The Brexit referendum and its aftermath

What if the UK leaves the EU? A Brexit scenario
What if the UK leaves the EU? A Brexit scenario

Below, we have a deterministic scenario that we have added to our standard scenario analysis toolkit which looks at a plausible set of outcomes that might come about should Brexit materialise. We are including this output because it allows us to take a longer time frame to look at how economies and markets react to Brexit, rather than just focusing on the immediate outcomes following any decision to leave the EU, which is so much the focus in the media and the output of so many market commentators on Brexit.

We refer to outcomes versus our ‘base case’ in our scenario analysis, which refers to the investment path taken in our global capital market assumptions. Given our observations about the scale of the uncertainties involved, this scenario should be seen for what it is, i.e., it is not predictive but indicative of what could happen.

Background

The referendum on whether the UK should remain in or leave the EU is one of the key risks being faced by the UK economy in 2016. The referendum occurs in June and our base case view is that UK citizens will vote to stay within the EU. Under this scenario, the negative impact of uncertainty in the lead up to the referendum is likely to be temporary and dissipate after the vote to remain within the EU. The alternative scenario is that UK citizens vote to leave the EU. The impact on the UK economy of a decision to leave the EU is highly uncertain as it is dependent on the decisions taken after a vote to leave the EU with alternative arrangements for trade in goods and services taking many years to put in place.

What might a Brexit scenario look like?

Under a Brexit scenario, a vote to leave the EU is likely to result in significant, negative economic and financial shocks for the UK and, to a lesser extent the EU, due to increased uncertainty over the future. Economic growth is likely to be slower than the base case, as it takes time for new trade deals to be negotiated and for companies to adjust to the new economic environment. Growth is likely to remain below that of the base case over the next five years, though there is more or less a reversion back to the base case within the five year period.

In the UK, the vote to leave the EU hits business confidence and investment due to uncertainty over future trade agreements with the EU (and other countries). Real wages rise at a slower rate as there is an uptick in the unemployment rate; new hiring is delayed and some multi-national companies choose to relocate headquarters overseas. Consumer confidence and spending are lower due to the poorer outlook for the economy and labour market. However, fiscal and monetary policy is adjusted to remain more supportive than they would otherwise have been.

Policymakers will have up to two years to agree the terms of leaving the EU. While there are a number of free trade models that the UK could adopt, we assume that the UK negotiates a special deal that retains free trade on goods, but not services, with the EU, while allowing greater control over external trade and immigration policy. While access to the single market will require the UK to be consistent with EU rules, the UK in theory should have some flexibility on what regulation is applied.

After a vote to leave the EU, the UK will become the EU’s biggest export market. We assume in this scenario that the EU behaves pragmatically and agrees a mutually beneficial deal which does not jeopardise the flow of cross-channel trade. We assume that over time there will be greater clarity on trade agreements which will allow confidence and investment to recover. This means that the scenario allows for the negative effects from the referendum to gradually moderate over time.

We assume that the recovery in the global economy is likely to be relatively unaffected by Brexit, as monetary policy remains accommodative and business confidence improves at a global level. Even so, reduced growth in the UK and the potential for spill-over effects in the Eurozone are likely to be a drag on global growth versus our base case. In particular, we envisage further unrest in some European countries and gains in support for anti-EU political parties after a Brexit, weakening the ties within Europe and weighing on growth in an already weak Eurozone economy. The outlook for the US and Chinese economies is largely unaffected by these developments.

A sharp fall in capital flowing into the UK leads to problems in financing the current account deficit and a fall in sterling against a trade weighted basket of currencies results in 2016. This causes moderately higher inflation in the UK compared with the base case scenario. However, inflation is kept in check by low commodity prices, a weaker domestic outlook and a weak Eurozone economy.
How will financial markets be impacted by Brexit?

Our scenario analysis covers some 128 macroeconomic and investment variables that are tracked over a five year period. Here is a snapshot of some key paths from this scenario. We show this in graphical form on the following pages.

