Bank of Melbourne

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'Brexit': What Now?

In this note we examine the potential impact of 'Brexit' on Australian and global interest rates and on the Australian dollar. Below we look at the facts and consider the, as yet, unknowns.

The Facts So Far:

- The UK voted to leave the European Union following a referendum held on Thursday (UK time). The 'Leave' vote was 17.4 million or 51.9% of votes while the 'Remain' vote was 16.1 million or 48.1% of the votes cast.
- The result had a significant impact on financial markets. The result was not expected by markets which had been trading with a 'risk-on' sentiment prior to the results unfolding.
- Following the results, UK Prime Minister David Cameron, who supported remaining in the EU, announced his resignation.
- Markets reacted negatively with the UK pound falling 9% against the USD on Friday and falling 7.7% against the AUD.
- A fresh Scottish independence referendum is possible, after the Scottish government agreed over the weekend to legislate for one (given Scotland voted to remain in the EU in the referendum). There is also the possibility that other European countries hold referendums on EU membership following the UK result.
- On Friday ratings agency Moody's lowered its outlook on the UK to negative, from stable. Moody's currently rates the UK at Aa1. Moody's reaffirmed the EU's top credit rating. Standard & Poor's global sovereign chief ratings officer, Kraemer, had said before the Brexit vote, that a vote to leave would lead to a ratings downgrade for the UK.
- Article 50 of the Lisbon Treaty of 2007, provides the rules for exiting the EU. It allows for a two year period of transition which can be extended if agreed by European leaders. The UK has yet to formally request that Article 50 be invoked.

Questions:

1. Will the EU play 'hard-ball' with the UK in an attempt to dissuade other countries from pushing for a similar referendum in their countries? The UK is a large and lucrative market for European goods. Companies in the EU will still want to trade with the UK.
2. Given that the referendum was non-binding could the invocation of Article 50 be delayed by the votes of Scottish parliamentarians? There are 54 Scottish National Party members in the 650 UK parliament. Members of the major Conservative and Labour parties appear to be split on the 'Brexit' issue.
3. Will the 'Brexit' vote encourage other nations or even regions to press for similar referendums? A coalition of 'nationalists' plus supporters of major parties who feel disenfranchised by EU activity could lead to 'Brexit' style referendums in other EU nations.
4. What roles will the Bank of England (BoE) and the European Central Bank (ECB) play in mitigating any negative impact of the vote? (see below)
5. What impact might 'Brexit' have on the Australian economy? Uncertainty is never helpful for economic activity. The UK is not a major purchaser of Australian goods and services but the EU is a major buyer of Chinese goods. If Europe slows, that could dent Chinese growth which in turn would

see a dampening effect on Chinese demand for Australian good and services.

Impact on the Australian dollar

- The pound sterling had its biggest one-day fall against the US dollar. After hitting a high of US$1.5018 just prior to the referendum result, GBP plunged to a low of $1.3229 before settling at around US$1.34 at the time of writing.
- The uncertainty and risk averse environment in financial markets impacted the AUD negatively. The Australian dollar fell from a high of 76.48 US cents before the referendum result to a low of 73.06 US cents. AUD has since recovered to 74.07 US cents. Against the pound, AUD has risen from a low of 0.5013 early Friday to trade close to 0.5522 this morning.
- While uncertainty prevails, the pound and risk currencies, including the Australian dollar, will likely remain under pressure. However, the risk is that these currencies will rebound once markets gain a better idea of the outlook. A clearer picture of the proposed relationship between the EU and the UK and what new leadership will be in place guiding the negotiations would be positives for sentiment, the GBP and the Australian dollar. A delay in the pace of further rate hikes by the Federal Reserve would be supportive of the GBP and the AUD.
- The prospect of a new Scottish independence referendum and the possibility of monetary policy easing from the Bank of England (BoE) will work in the other direction for GBP and likely keep the currency near historic lows.

Impact on Interest rates

- Government bond yields fell sharply as risk aversion jumped on the UK Brexit vote, driving funds into safe haven government bonds and pushing yields to record lows. Australian 10-year government bond yields fell to a record low of 1.97%, losing 28 basis points from Thursday afternoon's close, but have partially recovered and are trading around 2.03%. Financial market pricing for further RBA interest rate cuts this year increased to one rate cut fully priced in and 68% probability of a further rate cut.
- If financial markets remained volatile and there are follow on effects to global economic growth, the RBA would consider the implications of this in its decision making process. CPI inflation is a key consideration for the RBA's interest rate decisions. There is a high risk that the June quarter CPI inflation is weak, which could lead the RBA to cut interest rates again. We favour the August meeting as a strong possibility for an interest rate cut by the RBA.
- US 10-year government bonds fell from 1.75% to a record intra-day low of 1.40%, before rising to 1.56%. Investors have wound back expectations for a rate hike from the Fed this year and even started to price in a small chance of a rate cut by year end. We had expected two rate hikes from the Fed later this year. It is still a possibility, although one rate hike now seems more likely, with a risk the Fed leaves interest rates unchanged this year.
- Reduced prospects of rate hikes from the Fed, increased likelihood of an RBA rate cut and the possibility of an interest rates cut or further monetary stimulus from the Bank of England and the European Central Bank could weigh further on global bond yields. However, this will be mitigated to some extent if we see a reduction in financial market volatility. This could lead to a reversal in safe haven flows into bonds and put some upward pressure on bond yields.

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