



The road not taken

By Richard Jeffrey, CIO

The dust was never going to settle quickly after the EU referendum, almost whatever the outcome.

Perhaps the only result that would have proven more contentious would have been an even narrower exit majority. As it was, it was narrow enough. And over the next few months, if not years, the dust will continue to swirl, to different degrees obscuring our view of the future. Nobody will be able to claim 20-20 vision in this environment. Indeed, already the exit camp seems keen to downplay some of the claims made about the future benefits of leaving the EU. The country has taken a political decision with potentially profound, but as yet undetermined, economic consequences, and it may take many years before the implications of taking a new path are fully understood. As to whether it would have been better for the economy to have taken the other fork, we will never know.

So, having stepped only a few inches along what will likely prove a very difficult trail, it is difficult to reach any significant conclusions about the eventual destination. What is clear is that it is much easier to see the negative consequences of removing ourselves from the EU, and harder to understand the possible benefits. This is likely to remain the case for some while, at least until we have a better idea of how exit negotiations are progressing, and what the UK's new relationship with the EU might look like.

In understanding the near-term risks that face the economy however, we will be able to create a gauge against which we can judge future developments, both in the near and longer term. The overriding result of the exit vote is that the UK is beset by a feeling of uncertainty. The most obvious area in which this becomes manifest is the financial markets. While the greater fear remains that leaving the EU will have

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negative consequences, at least in the short term, we can expect the currency to be weaker than it would have been, for equities to be more modestly valued (at least to the extent that companies are reliant on the UK domestic economy for turnover and earnings), for bond yields to be higher (although, it is possible to argue that the relative safety of government debt will make it relatively more attractive), and for property prices to be lower.

But to what extent? So many plausible combinations of economic and financial circumstances can be described, that it ►

is impossible to say. However, what may turn out to be easier to identify is when particular markets become undervalued to an unwarranted degree, it is these opportunities that we will be looking for.

In the immediate aftermath of the Brexit vote, we were surprised there was not greater volatility in financial markets. But it would be foolish to conclude that there will not be more to come.

With regards to the near term outlook, there are some obvious economic hazards. Most obviously, the fall in the value of the pound, particularly against the dollar, will tend to put upwards pressure on inflation, initially through petrol and other energy costs and later through generally higher import prices. We doubt that this, in itself, will have a major impact on thinking within the Bank of England, which is likely to maintain its current policy bias. Indeed, it is not impossible that it will choose to reduce interest rates and endorse additional quantitative easing if it determines the economic outlook has deteriorated sufficiently.

The extent to which weakness in sterling does turn out to be inflationary will, in part, be determined by trends in the real economy. If the economy slows significantly, then inflation will tend to rise less. There are three main routes through which the economy will be impacted over the months and quarters ahead: household spending, capital investment and trade. Newspaper headlines dominated by the problems that Brexit might cause seem bound to cause uncertainty amongst consumers and the resulting negative impact on spending could be accentuated by a fall in house prices. At the moment, we believe that UK household spending has sufficient momentum to carry it through this period with only comparatively modest damage being registered. However, it is the area of highest risk, accounting for almost

two thirds of aggregate demand. The monthly retail sales data will provide a good gauge as to how consumers are reacting – and financial markets are likely to pay these numbers a more than usual degree of attention.

Meanwhile, the negative impact of uncertainty in the corporate sector will likely be seen in the continuing weakness in capital investment. Even before the referendum, this was an area of the economy which was under pressure, partly reflecting worldwide overcapacity in manufacturing. It seems inevitable that in the near term, companies will delay or cancel investment in the UK. While this does not account for a large proportion of GDP, it will not be helpful, particularly if it is accompanied by reduced demand for labour (which could have a further negative impact on consumption).

The impacts on trade will be complex. Initially, weaker sterling will push up the cost of imports, causing the trade deficit to widen. Later, (but with quite a long lag), exporting companies and those competing with imports should benefit

from greater competitiveness if sterling remains weak. This presupposes that conditions in our major export markets remain positive. However, there is a possibility that other EU countries will also see demand hit by the uncertainty caused by Brexit, and there could also be a negative demand reaction to the UK's decision.

These are perhaps some of the more obvious effects that we will see in the period ahead. Inevitably, we will be analysing other economic nuances, some currently unforeseen, as the situation develops. However, whatever the long term may bring for the UK, it is hard not to conclude that the economy will see duller growth for a couple of years, though quantifying 'duller' is impossible at the moment. And, to return to a theme that we have written about extensively in the past, with 'normal' growth now being at a pace significantly lower than what might have been perceived as normal in the 15 years prior to the recession, the increased downside risks will leave households feeling much more vulnerable. **d**



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