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Francis Scotland's Brexit Follow Up

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Judging from the violent market reaction on June 24, most investors were positioned for a continuation of the status quo going into the "Brexit" referendum. The whiff of panic was evident from the indiscriminate selloff in global risk assets, begging the question whether this is the beginning of another financial crisis.
In our view, this is less of a financial development than it is a geopolitical one, for now. As we have noted in previous commentary, the "leave" decision creates many uncertainties, but change is likely to evolve slowly in terms of whatever lies ahead for the relationship between the U.K. and Europe. In the meantime, the major central banks and public officials have been preparing for the possibility of a "Brexit." Consequently, the odds of a liquidity-stifling market reaction that extends into a full-blown financial/economic crisis seem low. Therefore, for the time being, the "Brexit" is most likely a geopolitical event and much less of a major economic shock for the world. Nonetheless, the potential for a more global reaction to these developments clearly exists.

There is still plenty of political uncertainty ahead, and little is expected to take place before October. Prime Minister Cameron has deferred the timing of the decision to invoke Article 50 of the Lisbon Treaty to his successor. Boris Johnson—the former mayor of London, a vocal leader of the "leave" campaign, and a potential replacement of the Prime Minister—has encouraged the idea for voting to leave as a way to prompt a renegotiation of concessions with the European Union (EU) sufficient to put the question back to the British public in another referendum. It is clearly a case of self-interest that both sides negotiate to a conclusion that is very close to what currently exists. If that turns out to be the case, the direct hit from this shock to the regional European economy will be small, and even less so for the global economy.

The main economic risk is to the British economy. The U.K. runs a large current account deficit. Foreign direct investment is likely to weaken as companies reconsider investing in the country ahead of the uncertainty surrounding the nature of any new relationship with Europe. The Bank of England has promised to support financial conditions in the short term, but the obvious risk is a capital account-induced slowdown/recession, stagflation, and a weak currency.

The breakaway of the U.K. clearly raises the probability of further disintegration in the economic union, and puts the euro project back under the spotlight once again. Who will be next? Pressure on peripheral spreads and a structural risk premium in the euro are natural byproducts. It is our view that Brussels must engage in serious reform efforts to address grievances and dissatisfaction from member countries. A majority of Europe's population is holding national elections over 2016 to 2017, and in several instances, populist resurgent movements are making headway. Italy and France have the highest proportion wanting a referendum on EU membership. Economic pain prevails in many of the crisis-stricken countries of the monetary union, a condition which has made the challenges of managing extraordinary immigration more difficult. The status quo is no longer an option.

The positive reaction to this historic development in the U.K., and signs of voter dissatisfaction across the continent, would lead to a concerted effort by Europe's leaders to drive toward reform and economic growth. Unfortunately, the more likely stance of European leadership is the status quo, at least initially, and will be along the lines of: take the same hard line with the U.K. that it has done with Greece and other peripheral members of the monetary union and demand that they adhere to the rules of the club. This is a recipe for a nasty divorce and further disintegration. Historically, it takes a crisis to evoke any significant change in policy direction from Europe's leaders.

The key variable to watch for any knock-on effects to the global economy will be the U.S. dollar. Dollar strength is tantamount to a tightening in global monetary policy, and under current circumstances would be very deflationary. In view of the negative structural bias that the "Brexit" creates for the euro, it will be up to the U.S.

authorities to respond appropriately in order to guard against the possibility of an unchecked surge in the dollar.

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