Bank rate
We expect that the policymakers will maintain accommodative monetary policy in the aftermath of a vote to leave the EU. This may involve the Bank of England cutting the bank rate or signalling that rates will be kept lower for longer. We would only expect further quantitative easing (QE) if there was a more severe, marked slowdown in the UK or global economy.

Sterling
A vote to leave the EU is expected to result in sterling weakness against a trade weighted basket of currencies in 2016. We expect the depreciation to be most pronounced against the US dollar. The depreciation against the Japanese Yen is expected to be slightly smaller due to more monetary stimulus being undertaken by the Bank of Japan to offset a weaker global outlook from Brexit. Depreciation against the euro is more muted as spillover effects and greater concern over a broader EU breakup put downward pressure on the euro. This suggests that Brexit will boost foreign asset returns in sterling terms. The size of the boost would be dependent on the local currency of the asset denomination.

Bonds and Credit
The short-term net effect of Brexit on the gilt market is difficult to determine as market pressures push nominal yields in different directions. A weaker economic outlook and looser monetary policy push yields lower, while higher inflation expectations and some concern from overseas investors on sterling and the health of public finances push yields higher. We expect nominal yields to be slightly higher than our base case. However, over the longer term, the effect is expected to be broadly neutral, with nominal yields under Brexit converging to those in our base case view over the next three to five years. Real yields are initially pushed lower than our base case due to the weaker economic outlook and increased demand for inflation protection. Real yields are expected to remain below those in our base case over the next five years. After Brexit, corporate credit spreads are expected to widen initially, due to greater uncertainty and a weaker economic outlook. However, credit spread differences with the base case are expected to gradually narrow over time. Over the next five years, we expect Brexit to lower returns from gilts and corporate bonds over the next five years, while adding to index linked gilt bond returns.

Equities
In the Brexit scenario, UK equities (and to a lesser extent European equities) sell off in the first year in response to the greater uncertainty generated by the UK’s decision to leave the European Union. Other equity markets are affected to a lesser extent and returns are lower but positive. In later years, equity returns are positive but remain below those in the base case due to a weaker economic outlook.

In general, the economic risks of Brexit are likely to be reflected in higher risk premiums to invest in UK and EU assets. This will lead to lower (local) returns relative to the base case, with much of the negative shock front loaded, over the next five years. Outside of Europe, growth assets are expected to be only moderately affected due to the weaker global outlook. However, in sterling terms, weaker sterling may lead to an overall boost in returns from overseas assets relative to the base case.
A Brexit scenario

Real GDP growth (YoY)

CPI inflation (YoY)

Long gilt yields

Long index linked gilt yields

Source: Aon Hewitt
The Brexit referendum and its aftermath — What if the UK leaves the EU?

**UK equity returns**

<table>
<thead>
<tr>
<th>Year</th>
<th>Brexit</th>
<th>Base case</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>10.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td>2017</td>
<td>5.0%</td>
<td>0%</td>
</tr>
<tr>
<td>2018</td>
<td>0%</td>
<td>-5.0%</td>
</tr>
<tr>
<td>2019</td>
<td>-5.0%</td>
<td>-10.0%</td>
</tr>
<tr>
<td>2020</td>
<td>-10.0%</td>
<td>-15.0%</td>
</tr>
</tbody>
</table>

Source: Aon Hewitt

**Global equity returns**

<table>
<thead>
<tr>
<th>Year</th>
<th>Brexit</th>
<th>Base case</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>2.5%</td>
<td>1.3%</td>
</tr>
<tr>
<td>2017</td>
<td>2.3%</td>
<td>1.3%</td>
</tr>
<tr>
<td>2018</td>
<td>2.1%</td>
<td>1.5%</td>
</tr>
<tr>
<td>2019</td>
<td>1.9%</td>
<td>1.7%</td>
</tr>
<tr>
<td>2020</td>
<td>1.7%</td>
<td>1.5%</td>
</tr>
</tbody>
</table>

