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British vote to exit the EU: what happens now?

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British voters have voted in favour of Brexit: the British exit from the European Union (EU). This means that in the coming months, British and European leaders will begin negotiating the terms of Britain's departure. Britain's exit will affect the British economy, immigration policy, and lots more. It will take years for the full consequences to become clear.

In the short run, uncertainty about Britain’s future relationship with the EU, its largest trading partner, could push the UK into a recession. The UK also faces political uncertainty given the weakened Cameron Government and a likely renewed push from pro-EU Scotland for independence. Investors should expect heightened volatility as markets process the implications of Britain’s exit, particularly the risk that it sets off a domino effect of countries seeking to leave the Eurozone.

The process of leaving the EU will take years

Under the Lisbon Treaty which governs the European Union on this type of issue, after notifying the European Council of intent to leave a withdrawal agreement would be negotiated. This could take up to two years after which membership lapses.

At stake would be what sort of trade relationship the UK will have with the EU. Here there are various models. For example, if Britain becomes a member of the European Economic Area like Norway and Iceland it would continue to enjoy free trade access to the rest of Europe. But it would also have to accept the free movement of people, contribute to the EU budget and accept virtually all EU rules and regulations without having a say in determining them.

Brexit will cause issues for Britain's economy

Leaving the EU is generally seen as negative for the UK economy given the impact on trade, the UK financial sector (which may over time lose its status as the pre-eminent European financial centre) and on labour mobility. The precise impact depends on the sort of exit deal negotiated in terms of trade access to the EU, but has been estimated by the UK Treasury and the OECD at around a cumulative 5% of GDP over 15 years. In other words GDP would be around 5% lower 15 years after exiting.

Of course these numbers are very rubbery but expectations of something like this would be negative for British assets, particularly the British pound (as the UK share market is dominated by a bunch of multinationals anyway). However, given the two year negotiation period it may take some time for the economic impact to become apparent.

Expect heightened volatility and uncertainty

The victory for Britain to leave EU will likely see more "risk off" turmoil, e.g.; shares down, commodities down, bond yields down, British pound and Euro down and $US, Yen and gold up. The $A would probably fall against the $US but rise against the British pound and Euro. Eurozone and British shares could easily fall 10% or so and Australian shares maybe 5%.

All this will likely prove to be a buying opportunity as Europe is likely to hang together as it did through its sovereign debt crisis for the reasons noted above. Central banks led by the Bank of England and European Central Bank would run easier monetary policies than otherwise fearing an adverse financial and economic outcome.

What about Europe?

The main concern globally is not the impact on the UK economy but rather whether Brexit will kick of a round of contagion to exit amongst Eurozone countries which would then see the Eurozone unravel. It's doubtful that it will because the hurdle to leave the Eurozone is high as it will mean adopting a new currency, paying higher interest rates, etc. Just think of Greece despite its woes over the last few years consistently deciding to stay in the Eurozone. However, the risk is there, with Italy perhaps being most at risk, and markets will likely fear the worst in the short term.

Implications for Australia

The implications of a hit to the UK economy on Australia would be small as the UK takes just 2.7% of our exports. The decision could affect short term confidence and may add to the case for the Reserve Bank of Australia (RBA) to cut interest rates again particularly if banks increase their mortgage rates out of cycle due to higher funding costs flowing from an increase in lender caution. That said we expect the RBA to cut rates again anyway.

Final thoughts

The key for investors is to either look through the short term noise caused by the Brexit decision or look for investment opportunities that it throws up as investment markets become oversold.

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