At our most recent Global Macro Committee (GMC) meeting we discussed the implications of Brexit on global growth and financial markets. Those conclusions are still relevant:

There is no real precedent to rely upon to assess the fall-out for the UK or the global economy more generally as a result of the decision to exit the European Union (EU). This, after all, is voluntary and limited to leaving a common market, rather than being forced by markets out of a currency peg. Trade and financial relationships will be disrupted, and the UK, which currently runs deficits in both the fiscal and the current accounts, would need to rely more on internal funding.

More problematic to analyze, the "leave" victory is not a controlled experiment in that it remains unspecified where the nation is leaving to. The UK government will have to negotiate new trade relationships in an uncertain process that might take years. The incentive of EU governments to take a cooperative stance in such negotiations will be limited, to say the least, as they worry about the precedent of voluntary exit. This uncertainty stands as a deadweight loss for risk-taking, both in financial markets and on decisions about capital investment. We will trim our 2016 forecast of UK real GDP growth from 2% to 1% as a result of the exit. This mostly owes to the drag of increased uncertainty on consumption and investment. The UK avoids recession, we believe, because domestic demand, especially from households, provides a floor for growth.

On balance, the Bank of England is likely to leave the door open to an easier stance of monetary policy through dovish communication.

The Federal Reserve, which showed itself sensitive to global economic and financial risks earlier this year, will delay again its anticipated policy tightening until later this year. The depreciation of the pound poses a particular challenge to the European Central Bank (ECB), which exhausted conventional policy accommodation some time ago, as the relative appreciation of the euro will drive the inflation rate even further below its goal. The immediate response has been to reaffirm its accommodative policy stance and promise to provide additional liquidity as necessary. Complicating matters for the ECB, though, investors might test other sovereign markets given the precedent that the EU is not inviolable. If strains do become acute, major central banks would presumably use their emergency tools to support large firms and markets.

Aside from some general market strains and potentially large changes in bilateral exchange rates, the direct global economic consequences are likely to be limited. The UK's share in world GDP stood under 4% last year, and its bilateral trading relationships are mostly regionally diversified and limited in scope. Finance is especially large in its economy, and adjustments within banking organizations to the changed trading regime would be still another drag on an already troubled industry.
More specific questions:

Q: Will this lead to a near term disintegration of the rest of the EU?

A: No we do not think so.

UK: In the short-term, Prime Minister Cameron has resigned effective October, which has seemingly calmed markets by offering a smooth transition of a caretaker government. Boris Johnson would appear the most likely replacement for PM, but that process is unlikely to be smooth. Other Members of Parliament might apply for the party leadership role, raising the possibility of a distracting party leadership contest for the next few months. Snap elections are just a tail risk, given the recent legislation passed on fixed term Parliaments in the UK.

Europe: We would expect efforts by key European politicians and policymakers to deepen European integration and cohesion. In particular, Chancellor Merkel and President Hollande will be keen that negotiations between the UK and the EU on their future relationship do not complicate the French and German elections in 2017. However EU policy makers are likely to take a hard stance on the UK in order to raise the political cost of leaving and reduce moral hazard. We will hear from the EU’s leaders tomorrow following the already scheduled summit.

More broadly speaking, the political calendar in Europe was already crowded: in 2016, we will see Spanish elections this weekend and an Italian constitutional referendum later in the year. In 2017, French elections will occur in April/May and German elections will be held in October.

The European Union has just lost one member, leaving 27 member states. Therefore, there is a non-negligible risk that one of those may leave over the medium- to longer-term but is unlikely over our forecast horizon.

Q: How have you changed your forecasts?

A: Adjustments are really in Europe only.

We are reducing our UK growth forecast for 2016 to 1% year over year with significant downside risks. We see the potential for the UK to enter recession, particularly in 2017 H1.

In Europe we are downgrading our growth forecast slightly for 2016 to +1.5% and 2017 to +1.2% with downside risks prevailing.

Q: What is the likely BOE and other Central Banks’ response?

Major G7 banks have made statements to the effect that they will support their respective markets and act in a coordinated fashion if required. In the short-term, this likely includes swap lines with other central banks if major currency markets become stressed.

The BOE already communicated their willingness to take all necessary steps to ensure stability. Their response function over the medium term to a weakening UK macro backdrop is unclear at this stage, although there is room for easing if required.

