HUGO*vision*

Assessing the economic and political environment in New Zealand

BREXIT UPDATE | June 26 2016 | Confidential to HUGO members

Brexit: first impressions as the dust settles

This second special edition of HugoVision following the Brexit poll last Friday represents our initial thinking. It is inevitably subject to revision because of the fluid and unpredictable nature of international financial markets, let alone further political developments either in the UK or Europe.

Impact on global markets

- Global market uncertainty and volatility is on the up and can be expected to remain for some time, meaning risk premia will rise;
- Beware the eventual correction;
- Credit conditions may tighten as bank stocks have fallen aggressively, putting pressure on the need for further capital. The unknown factor is whether this will largely be contained to UK/EU banks or whether it will spread;
- Liquidity shouldn't be a problem as that is central banks' control, meaning this is not a GFC, nor would the central scenario be that it will trigger one;
- Nonetheless, we would now expect the Fed to postpone tightening to December;
- The Yen is rising in an unhelpful fashion, prompting potential for Japanese monetary authority action, as it is seen as a "safe-haven" currency;
- The Euro is under pressure, though not free-fall;
- The immediate double digit decline in the GBP will spur competitiveness although UK GDP will take a big hit, with some inevitable flow on impact;
- the NZD softened but held up remarkably well for a currency that normally suffers when global risk increases;
- Bond yields are falling as central banks are expected to be more dovish and as equities come under pressure;
- Commodity prices under pressure, bar gold, which has risen as it's seen as a safe haven;
- UK credit rating likely to be downgraded. Ironically, this makes NZ banks look even better.

Scenario for a Major Correction? Maybe

For some time now there has been concern that asset prices have been overvalued. They are currently now under substantial pressure. The key European markets fell between 3% and 12%, Asia Pacific 1% to 8%, the Americas 1.5% to 4.0% last Friday. If Brexit acts as a catalyst for a major correction in asset prices, things could get a lot more ugly. However, we are not promoting this scenario and think that easier than anticipated monetary policy will eventually contain the damage.

Impacts for New Zealand

The combination of increased risk and the ongoing strength in the NZD increases the likelihood that the RBNZ will ease in August. Note that we were already predicting a rate cut in August. After the Brexit shenanigans, it would appear that the only thing standing between an August rate cut and not would be a VERY significant surge in housing market activity and/or a belated slump in the kiwi dollar.

More broadly, we expect limited and diffuse impacts on NZ. The UK is a small export market for NZ for most

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products, outside EU quota-protected beef and sheepmeat exports, with about half the quota trade going to the UK, raising significant uncertainty about the future of this trade. At the margin, tourism operators may be affected as the weaker GBP will attract international tourists.

Our early soundings suggest there will be little impact on dairy, where quota into the EU is not currently fully used anyway, although a weaker Euro will assist European exporters in markets where NZ competes in the currently over-supplied global market. The future for trade relations with the EU and UK is a medium term concern, but may present opportunities. However, NZ's desires are unlikely to be near the top of anyone's list in either London or Brussels right now.

While there may be an adverse impact on confidence short term, we are not changing our 2017 real growth forecasts of around 3.0% at this stage, but acknowledge clear downside risk, which is likely to place heightened pressure on the NZD. The RBNZ would continue to welcome this.

So far, the NZD is weakening significantly against the yen, and is softer against the USD and Chinese yuan while holding up against the AUD, stable against the Euro and rising aggressively against the Pound. We'd expect this process to broadly continue but watch out for Yen intervention and a down leg in the Euro.

Now is not the time to jump to too many conclusions. This is particularly so in New Zealand's case. The factors that are driving the economy are not likely to change any time soon:

— migration (may actually increase)

— tourism (is Asian dominated but might suffer at the edges)

— building (will keep going)

— education services (will keep going)

Nonetheless, the dislocation created by the volatility that this has, and will cause, is by definition unsettling for growth and domestic politics.

Brexit Process: what next?

- The UK must invoke 'Article 50' of the EU's founding Treaty of Lisbon to trigger departure, starting a two year process. That can be extended, but only by agreement of all EU member states. Once Article 50 is invoked, there is 'no going back' unless by unanimous consent of EU member states;
- The UK referendum bill allows six weeks for legal challenges. Departing PM David Cameron has said he will not invoke Article 50 before he resigns, which could be as late as October. Leave campaign leader Boris Johnson has said there is "no need for haste";
- Therefore, **the two-year process may not begin until late 2016, leaving the UK an EU member state until late 2018;**
- While some EU states' leaders have made angry or punitive remarks, that is the heat of the moment;
- Trade, migration and other cross-border arrangements will be renegotiated rather than scrapped. A prolonged period of renegotiation is an opportunity to pull back from the current sense that the UK will 'abandon' Europe. The security and defence, commercial, economic and people-to-people ties are too strong for that;
- **EU leadership will be more focused on ensuring their own discontented populations don't seek the same outcome as the UK;**
- Precedents exist for countries to have EU-like relationships while not belonging to the EU. The 'Norway model' is most often cited. Ironically, this requires Norway to meet EU regulations of the kind cited by the Leave campaign as reasons to leave, in order to trade with Europe. This may be one route for European leaders to ensure the UK is seen not to have its cake and eat it. Another may be to move against the quasi-tax haven status of the London financial centre in its dealings with EU entities;
- **Despite a widely reported and heavily supported call for a second referendum, we discount the likelihood of this happening.** However flawed the referendum process may be judged to be by the losing side, **the fact remains it is a democratic outcome**. The rifts revealed in UK society by the Brexit would risk serious exacerbation if efforts to overturn the result were mounted;

- Also, we expect the UK withdrawal will not be as dramatic, in practical terms, as the political impact of the Brexit vote itself. There are several reasons for thinking this:

  — The majority of UK MPs support EU membership, so will seek to retain a UK that is engaged with Europe;

  — The vote was as much a protest vote by Britons who felt 'left behind' by the economic changes of the last four decades since Thatcherism as it was a vote against the EU itself. Domestic political responses will need to be deeper than simply severing ties with Europe. In the process, ties with Europe can be carefully reconstructed;

  — Most of the rest of Europe faces the same societal pressures as triggered the Brexit vote. Urgent soul-searching will be required if the European project is not to suffer further defections, spurred by Brexit. That is especially true of countries inside the Eurozone that, unlike Britain, have lost control over their monetary or fiscal policy settings;

  — Polls show more than 50% of Germans, Italians, French, Swedes and Hungarians would want a referendum if the UK voted to leave and far-right and left wing politics is on the rise in Europe. Containing this may require significant EU reform, which current European leaders will have to manage alongside the rift with the UK;

  — Russia will seek to exploit any disunity that spreads as a result of this dynamic, as it seeks to buffer itself from western Europe and NATO.

All that said, the practical process of renegotiation may still take longer than two years. The European Parliament must vote on the renegotiated package with the UK, and in several countries, parliamentary ratification will be required for new trade agreements. The chilling effect of this process on the UK economy and trade between the UK and EU may be substantial.

Key quotes from EU leaders:

- French president Francois Hollande: "The (Brexit) decision … requires a lucid awareness of the inadequacies of Europe's functioning and people's loss of trust in the project."
- Angela Merkel: "Quite honestly, it should not take ages, that is true, but I would not fight now for a short time frame. The negotiations must take place in a business-like, good climate. Britain will remain a close partner, with which we are linked economically."