29 June 2016

Downgrading our forecasts on Brexit

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- **Following the UK's vote to leave the EU, we are lowering our forecasts for economic growth, interest rates, sterling and the euro**
- **Uncertainty is high, so next to our new base case scenario, we also present alternative adverse and positive scenarios**
- **In our new base case, UK GDP is around 2% lower in 2017, eurozone 0.6% and the US 0.3% compared to our pre-Brexit scenario…**
- **…within the eurozone, the periphery, Ireland, Belgium and the Netherlands see the biggest downgrades**
- **Cable is now seen falling to 1.20 in our base case, 10y Bund yields to -0.2% and Italian spreads rising to 180bp**
- **Our adverse scenario assumes contagion to the rest of Europe and heightened fears of euro/EU break-up; our positive scenario assumes that the uncertainty shock does not materialise**

Presenting a new base case and alternative scenarios following the Brexit vote

The exact political, economic and financial market implications of the UK's decision to leave the EU are highly uncertain. We have more questions than answers at this stage. Though the direction seems to be clear, with economic growth, especially in the UK, likely to be much weaker. Interest rates, sterling and the euro also look likely to be at lower levels compared to our pre-Brexit scenario. In this research note, we set our new base case, making assumptions about the negotiations between the UK and EU, the extent of European political contagion and related degree of risk aversion and hence tightening of financial conditions. Given the uncertainty, we also set out a more adverse scenario and a more positive one.

Assumptions underlying our base case

Our central view is that the UK will trigger Article 50 by the end of the year and negotiations will begin. These talks will not be straightforward. Although it is in both the UK and EU's economic interest to agree on free trade, the politics are pointing in the other direction. The EU may want to drive a tough bargain with the UK in order to dissuade other countries from following the UK's path out of the EU. At the same time, the UK would likely not be willing to accept free movement of people and other regulations necessary in order for it to have full access to the EU market as this is a key factor behind the vote to leave in the first place. It is therefore likely that the negotiations will be difficult.

Consequently, we assume that the talks will move only slowly forward and that the period of uncertainty will be prolonged. This will make the corporate sector cautious – especially in the UK – and will curtail investment and hiring. However, uncertainty should gradually ease during the course of next year.

Since the referendum outcome became known, there has been significant risk aversion in markets, which means financial conditions have tightened. We assume that financial conditions will not tighten too much further as markets will start to stabilise. This is based on the idea that risky assets are close to adjusting to the weaker outlook for economic growth and risk premiums for downside risks.

The assumption that financial conditions will not tighten much further also rests crucially on there being limited 'exit contagion' to the rest of the EU. This means that although we expect political risk to remain elevated across Europe, we do not expect perceived EU/euro break-up risk to rise very sharply.

Finally, we think central banks and other authorities will do what they can but do not have the tools readily available to be game changers. We could see further monetary easing and – possibly – co-ordinated FX intervention, but central banks doing more of the same will not dramatically improve the outlook.

GDP forecasts in new base case (%, year average)

Economy	Pre-Brexit		New base case	
	2016	**2017**	**2016**	**2017**
UK	**1.6**	**2.5**	**1.5**	**0.5**
US	**1.7**	**2.1**	**1.7**	**1.8**
Eurozone	**1.3**	**1.6**	**1.3**	**1.0**
Germany	1.4	1.7	1.4	1.3
France	1.1	1.5	1.1	1.0
Italy	0.7	1.1	0.7	0.1
Spain	2.6	2.2	2.6	1.8
Netherlands	1.7	1.9	1.5	1.2
Belgium	0.9	1.4	0.9	0.6
Ireland	4.1	3.0	4.1	1.5
Greece	-2.2	0.7	-2.2	-0.3
Portugal	1.1	1.4	1.1	0.4
Emerging Asia	**6.0**	**5.8**	**5.9**	**5.7**
China	6.5	6.0	6.5	6.0

Source: ABN AMRO Group Economics

Weaker economic outlook

Our base case sees lower economic growth (see table above), especially in the UK, where the uncertainty and hence corporate retrenchment will be more severe. These effects will also impact the eurozone, but to a much lesser extent the US and Asia. While for the UK we expect to see a moderate recession at around the turn of the year, in the eurozone, we see a scenario of modest growth, which will be somewhat below trend in the near term. UK economic growth will be partly cushioned by the fall in sterling. Within the eurozone, countries with significant trade links to the UK

(Ireland, Belgium and the Netherlands) or fiscal, banking sector and/or political vulnerabilities (the periphery) will see the biggest impact.

The implications for the inflation picture are not clear cut. In the UK, the weakness in sterling will push up core inflation. However, over time, weaker growth will lower core inflation. In the eurozone, we would expect core inflation next year to be somewhat lower. However, we are not changing our commodity price forecasts and still expect oil prices to move up. This means that headline inflation will rise significantly in the coming months in most economies.

Easier monetary policy

We will likely see easier monetary policy compared to our pre-Brexit scenario. Although the BoE will be faced with higher inflation (due to weakness in sterling) as well as weaker growth, we think it will put more weight on the recessionary forces engulfing the economy. We therefore expect the BoE to cut the Bank Rate by 25bp to 0.25%. More importantly, we think it will launch a new QE programme, which will also include risky assets such as corporate bonds and perhaps eventually equities, as well as gilts.