We believe the Fed is likely to push back interest rate hikes compared to expectations before the referendum. With the Fed potentially out of the picture in the near term, market participants may be much more sensitive to downside surprises on the economy than upside ones. The FOMC, however, remains ostensibly on a tightening trend over the next year and a half.

The ECB stands ready to provide additional liquidity, if needed, in euro and foreign currencies. Given the move in bunds, they’ll likely need to make some adjustments to their program relatively quickly if the bund yields do not reverse since the ECB is fast approaching the limits of their program, such as 33% issuer limit and -0.40% lower yield limit. Regarding economic policy, we see a rising likelihood that the ECB will add new stimulus to the system as it undershoots its inflation objective.

The Bank of Japan may now be more likely to step in given the move in the yen and risk assets. Governor Kuroda voiced his concern early but has yet to take action.
Q: Will U.S. Dollar (USD) strength reignite Chinese Yuan (CNY) stress?

A: Not necessarily. A much stronger Yen provides some respite for CNY for now. But more broadly, a shift to a more stable trade-weighted index would help anchor domestic FX (foreign exchange) sentiment and regional FX pressure. The USD/CNY will depreciate, but the pace against the USD will have to moderate to maintain a stable trade weighted index. A modest reserve requirement ratio (RRR) cut of 50-100bps cut will also result in a more permanent infusion of liquidity and underscore the message that the authorities are taking some precautionary measures against a broader or more sustained waning of animal spirits in domestic markets. The risk is that the authorities over-do it, or their actions are not well coordinated with policy actions elsewhere.

Q: What about the trade-weighted dollar?

A: The US policy response is expected to diverge from that of Europe and Japan, thereby supporting the dollar against the major currencies.

Q: What is the implication for commodities, specifically oil?

A: We expect oil to be relatively well-behaved and still in line with Standish trading of $43-$53 in 2016. Precious metals have been the largest beneficiaries of the Brexit vote but oil is reflecting slightly weaker global growth expectations, consistent with what is now expected by the Standish GMC forecasts. Looking forward, the marginal move in the dollar and supply factors are likely to dominate price action in the oil markets. Standish oil forecasts are at $48 in 2016 and $50 in 2017.

Implications for Investment Strategy

Our investment process over the past several months correctly concluded that valuations across most risk opportunities were challenged and the risks to our outlook were asymmetric to the downside. As a result, our portfolios were conservatively positioned heading into the Brexit vote, with risk budgets at the low end of our historical ranges and very modest to underweight positioning credit sectors depending on strategy.

The implications of Brexit on current portfolio strategy depends on the answers to two broad questions: 1) the impact on our global and regional growth forecasts and 2) the potential for systemic risk.

As noted above, we will trim our 2016 forecast of UK real GDP growth from 2% to 1% as a result of exit. This mostly owes to the drag of increased uncertainty on consumption and investment. As also noted, aside from general market volatility and potentially large changes in bilateral exchange rates, the direct global economic consequences are likely to be limited. The UK's share in world GDP stood under 4% last year, and its bilateral trading relationships are mostly regionally diversified and limited in scope. However, Brexit means that the uncertainty around our medium term forecasts has increased and the balance of risks are asymmetric to the downside.

At this point, we do not see meaningful threats to the global financial system as a result of the Brexit vote. Lower rates for longer will have an impact on bank earnings, but the stress tests released for US banks give us confidence that credit issues are unlikely. Again, were strains to become acute, major central banks would presumably use their emergency tools to support large firms and markets. However, while we do not see a systemic financial crisis developing as a result of Brexit, systemic risks have undoubtedly increased. This means that global risk premiums should be higher to accommodate this greater level of uncertainty.

Given our current view that the impact of Brexit on our global macro forecasts will be modest and the low systemic risks, there are certain areas in which we will be looking for potential opportunities. In the US, TIPS (Treasury Inflation-Protected Securities) and curve flatteners are areas that may have immediate value. More broadly, one implication of Brexit is the likely increase in demand globally for high quality US dollar fixed income assets. Therefore US duration in government, agency and higher quality US corporate credit assets will likely have strong demand and indeed early market activity supports this view. Other areas include higher quality structured assets in consumer credit and mortgages. Given the higher uncertainty around global growth forecasts, it is early to make large asset allocation shifts into lower quality credit and high yield. However, there may be opportunities to move to a more neutral or modestly overweight credit position over the intermediate term.
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