Source: Aon Hewitt

**Corporate AA spreads**

<table>
<thead>
<tr>
<th>Year</th>
<th>Brexit</th>
<th>Base case</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>1.0%</td>
<td>1.1%</td>
</tr>
<tr>
<td>2016</td>
<td>1.1%</td>
<td>1.0%</td>
</tr>
<tr>
<td>2017</td>
<td>1.2%</td>
<td>1.3%</td>
</tr>
<tr>
<td>2018</td>
<td>1.3%</td>
<td>1.4%</td>
</tr>
<tr>
<td>2019</td>
<td>1.4%</td>
<td>1.5%</td>
</tr>
<tr>
<td>2020</td>
<td>1.5%</td>
<td>1.6%</td>
</tr>
</tbody>
</table>

Source: Aon Hewitt
Contacts

Tapan Datta
Head of Global Asset Allocation
tapan.datta@aonhewitt.com
+44 (0)20 7086 9076

Peter Williams
Head of Technical Support and Research (TSaR)
peter.williams@aonhewitt.com
+44(0)1372 733763

About Aon Hewitt

Aon Hewitt empowers organisations and individuals to secure a better future through innovative talent, retirement and health solutions. We advise, design and execute a wide range of solutions that enable clients to cultivate talent to drive organisational and personal performance and growth, navigate risk while providing new levels of financial security, and redefine health solutions for greater choice, affordability and wellness. Aon Hewitt is a global leader in human resource solutions, with over 30,000 professionals in 90 countries serving more than 20,000 clients worldwide. For more information on Aon Hewitt, please visit: aonhewitt.com

Follow Aon on Twitter: twitter.com/Aon_plc

Sign up for News Alerts:
About Aon

Aon plc (NYSE:AON) is a leading global provider of risk management, insurance brokerage and reinsurance brokerage, and human resources solutions and outsourcing services. Through its more than 72,000 colleagues worldwide, Aon unites to empower results for clients in over 120 countries via innovative risk and people solutions. For further information on our capabilities and to learn how we empower results for clients, please visit: http://aon.mediaroom.com/

© Aon plc 2016. All rights reserved.

This document and any enclosures or attachments are prepared on the understanding that it is solely for the benefit of the addressee(s). Unless we provide express prior written consent, no part of this document should be reproduced, distributed or communicated to anyone else and, in providing this document, we do not accept or assume any responsibility for any other purpose or to anyone other than the addressee(s) of this document.

Notwithstanding the level of skill and care used in conducting due diligence into any organisation that is the subject of a rating in this document, it is not always possible to detect the negligence, fraud, or other misconduct of the organisation being assessed or any weaknesses in that organisation’s systems and controls or operations.

This document and any due diligence conducted is based upon information available to us at the date of this document and takes no account of subsequent developments. In preparing this document we may have relied upon data supplied to us by third parties (including those that are the subject of due diligence) and therefore no warranty or guarantee of accuracy or completeness is provided. We cannot be held accountable for any error, omission or misrepresentation of any data provided to us by third parties (including those that are the subject of due diligence). This document is not intended by us to form a basis of any decision by any third party to do or omit to do anything.

Any opinions or assumptions in this document have been derived by us through a blend of economic theory, historical analysis and/or other sources. Any opinion or assumption may contain elements of subjective judgement and are not intended to imply, nor should be interpreted as conveying, any form of guarantee or assurance by us of any future performance. Views are derived from our research process and it should be noted in particular that we cannot research legal, regulatory, administrative or accounting procedures and accordingly make no warranty and accept no responsibility for consequences arising from relying on this document in this regard.

Calculations may be derived from our proprietary models in use at that time. Models may be based on historical analysis of data and other methodologies and we may have incorporated their subjective judgement to complement such data as is available. It should be noted that models may change over time and they should not be relied upon to capture future uncertainty or events.

Aon Hewitt Limited is registered in England & Wales.
Registered No. 4396810.
Registered Office: 122 Leadenhall Street, London EC3V 4AN
Aon Hewitt Limited is authorised and regulated by the Financial Conduct Authority

Follow us on twitter @aonhewittuk

www.aon.com