The Brexit referendum and its aftermath

Economic impact
Summary

Brexit risk is rising. We expect the referendum result in June to be close. The odds still favour remaining in the European Union (EU), though by a narrowing margin.

Uncertainty will be the biggest single impact from any decision to leave given many possible exit routes out of the EU and highly unpredictable timescales for putting new arrangements into place. We identify the key channels for Brexit to make itself felt on the UK, whether it is trade access, financial services or migration.

That so much is unknown about how the UK will engage with the EU after a potential exit is a problem for sterling and financial markets. The likelihood of at least some disruption to economic conditions, trade and foreign investment flows is likely to be enough to weaken sterling further and for equity markets to come under renewed pressure. Gilts will fare better, with nominal yields broadly unchanged and index-linked gilt yields falling.

Our Brexit scenario allows us to take a somewhat longer-term (five year) perspective on the impact beyond the knee-jerk shorter-term impacts. Our view is that though there are some marked negative impacts on the economy and risky assets for a period, this will fade over time. The UK economy will eventually learn to adapt.

Brexit: what is the probability?

There is plenty of time for opinions to turn and then turn again on the Brexit issue, in either direction, before the EU referendum date of 23 June. That said, the strong likelihood is that the result will be far closer than the two to one majority for retaining membership achieved in the 1975 referendum. There is much more Euroscepticism now than then.

Opinion polls are split fairly evenly now, from a high level look at the polls (see chart below for a ‘poll of polls’). One of the key questions that will settle the final outcome is how those currently undecided will move as the referendum approaches. Many have argued that the undecided segment will swing in favour of staying in, but this is far from obvious.

At the present time, we think it is sensible to consider a probability of at least one in three that a decision will be made to leave.

Source: www.WhatUKThinks.org/EU run by NatCen Social Research
Brexit: key impacts

The key impact of any decision to leave will be to create uncertainty. There is uncertainty on every possible front. For a start, the mode of exit is unknown. As well known, there are four countries with different engagements with the EU — Norway, Iceland, Turkey and Switzerland — which provide some clues on potential exit paths. However, there are other exit paths that are in the fray, including a most-favoured nation approach or negotiating separate free-trade agreements. It is noteworthy that many Eurosceptics envisage a very different relationship with the EU altogether which does not fit comfortably into any of the above paths. This is undoubtedly a factor that increases uncertainty since it involves starting from scratch in negotiating trade and other access privileges.

How easily the UK secures access, the level of access secured (in terms of tariff and on-tariff barriers) for goods, how and whether access for financial services is equivalent to that in goods are just some of the key uncertainties. There are many more such as how migration restrictions will work, important for the City and other sectors reliant on workers from the EU, assuming that controls are tightened.

The most unpredictable aspect is simply time. The timescale for the UK to negotiate and settle into a reasonably predictable set of economic and financial relationship with the EU is clearly an unknown and it matters. The exit clause in the EU treaties allows for two years completing negotiations on the mechanics of exit. The free trade and access treaties needed could take a decade or more to put in place.

We know little about how businesses would react to these uncertainties, though business survey evidence suggests that they will not like it. Many businesses have been cautious in expressing an opinion at all as it appears to resemble political meddling. Fewer have argued the exit case than for staying in. Though some of this is undoubtedly a resistance to change and more complexity, it is reasonable to believe that there will be some business disruption (think of all the contracts that are likely to have to be re-written). We believe that there will be some detrimental impact for a time on investment intentions of business, including foreign businesses operating in the UK or considering it. This in turn impacts the economy. Our deterministic ‘what-if’ economic scenario allows for some lowering of economic growth resulting from higher levels of uncertainty following a decision to leave.1 That said, we should note that the damage should fade over a longer period of time (a decade or more) on the view that even though access restrictions may continue to be a problem at that time, many of the uncertainties over engagement with the EU will have eased.

