International developments

Brexit: It happened, risk-off in markets as questions outnumber answers

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After the shock

Confident markets and pundits went to bed last Thursday night thinking Brexit had been defeated, only to wake up to a surprise Brexit victory Friday morning: 52-48%. The markets were thus positioned "wrong", which exacerbated the volatility and the downdraft moves.

Not surprisingly, it was risk-off immediately and in a big way: equities down all over, bonds up and interest rates down (including the UK). Currencies were damaged where the Brexit uncertainty is highest and where its economic impact is likely to be more severe. The GBP was hardest hit (down 8% on the day), followed by the euro. Flight-to-quality benefitted the USD, the JPY and gold.

These market moves are in line with what obvious analysis points to: uncertainty and change will weigh heavier on the European economies, less so on the US and world economies, hence the relatively more muted responses there. On Friday last week, US stocks fell 3.5%; Europe over 8%, the UK was off 3%. Further but milder pressure followed this week. Rating agencies revised down their outlooks and/or ratings, with S&P downgrading the UK's credit rating by two grades from AAA to AA.

In their first post-vote trading session, all GCC equity markets lost ground. The smaller markets of Bahrain and Oman fared better than their peers with losses under 1%. Kuwait and Qatar retreated 1.1% and 1.2%, respectively. Saudi's Tadawul and Abu Dhabi Stock Exchange (ADX) were off 1.9% on the day. Dubai Financial Market (DFM) took the biggest hit with the index down 3.3%. DFM with its relatively large foreign investor base is more susceptible to international markets and tends to be more reactive to big events. In subsequent sessions this week, the markets retuned to more "normall" activity.

For the GCC countries, we do not expect anything particularly big or special, barring persistent volatility in international financial markets. Marginally weaker world growth, would be slightly less supportive of oil prices (which should continue to firm). The Fed will be less prone to raise rates more than once this year, similarly for GCC central banks. And, as mentioned in an earlier piece, the GCC and other international blocs or areas could (after actual exit) negotiate separate trade deals with the UK.

What is totally unknown at this point is the magnitude and timing of all sorts of effects. According to numbers bandied about (that we do not trust) the world economy could lose 25 basis points (bps) of GDP growth in the next year or two, while the UK could lose about 1-1.5% of GDP growth this year, with heightened probability of a recession in the near term. These unknowns will be driven by political dynamics, to be set in motion in the coming weeks and months. In the meantime the central banks (BOE, ECB, etc.) all stand ready to provide liquidity and support to calm financial markets, and said as much.

Where are the politics?

Many of the unknowns lay in the politics of the UK and Europe. David Cameron, the British prime minister who campaigned to "Remain" in the EU, will be gone within three months. His successor will manage the

transition and decide when to invoke article 50 of the Lisbon treaty. That article starts the negotiation clock for the actual exit within two years, if not extended. The process should take two years from the time article 50 is invoked. During that time the UK will renegotiate its exit and its new relationship with the EU. This is all uncharted territory but, on the plus side, likely subject to a lot of "bending" or flexibility.

The tug-of-war is currently between an EU that is signaling it wants quick negotiations to remove uncertainties (but also to look tough against other potential leavers), and a UK that wants to move cautiously, the prudent thing to do. It is likely that heads will cool in the months ahead and that negotiations will take place in an orderly fashion and over an agreed time frame. Markets will then also get a chance to cool off and digest those changes slowly and gradually as they unfold (see our earlier brief on Brexit).

Risks

The risks in our mind are also political, with potential for more serious damage if they materialize: a spillover of independentist and separatist sentiment to other major European countries. Those may ask for their own exit referenda at some point (the Netherlands, Finland, etc.). A risk also of further protectionist momentum, the latter already in motion in the US with the Donald Trump campaign, as well as other anti-establishment and Euroskeptic movements.

What to monitor next

Which way the balance in the negotiations and in Europe? Will the negotiations be "friendly" and look to minimize shocks for the economies of both sides? Or will the EU decide to make an example of the UK to scare off other potential "leavers"? When will article 50 be triggered? (It is a UK decision, and cannot be forced by the EU.)

Elections in Europe and France's presidential election next year. How aggressive will the separatist, anti-establishment movements become in the rest of Europe, and can these translate post-Brexit energy into actual electoral gains and political seats? (Different but related: Scotland's serious threat to leave the UK.)

On the positive side, Brexit may present the EU with a wake-up call and an opportunity to address long standing concerns about heavy handed regulation and some problematic immigration issues.

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