



# The Potential Impacts of Brexit on the Global Economy

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Macro Trends Group

## SHORT SUMMARY

The markets and the oddsmakers have been caught off guard by the UK's Brexit vote. The immediate reaction in the financial markets has been swift and violent owing to the surprise. Financial markets will likely calm somewhat after a period of shock and awe, but will find themselves settling into an entirely new vector of macroeconomic and geopolitical uncertainty.

- The Brexit vote will undoubtedly embolden other EU skeptic parties, particularly in the Eurozone heart of the European Union. Other exit referendums may arise in the coming months to years. The UK itself may face an additional exit referendum from Scotland.
- The process of Brexit is without precedent, with only the most general timetable outlined in the Treaty of Lisbon. Thousands of details will have to be worked out in the process of unwinding the ties that bind Britain with the EU.
- The financial market reaction will also feed into the far-flung macroeconomic consequences of Brexit. For example, a sharp and sustained rise in the value of the US dollar versus the euro will put added pressure on the weak US manufacturing sector just as it seemed to find a

new footing. This puts additional downward pressure on historically weak US growth momentum.

## GLOBAL IMPACT

There is no roadmap to follow or analogy to invoke as a guide or pattern for how the Brexit vote will reverberate in the months and years to come. However, a few immediate consequences seem highly likely:

- The flight to safety away from the epicenter of this British-EU divorce will push capital away from the region and toward key safe-haven markets including the US – especially Treasuries – and to Japan. This will further lower market interest rates and raise relative currency values.
- A higher US dollar and Japanese yen are negative to both economies' export sectors. In the case of Japan, this is particularly unhelpful to its efforts to reflate and reinvigorate the economy after decades of deflation.
- The higher US dollar also triggers additional pressure on China to float the yuan lower, as it is caught in the divergence between its two largest export markets – the EU and the US.
- For the US, the negative impact on exports is relatively small compared with trends in domestic demand, but the deflationary pressure on tradable goods will widen the divergence between reasonably strong inflation in the services sector vs. reasonably strong deflation in the goods sector.
- The European Central Bank will be compelled to raise its level of intervention yet again, as risk premiums across the region rise. Among the larger Eurozone members, Italy is in a particularly vulnerable position – now made more vulnerable. Each blow to members of the Eurozone periphery also further make Germany's outperformance in the Eurozone even more unsustainable.

## MACRO TRENDS GROUP BASE CASE GOING FORWARD

At this point, key elements of our global macro base case scenario remain unchanged; in some areas they are further reinforced.

While no one could have foreseen the exact sequence of events, especially those of a fundamentally political and social nature, the general arc of the global macroeconomy continues to follow a basic configuration, and we will continue to use that pattern as the guide for our global base case scenario. Among the key elements of our base case scenario as they are affected by the Brexit vote:

- The US remains the most stable major global economy, but the uncertainty spread between the US and the EU has now increased. This further tilts macro conditions to the favor of the US market vs. the EU. But this relatively bullish view (emphasis on the word “relatively”) is tempered by the signs of an increasingly mature economic cycle. Stability means the US may expand longer than the other major economic regions, but it will not remain immune from negative global pressures that have just become more negative. The uncertainty may create additional incentives for the Fed to reconsider any nearer-term rate hikes.
- The Eurozone’s expansion cycle has been relatively weak and has mainly benefited from coming off a low base. We had earlier cautioned that this cycle is likely to be relatively short. The Brexit vote will probably chill European banks’ appetite for risk, supporting the notion that this expansion cycle may be cut short.
- The Eurozone (and now the broader European Union) faces profound fractures in the structures that hold it together. We continue to expect some level of Eurozone breakup over the medium term (i.e., not next year, but before 10 years) in our base case scenario for the region. Underlying this thesis is a recognition of the shearing forces to the Eurozone macroeconomy, but the overlay of the political and social environment potentially fills in the narrative of how an economic potentiality may become reality.
- China faces further negative pressure on growth rates. The bulk of deceleration pressures are intrinsically of domestic origin. However, the likely need to counterbalance an even bumpier global environment will further slow progress toward a new, slower but stronger economic model. The inward turn of the Chinese economy that we anticipated in our base case scenario may be facilitated or accelerated by similar inward turns implied by the emerging political and social climate in other parts of the world.
- In general, this recent event reinforces our view that we will continue to be in a period of heightened political volatility reflected

everywhere from Russia to Spain to the US in the upcoming election run-up.

Finally, these individual elements of the base case scenario collectively sum up to our global base case scenario. We are now 7 years from the Great Recession of 2009, when the global economy contracted. The longest expansion cycle since 1980 has only been 11 years, the shortest was 7 years. While growth cycles do not necessarily die of old age, they also do not live forever. Our base case scenario is that recession will again visit before the end of the decade in the US, and will have repercussions in most economies. In other words, we give the current global expansion cycle no more than 3 years to live.

**NOTE:**

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