Precisely because the economic uncertainties around exit are so high, financial market conditions will turn more volatile. This is more of a medium-term than a longer-term issue. Sterling, gilts and equities will react to a Brexit announcement, though it is probable that some of the reaction will pre-date the referendum, as we have already seen with sterling. Greater volatility is much more likely in the next few weeks and months if the projected outcome looks to be shifting towards a greater likelihood of exit, for the obvious reason that markets strongly favour the status quo rather than a ‘leap in the dark’ EU exit. We make some comments below on potential investment impacts on sterling gilts and equities. Our Brexit scenario is also helpful in providing some clues on how market reactions could extend to a longer period of five years. That said, though very plausible as a set of outcomes, we have to caveat the investment path in this scenario heavily given all the uncertainties surrounding exit.

Crucially, Brexit will impact the EU itself, which could well rebound back on the UK. There is a likelihood of an increase in tensions as the UK example might bring more of the already established tendency in the last few years towards fragmentation, rather than integration, to the fore. This is a huge unknown, but the UK is unlikely to escape some of the effects just because it is not in the EU. An example is the way that the UK has been a big buffer in balancing the very different views on EU policies between France and Germany. This stabilising influence on the Franco-German axis will no longer operate, potentially creating divisions at the very core of the European project. It is in no way fanciful to argue that the EU will move into an existential crisis post Brexit. Of course, we do not know how these European issues in a Brexit world will be resolved, but the point here is that the UK is unlikely to be spared the effects. The UK remains too deeply intertwined in terms of its economic and political relationships with the EU to be spared the ill effects of a severely weakened EU, let alone its dissolution. In a related vein, the Scottish issue will again resurface on Brexit, this time with a potentially higher probability of a vote for independence.

1 Please see ‘The Brexit referendum and its aftermath - What if the UK leaves the EU? A Brexit scenario’
These are hugely complicated and uncertain effects that we have outlined on the previous page. Any analysis of impacts is bound to be tentative, which suggests we should be very wary of views from commentators which appear firm. Some of the above appears to convey major negative effects, but we should note that over time, we would expect these to wane. Uncertainty will diminish the longer the period allowed for. History suggests that companies and individuals eventually find ways around any new set of arrangements, though some of this may come at higher cost which society will have to bear. For now, the key impacts, as set out in a highly simplified form in the table below are a reasonable summary of the ways we should be looking at the impact of Brexit.

<table>
<thead>
<tr>
<th>Issue</th>
<th>Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Trade access</strong></td>
<td>Access has to be secured — if the Norwegian model is rejected, then access has to be negotiated for specific sectors. The UK may have to adopt EU regulations if it is not to burden companies unduly.</td>
</tr>
<tr>
<td><strong>Financial services</strong></td>
<td>Again the UK could need to negotiate access. An equally big issue is whether there are threats to the UK’s domination in the European banking / derivatives / FX markets and whether attempts are made to bring within the EU rather than be based ‘offshore’ in London.</td>
</tr>
<tr>
<td><strong>Foreign investment into the UK</strong></td>
<td>The UK has been a great success story for European foreign direct investment (for exports, for R&amp;D and head office locations), but its position as a gateway to Europe becomes an issue. Long-term and shorter-term capital flows into the UK are more important now because of the size of the external deficit.</td>
</tr>
</tbody>
</table>
The Brexit referendum and its aftermath — Economic impact

**Issue**
The UK would have more freedom to decide who to let in to the UK. However, some exit paths will not allow restrictions to operate on the free movement of labour.

**Impact**
Restrictions on free movement of labour will impact London-based financial services. Migration’s benefits have outweighed costs so reduced migration will impose economic costs. Also, leaving the EU will not impact migrant flows from outside the UK — the UK will have to manage borders without sharing costs with the EU.

**Issue**
Uncertainty created means markets will turn more volatile in an attempt to ‘price’ the risk. Reactions will partly pre-date referendum date.

**Impact**
Sterling is a focal point but it goes beyond to equities, bonds and beyond. Impact to be wider than just the UK. Concern over the financing of the current account deficit and still weak public finances will have an impact. We would see this as a shorter-term phenomenon on financial markets, which should fade over time.

**Issue**
Uncertainty over trade (particularly UK’s position in EU supply chains), financial services, foreign and domestic investment intentions, and the backdrop of financial market volatility.

**Impact**
UK economic growth slows, though sterling weakness may help cushion to a degree. A cut in rates or more quantitative easing only likely if gilts are badly impacted, which we regard as unlikely.
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