Market Brief

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UK's Brexit vote to have wide repercussions, leads to change in economic and market scenarios

Results from the UK's referendum on membership of the European Union (EU) indicate that voters have decided the UK should leave the EU. This result is likely to have wide political, economic and financial market repercussions, leading us to alter our economic and market forecasts and, potentially, our asset allocation.

Looking at the referendum result in terms of macroeconomics, financial markets and politics, our views are as follows:

Macroeconomics. The vote for Brexit is, we believe, likely to reinforce a recent loss of momentum in parts of the UK economy. We believe the result of the referendum will hit consumer and business confidence, at least in the short term. Business investment, already fragile, will be hurt, and so will credit growth. Capital outflows are to be envisaged; the UK's current account balance will be hurt, as will government finances. As a consequence, our baseline scenario is for real UK GDP growth of the order of 1.3% this year and 0.9% in 2017, well below our expectation earlier this year that UK GDP would grow by 1.8% in 2016 and by 2.0% in 2017. In addition, a sharp drop in sterling can be expected to lead to a rise in imported inflation that will offset any weakness in domestic inflation, at least in the short term.

BREXIT: CHANGES IN PICTET'S BASELINE SCENARIO FOR GROWTH AND INFLATION

	UK		Euro area	
		REAL GDP		
2016	1.8%	1.3%	1.8%	1.5%
2017	2.0%	0.9%	1.7%	1.3%
		INFLATION		
2016	0.7%	0.9%	0.3%	0.1%
2017	1.7%	1.9%	1.3%	1.1%

source: Pictet WM – AA&MR

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We now believe real growth in the euro area could be 1.5% this year instead of the 1.8% rate we had been forecasting. And we expect the euro area economy to expand by 1.3% rather than 1.7% in 2017. But given that the UK only accounts for 2% of the world economy (on the basis of purchasing power parity), we believe the Brexit vote will have only a slight impact globally. Our central scenario now is that world growth will be of the order of 3% this year and next, instead of 3.2%. Central banks will likely take coordinated action to avoid a liquidity crisis.

Markets. Given our analysis that financial markets had never fully priced in Brexit, and given the rebound seen in the days running up to the referendum, we believe that volatility will rise significantly despite central banks' interventions and that risk assets will come under pressure in the days that come. We also believe that after the shock has passed, risk assets will stabilise while market participants tease out the form that Brexit takes. But this stabilisation could prove temporary and give way to renewed market pressures.

Brexit: Pictet's forecast of the short-term impact on financial markets (1 month)

Equities (from 23 June level)

- UK −15% to −20%
- Euro area −7% to −10%
- US −3% to −5%

Currencies

- GBP −15% to −18%
- Euro +3% vs Sterling
- Yen+5%
- CHF +2%
- Gold +8%

Bond yields

- 10yr US Treasuries −20 bps to −30 bps (1.4%)
- 10yr German Bunds − 10 bps
- 10yr UK Gilts + 10 bps
- 10yr euro periphery + 50/70 bps

Source: Pictet WM – AA&MR

Our central forecast foresees a short-term drop of 12-15% in UK equities from their current levels. We also believe that the fall-out from Brexit will be felt in euro area equity markets, with the Euro Stoxx 50 sliding by 7-10% in the short term. By contrast, we believe US equities will remain relatively (but not totally) immune from the Brexit vote. We expect a number of 'safe haven' assets to be boosted by the UK referendum result in the short term, including the Swiss franc, the US dollar, Japanese yen, gold and core government bonds. Having risen close to GBP1:USD1.50 by referendum day from less than GBP1:USD1.39 at the end of February, we believe the shock caused by the Brexit vote will cause sterling to drop sharply again before stabilising in a range of GBP1:USD1.25—USD1.35. The Swiss franc will also come under renewed upward pressure, forcing the Swiss National Bank to intervene in an effort to stop the Swiss franc from rising beyond €1:CHF1.08.

We expect a steepening in the yield curve on UK gilts in the short term before action by the Bank of England (BOE) leads to curve flattening. Expectations that the BOE would gradually move to normalise policy will need to be put on hold. We also foresee a renewed decline in US Treasury yields, with 10-year US Treasury yields perhaps falling by 20-30 basis points from their current levels. We expect a slight fall in German Bund yields (perhaps by 10 basis points) to be accompanied by a rise in yields on peripheral euro area bonds before possible intervention by the European Central Bank steadies the fixed-income market. Similar trends are to be expected in European corporate bonds.

Politics. The political impact of the vote for Brexit will be significant, but the UK and Europe have time to negotiate the mechanics of the UK's exit from the EU. Article 50 of the European Treaty establishes a two-year negotiating period. During this time, the UK parliament will have its say, with results that cannot yet be foretold. There could be a "hard" exit (with no preferential access for UK exports to the EU) or a "soft" one (with some preferential access in return for notable concessions, in line with Norway's relationship to the EU). We believe the UK could lose around 4% of potential GDP growth in the next five years if we see a "soft" exit, but that the UK could fall into recession in the short term and lose a cumulative 8% of potential GDP growth over five years should there be a "hard" exit.

The result has led David Cameron to announce his resignation as British prime minister. More fundamentally, we believe the referendum result provides a second wind to populism (and the tenants of economic protectionism) throughout the western world. We believe this populism will remain centre-stage in European politics for some time, increasing uncertainty and making life uncomfortable for mainstream policy makers. The future of the European economic union is at risk.

Notes to the Editor

The Pictet Group

Founded in Geneva in 1805, Pictet is today one of Europe's leading independent wealth and asset managers, with more than GBP 281 billion in assets under management or custody at 30 September 2015. The Pictet Group is owned and managed by seven partners with principles of ownership and succession that have remained unchanged since foundation.
The Pictet Group, headquartered in Geneva, employs more than 3,800 people. It is also present in Amsterdam, Barcelona, Basel, Brussels, Dubai, Frankfurt, Hong Kong, Lausanne, London, Luxembourg, Madrid, Milan, Montreal, Munich, Nassau, Osaka, Paris, Rome, Singapore, Taipei, Tel Aviv, Turin, Tokyo, Verona and Zurich.