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Column

The victims of Brexit

18 July 2016 | Author: Pieter Jansen, Senior Strategist Insurance at NN Investment Partners

- **The UK could sink into a recession as early as the second half of this year, says NN Investment Partners.**
- **Ireland, Belgium and the Netherlands are particularly vulnerable to Brexit-related consequences because trade with the UK delivers an important part of their income, a recent IMF report shows.**
- **Foreign direct investments in the UK may decline and a weaker pound sterling may cut into the returns of foreign securities portfolios.**

In the short run, the confidence shock of the Brexit vote will impact economic growth. The longer-term outcome depends primarily on the deal the British strike with the EU. While the exact terms of the approaching divorce are uncertain, the chances of the British reaching favourable new trade arrangements with the EU are slim.

The IMF concluded in a UK country report published a week before the vote that the economic consequences of a Brexit would be negative for the UK and to a lesser degree for other countries. According to the IMF these 'casualties' are concentrated in the EU, where the smaller trading partners in particular would bear the brunt of the impact.

The British are on a path towards recession
Most experts agree that Brexit will foremost adversely affect the UK economy. Our view is that the current upheaval could well push the UK into a recession starting in the second half of this year and impose additional headwinds for European growth momentum over the next 12 to 18 months.

The uncertainty around future ties between the UK and the EU may cause shifts in foreign direct investments in the UK. Multinationals may reconsider the extent of their presence in the UK. The biggest foreign investor is the US, with 23.2 percent of total direct foreign investments. The Netherlands account for 16.4 percent, followed by Luxembourg with 7.5 percent and France with 7.3 percent. Other important investors from outside the EU are Japan (4.1 percent) and Switzerland (4.5 percent). The uncertain future relation with the EU and the internal political turmoil in the UK don't create an environment in which businesses will quickly make long-term investment decisions or hire new personnel. The weaker sterling exchange rate may be positive for exports but it will also temporarily boost inflation.

The UK exit also creates a cloud of uncertainty over London's role as the financial center of Europe. Financial firms based in the UK have a passport with which they can offer financial services in Europe. These firms may be hurt if the UK loses access to the single market.

Businesses and financial markets plan ahead and this may already lead to divestments in the UK. Banks have been under pressure, and the UK real estate market could also be facing long-term uncertainties.

Outside the UK, Ireland, Belgium and the Netherlands are the most vulnerable

The IMF report estimates that the smaller open economies close to the UK -- Ireland, Belgium and the Netherlands -- are most heavily exposed to Brexit risks. Malta and Cyprus are also mentioned. Trade with the UK accounts for a high percentage of these countries' GDP. Net recipients of EU spending, notably the newer EU member states, could also be affected financially. The UK's exit would automatically lead to a 10 percent reduction of available EU funds, according to the IMF.

After the UK itself, Ireland is potentially the biggest loser of Brexit. The Irish have close trade and financial ties with the UK. In addition, some 400,000 Irish citizens work in the UK. After a Brexit, these workers will probably have to obtain visas in order to keep their jobs. According to IMF figures, exports to the UK account for 11.2 percent of Ireland's GDP. For Malta this sums up to 8.4 percent of GDP, Cyprus 7.6 percent, Belgium 7.5 percent, and 6.7 percent for the Netherlands.

Institutional investors such as pension funds may feel the impact of the weaker pound in their returns on investment unless they have completely hedged the currency risk. In Luxembourg, investment in UK securities amounts to 175.5 percent of local GDP. Irish investors have as much as 94.5 percent of GDP in British securities. For the Netherlands this amounts to 24.1 percent; for France it is 10.7 percent.

The impact of Brexit on global growth and the Eurozone

The impact of Brexit on global growth may be small. The biggest risks here are a continued increase in political uncertainty and sustained market volatility which could depress global financial conditions. We have reduced our expectations of earnings growth in the Eurozone from 4% to 2% this year and from 8% to 3% for 2017.

Greater political uncertainty, fears of other referenda in Europe and underperformance of banks and risky assets in general can lead to weaker economic fundamentals. We often see that this is an important transfer mechanism of shocks and that a focus on trade linkages alone often underestimates the impact. Economy is all about confidence and financial conditions. Weaker asset prices and tighter lending standards by banks can negatively impact consumer and corporate behaviour. This is a potential risk for the global economy.

Are there any winners?

Some sectors and companies may benefit from the current currency moves. We have seen a stronger US dollar and a much weaker pound sterling. This may be positive for UK-based pharmaceutical firms, for example. Global companies with costs in sterling may benefit in the short run. The uncertainty about the UK's long-term relationship with the EU may lead to some companies reallocating parts of their businesses to EU countries. Other European financial and business centres, such as Frankfurt, Paris, Dublin and Amsterdam, may benefit from this.

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** Figures as per 31 March 2016*.