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Q&A: How Will Brexit Affect the UK and EU?

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Global Strategist Neil Dwane answers investors' most pressing questions about Britain's current and future relationship with the European Union.

Key takeaways

- Post-Brexit vote, the UK may be in a better position than the EU, at least until Article 50 is triggered. Exit negotiations could hurt UK consumption, hiring and investment, potentially causing a UK recession.
- Brexit will play a role in Europe's upcoming elections, especially in Italy and France. If unease spreads, EU economic growth could be stalled by delayed corporate investment and the fragile state of euro-zone banks.
- If the UK imposes migration constraints, it may be unable to maintain its EU trade relationship. Perhaps the British Government can successfully define the difference between the free movement of labour vs. people.
- While the British pound was initially more robust than expected after its initial fall, it may be undermined by the UK's budget deficit, high levels of indebtedness and persistent trade deficits.
- Oil and food prices will be major drivers of UK inflation over the coming years, as will potential trade tariff changes.

As investors begin to navigate what the UK and EU will look like in the new post-Brexit world, it may be helpful to think in terms of the famous Donald Rumsfeld quote about "known knowns", "known unknowns" and "unknown unknowns". Clearly, the UK and the EU have started a "journey into the unknown" with a timeframe that, for now, is similarly "unknown". Yet what is known is that some of the post-referendum pain has already been felt, and that the UK may be in a better position than the EU – at least until terms of the UK's actual exit from Europe are defined. Nevertheless, growth will be lower, sentiment across Europe will be more fragile and politically sensitive, and the need for investors to find sufficient returns remains extremely pressing.

Known knowns

What has changed and when will Brexit happen?

The UK will be part of the EU for most likely another two and a half years – at least. As such, EU laws and responsibilities should remain unchanged until negotiations have been completed, probably in late 2018 or early 2019. Scotland and Northern Ireland remain very much part of the UK and, despite having voted against Brexit, there is no appetite nor essential mechanism whereby they can force the British Government to allow them their own independence referendum. Indeed, for reference, Scotland rejected its 2014 independence vote with a strong turnout (85 per cent) and a majority voting to stay (55 per cent); in the 2016 Brexit referendum, turnout was 67 per cent and 60 per cent were in favour of remaining.

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Is there any chance of another UK referendum on EU membership?

Despite a very large online petition essentially calling for a "do-over", it is unlikely that another referendum will occur; the British Government has already said that this referendum result is final and that it will comply with the voters' wishes.

Will the changes to Britain's Conservative government lead to another UK General Election?

This is unlikely, since the UK now operates fixed-term Parliaments and the Conservative Party manifesto for the last General Election, held in May 2015, carried a pledge to have the UK "in/out" referendum; as a result, even if, following the resignation of David Cameron, a new Prime Minister is needed, another election won't be. However, there may be a referendum or General Election on the terms of the exit deal agreed to with the EU; this might occur in 2019, just ahead of the next scheduled election in 2020.

When will Article 50 be invoked?

The exercising of Article 50, which starts the negotiation process to leave the EU, is the British Government's prerogative alone; after that, the UK will have up to two years to negotiate the terms of its departure. As a result, it is very clear that no one can force the British Government to make this decision before it is ready to do so. Then again, Article 50 also enters into "unknown" territory here: It is legally unclear whether the Prime Minister can invoke Article 50 or whether the process requires an act of Parliament, and it is also "unknown" if Article 50 can be revoked after negotiations begin; this will weigh on the Government's thinking and timing.

But Article 50 will certainly place more negotiating pressure on the UK once it is triggered, because if an agreement is not reached within two years, the UK will essentially exit the EU without any trade agreement or access to the single market. Knowing the complexity of this negotiation and the potential for a stand-off, it would seem prudent for the British Government to take its time before triggering Article 50 and entering into an exhaustive process with the EU.

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It should also be noted that the UK has delegated trade negotiations to the EU since 1975 – and, according to some sources, the UK actually has only two international trade negotiators, where 400 will be required.

What is the EU's position?

As expected, the EU is taking a firm stance on the UK's referendum result: Communiqués have stated that the UK should invoke Article 50 as soon as possible and that the EU will not engage in any pre-negotiation until that point.

