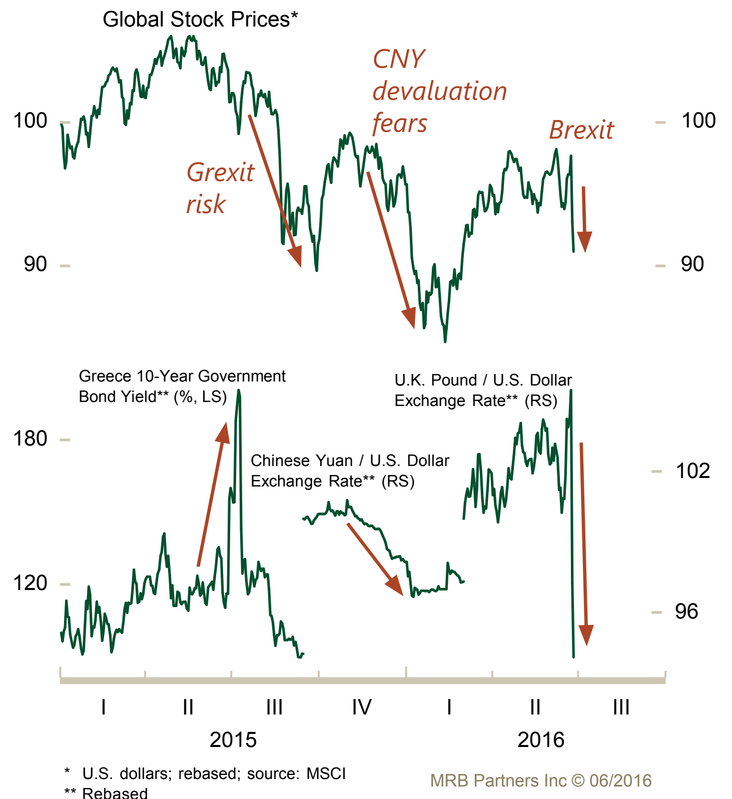
Since the commodity fallout, the world needs China, the euro area and U.S. to all contribute to growth

- Since the unwinding of the Commodity Supercycle began, MRB's view has been that the U.S., China and euro area all need to contribute positively to growth in order for the global expansion to persist and equities markets to strengthen. This is being threatened by Brexit and accordingly we have shifted to a more defensive stance

in our asset allocation (see the June 24 **MRB *Weekly Macro Strategy Report***). Note that we did not cut exposure during the Chinese devaluation scare because we rightfully felt that the market had misjudged the underlying situation in China, albeit in hindsight it still would have been good to temporarily trim and play the swing in investor sentiment.

❍ Prior to Brexit, 60% of the world economy was strengthening, with the potential of increasing to more than 80% upon a pickup in global trade. In this environment, it was appropriate to maintain a pro-growth investment stance and expect the Fed to resume its tightening campaign. In the event of the U.K. voting to "remain" in the EU, we had expected government bond yields to move up and global stocks to break higher. Equity leadership would likely have rotated away from the U.S. in favor of growth-sensitive markets, including the euro area and non-commodity exporters.

Chart 12 **Global Equities Need Policymakers To Ring-Fence The Crisis**



❍ With Brexit, the portion of the global economy that is acting as a drag on growth conditions (43.5%) slightly outweighs those that provide support (40.5%), with the euro area (16%) providing the swing factor (see above). Indeed, there is a risk that the weaker camp increases to 60% of the world economy if the euro area economy cannot withstand the shock and/or authorities do not move in a timely fashion to provide offsetting reflation. Until there is evidence of the latter, a somewhat more defensive portfolio stance is warranted and investors should expect the Fed to be sidelined (despite already being well behind the curve[6]), keeping bond yields anchored. Within equities and foreign exchange, the U.S. will likely continue to outperform (despite being ***comparatively*** pricey) due to its more defensive characteristics. Also, the U.S. economy and banking sector are among the most durable and least exposed to the Brexit fallout.

The potential swing in global growth makes it prudent to de-risk

❍ The decision to shift our asset allocation stance to a 0-3 month timeframe (from the traditional 6-12 month horizon) was made because the euro area economy will not stay in flux for very long. There needs to be a sufficient policy response soon to protect regional banks and shore up confidence, which would cause us to shift back to a pro-growth asset allocation stance. Otherwise, the resilience of the euro area recovery to withstand shocks will be tested and investors will be watching over the next month or two for economic data collected after the June 23 U.K. referendum. If the regional

[6] **MRB *Theme Report***, "***Reflating A Deleveraging World (Part III): Regional Assessment***", June 15, 2015

economy can hold up, we would become more constructive. But, without a policy response, the euro area will likely weaken and our current defensive recommendations will become appropriate on a 6-12 month horizon. We will provide regular updates as events develop.

Stay nimble in the near run until the clouds clear a bit

Note: The entire research team at MRB discussed and debated the appropriate de-risking of our investment recommendations in the immediate aftermath of the Brexit vote (as we had in the run-up to the referendum). The imminent threat to the global economy warranted cutting our mild pro-growth exposure, but the discussion centered around whether a neutral or more defensive portfolio stance was appropriate in the ***near run*** until the dust settles a bit and allows for a more decisive allocation shift.

- The case for our decision to shift ***temporarily*** to a more defensive asset allocation stance was partially based on the fact that global investors have shown a tendency to pile into risk-off trades during periods of elevated uncertainty and Brexit is a shock that hits at the heart of a major financial center. Also, without policy intervention, there is a good chance that the euro area economy would not be able to hold up, and European politicians often drag their feet unless markets are rioting. Material weakness in the euro area economy would be hard to offset elsewhere, and would warrant shifting more defensively on a 6-12 month horizon (i.e. make our temporary allocation more permanent).

Remain cautious for now and monitor the policy response

- Conversely, the argument for a more neutral stance is that heading into the referendum vote, the global economy had greater momentum and was more durable than investors appreciated and financial market pricing reflected. Also, investors had been skeptical about the rally since mid-February and most were not aggressively positioned, limiting the amount of potential selling pressure. Finally, policymakers across the globe have painfully learned in recent years the cost of dithering. Thus, there are higher odds that they will not lag as much as earlier this decade (there is already discussions at most major central banks about potential support). In this regard, there is room for positive surprises and more resilience in the global economy and equity markets.

Regardless, our shift in asset allocation was a prudent attempt to take some money off the table. For now, we will leave it to clients to decide whether a neutral or defensive tilt better suits their risk tolerance. However, we view this as a ***short-term*** shift until the political chaos starts to dissipate. At that point, we will provide clear recommendations (as usual) and either shift back to pro-growth or stay defensive.

Final Word: *Whether or not the global equity bull market can resume will largely depend on the policy response in the weeks ahead and if euro area economic confidence can hold up in the face of Brexit. We will maintain a cautious stance until there is greater clarity.*

Phillip Colmar

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