Bond yields & FX in new base case (%, end of year)

Market	Pre-Brexit		New base case	
	2016	**2017**	**2016**	**2017**
Germany 10y	0.2	0.7	-0.2	0.1
US 10y	2.0	2.5	1.4	1.8
UK 10y	1.4	2.2	0.5	0.2
Spain 10y spread	1.4	1.3	1.7	1.6
Italy 10y spread	1.3	1.3	1.8	1.7
EUR/USD	1.15	1.15	1.10	1.10
GBP/USD	1.48	1.56	1.20	1.35
EUR/GBP	0.78	0.74	0.92	0.81
USD/JPY	110	105	103	110

Source: ABN AMRO Group Economics

We already expected the ECB to step up its QE programme in September (monthly asset purchases rising to EUR 100bn from EUR 80bn) and extend the programme (to June from March). We now expect the ECB to extend the programme through the end of next year. Given the more modest impact, we have kept our base case for the Fed unchanged. However, we already had expected the Fed to delay rate hikes until 2017 (when we expect three rate hikes). The risks to our Fed view is for an even longer delay.

Lower yields, sterling and euro

We have lowered our forecasts for Bund, US Treasury and gilt yields, given weaker growth, lower underlying inflation, easier monetary policy and heightened risks. 10y Bund yields are now seen declining to -0.2% by year end. On the other hand we have raised our projections for peripheral spreads, given heightened political risks. Finally, we expect sterling – and to a lesser extent the euro – to be weaker than in our pre-Brexit scenario. In particular, sterling looks likely to fall further – to a low of 1.20 against the dollar - given the risks related to the UK's huge current account deficit and the capital flows necessary to fund it as well as the cushion the UK economy will need.

Adverse scenario

In our alternative scenario, the UK-EU Brexit negotiations will be very messy and acrimonious and will not make clear progress. In addition, political risk escalates sharply across Europe, with anti-establishment and anti-EU parties seeing rising support. There could be EU in-out referendums planned in other countries. Political fragmentation would grow resulting in either weak centrist or more militant governments. Investors would start to fear EU/euro break-up. Financial conditions will tighten sharply especially in Europe's periphery and banks. Furthermore, the period of uncertainty will be prolonged leading to corporate retrenchment.

The UK would see a deep recession, the eurozone a moderate one, while there would be significant negative effects on the rest of the world economy (see tables below). Deflationary forces would rise given the weakness in the economy, the low starting point for core inflation, and the likely correction in commodity prices.

GDP forecasts in adverse scenario (%, year average)

Economy	Pre-Brexit		Adverse scenario	
	2016	**2017**	**2016**	**2017**
UK	**1.6**	**2.5**	**1.3**	**-1.0**
US	**1.7**	**2.1**	**1.4**	**1.2**
Eurozone	**1.3**	**1.6**	**1.2**	**-0.3**
Germany	1.4	1.7	1.4	0.7
France	1.1	1.5	1.1	0.3
Italy	0.7	1.1	0.3	-1.9
Spain	2.6	2.2	2.6	-0.3
Netherlands	1.7	1.9	1.3	-0.3
Belgium	0.9	1.4	0.6	-1.1
Ireland	4.1	3.0	3.6	-0.5
Greece	-2.2	0.7	-2.6	-2.3
Portugal	1.1	1.4	0.7	-1.6
Emerging Asia	**5.9**	**5.8**	**5.7**	**5.4**
China	6.5	6.0	6.4	5.7

Source: ABN AMRO Group Economics

Bond yields & FX in adverse scenario (%, end of year)

Market	Pre-Brexit		Adverse scenario	
	2016	**2017**	**2016**	**2017**
Germany 10y	0.2	0.7	-0.5	-0.4
US 10y	2.0	2.5	0.9	0.9
UK 10y	1.4	2.2	0.2	-0.1
Spain 10y spread	1.4	1.3	3.00	2.25
Italy 10y spread	1.3	1.3	3.00	2.25
EUR/USD	1.15	1.15	1.00	1.00
GBP/USD	1.48	1.56	1.20	1.20
EUR/GBP	0.78	0.74	0.83	0.83
USD/JPY	110	105	90	95

Source: ABN AMRO Group Economics

The authorities would take more aggressive measures to stabilise the situation. There would be aggressive QE across all the major economies and large fiscal stimulus. Treasury and Bund yields would fall sharply and peripheral spreads would surge. The ECB would employ the OMT, in order to target asset purchases on vulnerable countries in the periphery. This would calm the situation down somewhat, but spreads would remain elevated as investors would continue to worry about Europe's fundamental problems. In this scenario, the euro would fall below parity against the dollar early in 2017, reflecting European risks, as well as safe haven flows into the dollar.

Positive scenario

Although the risks to our base case are skewed to the downside, it is also possible to sketch a more positive scenario. For instance, the corporate caution that we expect to see may not materialise. It could be the case that companies continue to move forward with their plans despite the uncertainty. The outlook for the economy, bond yields and currencies would then look more like our original pre-Brexit scenario. Another – albeit rather remote – possibility is that the Brexit does not actually happen. For instance, if there is a new referendum, following a re-negotiation with Europe. We do not think this is very likely at all, as all the political parties are committed to implementing the result of the referendum, while other EU countries also want to move forward and negotiate the exit.

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