While it is certainly in the EU's interest not to make leaving the EU an easy process for the UK, its member states have an interest in reaching a solution that is mutually beneficial. Indeed, the language from Angela Merkel, the German Chancellor, has been far more conciliatory and patient in tone and message.

For now, it seems likely that the EU can either press on for "more Europe" as detailed in the Five Presidents Report – hastening closer fiscal, monetary and political union – or it can muddle through while waiting to determine both the direction of Europe and the Brexit deal.

As of now, it seems impossible for the UK to keep its existing EU trade relationship if, as seems likely, the UK imposes constraints on the migration of EU citizens. While immigration has become a leading factor in the growth of nationalism across Europe, exacerbated by recent terror attacks in Belgium and France, the EU will not allow one of its principle tenets – namely "the free movement of people" – to be reinterpreted by the UK.

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How will Brexit affect upcoming European elections and national politics?

Europe has many important election dates coming in the next 18 months, and with Brexit reverberating within the EU and within individual countries, the tone and tenor of discussions may change.

- Spain's 26 June elections went well from an EU perspective; the anti-EU protest vote did not gather more momentum, which could allow the EU to conclude that they should stay the current policy course.
- In October, Italy will hold an important constitutional reform referendum, which may well turn into a de facto vote on the Renzi government itself and on membership in the EU – particularly with the very anti-EU Five Star Party becoming more popular.
- In March 2017, the Netherlands elections will come essentially on the heels of another refusal to approve trade relationships with the Ukraine. The French will vote in April/May; many hope for a mainstream candidate to be elected, but anti-EU sentiment is making a strong showing. And, of course, Germany itself will hold important elections in the autumn.

Of all these political events, it is Italy and, remarkably, France that have the biggest potential to transform the political narrative in Europe.

Elections in Italy and France have the biggest potential to transform the political narrative in Europe

Known unknowns

Where is the British pound sterling headed?

Sterling – which priced in a tremendous amount of volatility and hedging before the Brexit referendum, and which suffered from a dramatic overnight fall as the result unfolded – was initially more robust than expected. However, when Article 50 is enacted, Sterling may be undermined by government budget deficits (approximately 6 per cent of gross domestic product), by high levels of government and consumer indebtedness, and by persistent trade deficits. Still, the timing of Article 50's invocation is uncertain. Fundamentally, Sterling should be expected to work lower, but how much lower depends on politics and policies; USD/euro parity is also possible. Juxtaposed against this fragility is the intense allure of UK and London assets to overseas investors who value legal certainty and exceptional property rights as much as they value returns.

What are the economic growth prospects for the UK?

The Brexit decision will, if it hasn't already, cost the UK some of its recent reasonable economic momentum. The period of exit negotiations will affect domestic consumption, corporate investment and hiring, and international inward investment – all of which will reduce the UK's economic growth rate and could cause a recession later in 2016 or 2017.

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The UK Government, despite much protest from the Chancellor of the Exchequer, George Osborne, has not been managing its finances in an austere fashion. The markets could force the UK to reduce its deficit by raising taxes, lowering spending or both; this pressure can already be felt with the recent downgrade of the UK's credit rating by Standard & Poor's, and with Moody's to a negative credit-rating outlook. However, in the short term, the Bank of England would be ready to support economic activity with more quantitative easing.

With uncertainty to remain until at least 2018, the UK may well experience something of an investment recession as UK and international companies postpone capital and employment decisions until the terms of trade become clear. It would be prudent to expect that UK consumption would also slow or even fall during this period as higher levels of inflation reduce discretionary purchases.

Will inflation hit the UK?

The prospects for inflation in the UK will be watched very closely, especially with a weaker pound feeding domestic inflation because the UK economy imports 60 per cent of what it consumes. Just look at history as a guide: During the Global Financial Crisis, the pound fell 25 per cent and, later, inflation rose to 5 per cent. Clearly, oil and food prices will be major drivers of UK inflation over the coming years, as will potential trade tariff changes. It's important to note that rising inflation, while essential to our financial repression thesis, will erode the purchasing power of investors' wealth and compromise the Bank of England's monetary policy.

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Will the UK experience stagflation?

