July 01, 2016

Economics Group

WELLS FARGO SECURITIES

Special Commentary

Jay H. Bryson, Global Economist
jay.bryson@wellsfargo.com • (704) 410-3274

U.K. Recession Post-Brexit Referendum?

Executive Summary

Although the United Kingdom will remain a member of the European Union for the foreseeable future, the UK and the EU will need to enter into negotiations to determine the rules that will govern their economic relationship in the future. In our view, uncertainty related to this ultimate relationship will depress investment spending in the UK. Indeed, there already is anecdotal evidence that uncertainty ahead of the June 23 referendum has already contributed to weakness in investment spending. In our view, further contraction in investment will lead to a modest U.K. recession later this year and into early 2017. We believe that the Bank of England will provide further policy accommodation in an effort to combat the downturn in the economy. We also look for the British pound to weaken further vis-à-vis the U.S. dollar in coming quarters.

The direct effects of a U.K. recession on the rest of the world should be limited because the British economy accounts for only 4 percent of global GDP. If the financial market volatility that was observed in the immediate aftermath of the June 23 referendum should return and intensify, then the outlook for other economies could darken. However, financial markets seem to have stabilized, at least for now. Expectations about a potential breakup of the EU could be a catalyst for financial market volatility to return, but we believe that the probability of a shattering of the EU is low, at least in the near term.

Uncertainty Likely Will Weigh on U.K. Investment Spending

We now look for the British economy to experience a modest recession.

The U.K. economy has generally been expanding since it pulled out of recession in Q3-2009, and real GDP currently stands more than 7 percent above its pre-crisis peak. Prior to June 23, we had looked for this expansion to continue through at least the end of 2017. This forecast was predicated on the assumption that British citizens would vote on June 23 to keep the UK a member of the European Union. However, voters decided by a margin of 52 percent to 48 percent to leave the EU (a.k.a., Brexit). Post-referendum, our views of the U.K. economic outlook have changed. In short, we now look for the British economy to experience a modest recession later this year and into 2017.

As we noted in a recent report, the UK will remain a part of the EU for at least the next two years.[1] Until new terms under which trade in goods and services between the UK and the EU are negotiated, British exports to other EU countries, which accounts for nearly 45 percent of total UK exports, will continue to enter those countries on a duty-free basis. So why is the U.K. economy now facing recession? The answer relates to uncertainty.

Although nothing has changed at this point regarding British exports, the terms under which trade between the UK and the EU is ultimately conducted are uncertain at this point and will depend upon the negotiations that will be conducted between the UK and the EU. By leaving the EU, the UK may lose its "passport" status to the other 27 members of the EU (EU-27). That is, businesses can set up centralized operations in the business-friendly environment of the UK and

[1] **See "Brexit – Now What?" (June 24, 2016). Any Wells Fargo report mentioned herein is available upon request.**

then use these operations to export duty-free to other EU countries. If the UK were to lose this passport status, then some businesses may want to move operations to another EU country where the passport was still valid. Although it is impossible to know the ultimate outcome of the negotiations between the UK and the EU, the point is that many businesses may put their expansion plans in the UK on hold until the uncertainty is cleared up.

The financial services industry is a notable sector which now faces uncertainty. London is the financial capital of Europe due, at least in part, to the passport that allows British firms to provide financial services to EU-27 countries. Uncertainty over the status of the passport likely will lead investment by financial services firms in London to come to a screeching halt. Some firms may even opt to move some of their operations to the continent. Hiring and non-residential investment in London likely will weaken in coming quarters.

Residential investment likely will take a hit as well. There are about 2 million workers of EU-27 origin who are employed in the UK. Everything else equal, the outcome of the Brexit referendum dampened their enthusiasm to invest in real estate because their legal status to remain employed in the UK in the long term is now uncertain, pending negotiations.

Investment spending in the UK likely will contract further in coming quarters.

In sum, investment spending in the UK, which already had decelerated ahead of the referendum, likely will contract further in coming quarters (Figure 1). Indeed, there is anecdotal evidence that uncertainty ahead of the referendum has played a role in weakening investment growth to date. In its statement following the policy meeting on June 16 the Monetary Policy Committee (MPC) noted that "there is growing evidence that uncertainty about the referendum is leading to delays to major economic decisions that are costly to reverse, including commercial and residential real estate transactions, car purchases, and business investment."

As investment spending weakens further, employment growth should slow and may ultimately turn negative, which will weigh on personal consumption expenditures. We look for the U.K. economy to experience a modest recession later this year/early in 2017 (Figure 2). We now expect that real GDP in Q4-2017 will be about 2-½ percent lower relative to the forecast we made about a month ago, which had looked for the economy to continue to expand through the end of next year.

