Macro Matters.

EU referendum result

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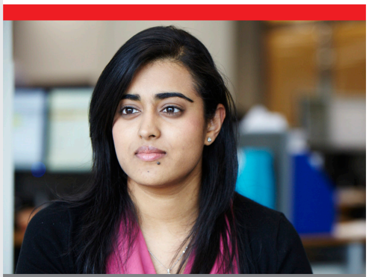

Hetal Mehta - European Economist

Hetal is a European economist and is responsible for providing macroeconomic research and forecasts for the fixed income, asset allocation and equity teams. She joined LGIM in 2011 from Daiwa Capital Markets where she held the role of UK economist. Prior to that, she was a senior economic adviser to the Ernst & Young ITEM Club and an economist at the Oxford Economics Consultancy. Hetal has also worked for HM Treasury and the Office for the Deputy Prime Minister. Hetal graduated from the University of Bath in 2004 and holds a BSc and MSc in economics.

Christopher Jeffery - Strategist

Chris is a strategist in LGIM's Asset Allocation team. In this role he is responsible for macro research and idea generation for the Multi-Asset funds managed by the team. Chris joined LGIM in 2014 from BNP Paribas Investment Partners where he worked as a senior economist and strategist within the Multi-Asset Solutions group. Prior to that, he worked as an economist within monetary analysis at the Bank of England, with a focus on the UK domestic economy.

The UK has voted to leave the European Union by a margin of 52% to 48%. Although opinion polls had narrowed during the final few weeks of the campaign, financial markets had been broadly positioned for 'remain' given the lead in bookmakers' odds. The shock for financial markets has been particularly marked this morning given that the final poll on the day of the vote indicated a 4-6 point lead for 'remain'.

The initial market response to this unexpected result has been stark. At the time of writing, sterling is 5% lower (on a trade-weighted basis), UK equities are down by 5% and 10-year gilt yields are 30bp lower.

Short-term economic risks are acute

Whatever you think of the long-term costs/benefits of leaving the EU, it seems fairly clear that there will be a significant short-term economic adjustment cost. From a global perspective, 'Brexit' had been identified as a major concern by various international bodies, such as the G20 and IMF, and had topped the list of market concerns among surveys of fund managers.

In the UK, there is plenty of evidence that greater uncertainty about the business environment has already been weighing on business investment. Measures of corporate investment intentions, for example, fell sharply in the run-up to the referendum. This is likely to deteriorate further in the immediate aftermath.

Consistent with the Treasury's assessment ahead of the vote, our base case has now shifted to a UK recession in the second half of 2016. This is likely to be triggered by a short-term retrenchment in both corporate and consumer spending.

On the back of this recession, expectations for interest rate hikes by the Bank of England are firmly off the table. Instead, the focus will now switch to how the Bank can support the economy through this period of adjustment. We do not expect interest rates to drop below zero as in Europe, but a small cut in policy rates and additional quantitative easing are a likely policy response, alongside credit easing measures and liquidity provision.

Political risks multiply

The vote to 'leave' is likely to be a catalyst for a series of highly unpredictable political dynamics.

David Cameron has already announced that he will step down as Prime Minister by October.

The Scottish independence movement will have been given a boost by this result. With the SNP no longer commanding a majority in the Scottish Parliament, a second Scottish referendum is not imminent, but it is firmly back on the agenda.

Legal & General INVESTMENT MANAGEMENT

Beyond these domestic concerns, the UK now has to negotiate the terms of its exit from the EU. Under article 50 of the EU Treaty, the negotiation period will last two years from the date on which we formally announce our intention to leave. David Cameron intimated this morning that the decision on when to trigger that withdrawal process will be a matter for his successor.

The referendum result is only politically, not legally, binding on the UK government. It is unclear, at this stage, whether the UK's decision to leave will require ratification by parliament in the coming weeks. Given that over two-thirds of the country's MPs supported the 'remain' campaign, this is unlikely to be a particularly harmonious process. A fresh general election cannot be ruled out, although the Fixed Term Parliament Act makes the process for this complicated.

Once this hurdle has been cleared, the list of matters to settle with the rest of Europe is extremely long and complicated. Those advocating a vote to leave the EU have supported various models for life on the outside of the club: Norway, Switzerland, Turkey, Canada and even Albania have been held up as possible examples to follow.

However, we now need to move from the abstract to the specific. The ramifications for the UK economic and market outlook will depend most heavily on the specifics of the trade and immigration agreements (i.e. will we retain single market access in services and will we retain free movement of labour with the continent?).

European contagion

One of the key concerns in the months ahead is how the European political debate will respond to the UK's departure. The euro has been held together by the promises of the ECB to do "whatever it takes" to save the single currency, but the faultlines are there for all to see.

The UK's departure from the EU could be the catalyst for deeper integration across the continent, or it could embolden anti-EU sentiment elsewhere (e.g. the French National Front, the Dutch Freedom Party). At this stage, we simply do not know.

On the morning after the referendum, there are lots more questions than answers.