Some fear that over the next few years, the UK may see little or negative growth while experiencing inflation of 4-5 per cent from Sterling weakness. This would affect domestic assets, including corporate earnings, and it would challenge the environment of very low bond yields, especially because rising inflation could cause the Bank of England to raise rates, which would worsen the economy through the feedback loops of extensive leverage and floating rate mortgages.

What are the economic growth prospects for the EU?

The ECB has already forecast that Brexit would lower economic growth by 0.3 to 0.5 per cent per annum over the next three years; the current growth forecast is 1.6 to 1.7

per cent. The decline would happen mostly through falling trade, which would affect Germany, France, Italy and Ireland. Additionally, investors may want to watch for signs of further contamination of Brexit uncertainty into Europe, as seen by investors or corporations delaying or deferring investment spending there. This, combined with the still apparent fragility of the euro-zone banks, could hinder or stall the EU's reasonable economic growth to date.

Investors should watch for signs of further contamination of Brexit uncertainty into Europe, such as delayed or deferred investment spending

What will happen to the EU's core tenets?

The EU is built on four key tenets: the free movement of goods, capital, services and people. Any attempt during negotiations to inhibit or control one of these tenets may become a deal-breaker.

What will happen to the EU's core tenets?

The **free movement of goods** – or the "common market" that the UK voted to join in 1975 – will be an important economic filter from an individual country perspective. The UK is a large market for many EU exports: It is Germany's third-largest market and France and Italy's fifth-largest. Security will also influence many EU members, as the commitment to and effectiveness of NATO rests mostly in the hands of the US and the UK, and thus the members in central and eastern Europe will not wish to totally alienate the UK. Accordingly, investors must learn to navigate the differences between the "cold" negotiating stance of the EU and its representatives in Brussels and the "warmer" economic self-interests of the EU members themselves. Indeed, the auto sector alone exports approximately 60 billion euros' worth of cars to the UK each year – a market that would be impossible to replace.

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The **free movement of capital** is very important for both the UK and the EU, albeit through different lenses. The UK has built the world's leading financial franchise in the City of London, and many EU capitals envy the employment, value creation and tax payments it generates. It seems, at least initially, that the EU and ECB would seek to take back into Europe certain euro-clearing and related services and regulations, reviewing at the same time the "passporting" that allows all banks and insurers globally to be based in London but offer services in the EU. From a UK perspective, the loss of "passporting" would seriously affect the City of London. However, moving operations to a less empathetic and more bureaucratic Europe may also affect the EU, where a Financial Transaction Tax is pending; with other financial centres seeking to woo investors too, London would not necessarily be diminished as a significant "offshore" source of capital for Europe and the world. Global financial centres rely on a delicate but robust infrastructure of talent, legal expertise, information technology and regulations. This will make replacing London a very tall order for the EU in the years ahead.

The **free movement of services** seems to be a much less problematic arena because so many services are requested and delivered locally. Where there is regional co-ordination in areas like research and development, the UK is involved separately, and thus there would be little complication from a Brexit. Agriculture would be a complex issue for both the UK and EU to address, but strategically the UK supplies itself with only 60 per cent of its food, and thus may voluntarily seek to invest and encourage this industry.

Regardless of how the UK solves the immigration issue, it remains a key concern for all of Europe; nationalist parties in France, Italy and Austria are growing in influence

The **free movement of people** – a.k.a., immigration – was clearly the "hot button" topic of the Brexit referendum. Without control over this issue, the British Government will fail to deliver what the referendum sought. At this time, the rhetoric remains bold and clear, but it seems that there can be a difference between the "free movement of labour" (where EU citizens with work or skills can migrate) and the "free movement of people" (where EU citizens can move and arbitrage education, health and welfare systems). Regardless of a resolution in time for the UK, it remains a key political issue for all the member states themselves. Nationalist parties in France, Italy and Austria, to name a few, are growing in influence; as such, this issue must be resolved before an EMU member potentially seeks to leave.

Unknown unknowns

As Donald Rumsfeld himself explained when he uttered this now-famous phrase, it is impossible to know what is essentially unknowable. As a result, this area has been deliberately left blank. The ongoing fallout from Brexit will undoubtedly give rise to new considerations that as of now cannot even be contemplated, so investors would be well-served to remain vigilant and poised to navigate the volatility that is certain to ensue.

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