Figure 1

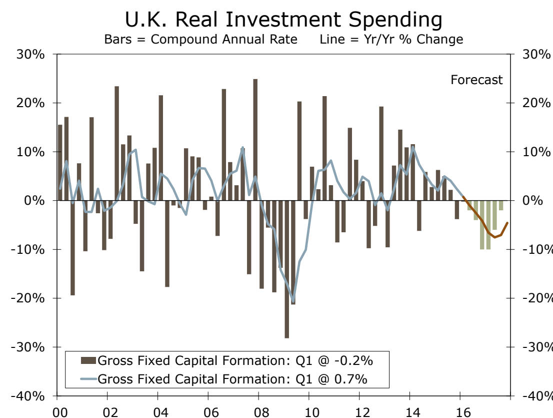
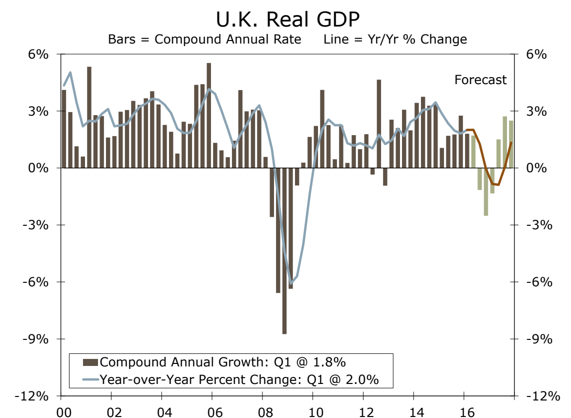


Figure 2



Source: IHS Global Insight and Wells Fargo Securities

Further Monetary Accommodation Seems Likely

The Bank of England (BoE) has maintained "Bank Rate," its main policy rate at 0.50 percent since March 2009 (Figure 3). If, as we expect, the British economy is headed for a modest recession, then the BoE likely will cut further. Indeed, BoE Governor Carney said in a speech on June 30 that "some monetary policy easing will likely be required over the summer." Accordingly, we look for the MPC to cut Bank Rate to 0.00 percent by late summer/early autumn.

The BoE has also engaged in unconventional monetary policy via its asset purchase program. That is, like the Federal Reserve, the BoE has a quantitative easing (QE) program in place. Specifically, the MPC increased the size of its QE program in a number of steps from its initial £75 billion in March 2009 to £375 billion in July 2012, where it has been subsequently maintained (Figure 4). In our view, it is likely that the MPC will increase the size of its QE program this autumn.

Sterling likely will weaken further against the dollar.

In the immediate aftermath of the Brexit vote the British pound nosedived to its lowest level vis-à-vis the U.S. dollar since September 1985. According to our currency strategy team, further sterling weakness seems likely in coming quarters. We look for the Federal Reserve to lift its target range for the fed funds rate by 25 bps by the end of the year and by 50 bps in 2017. Further policy accommodation by the BoE in conjunction with policy tightening by the Fed, albeit at a slow pace, should weigh on the value of sterling versus the greenback.

Figure 3

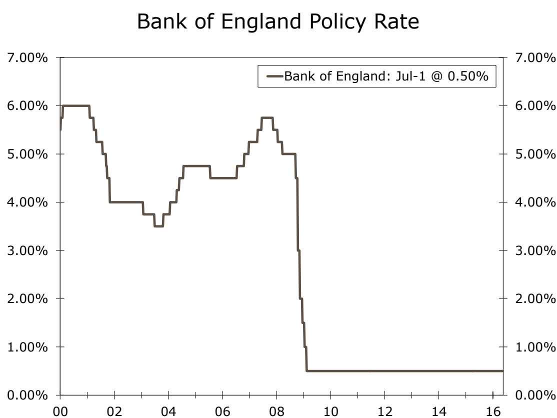
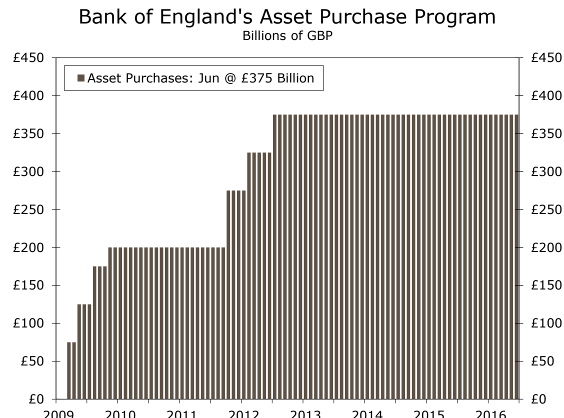


Figure 4



Source: Bloomberg LP and Wells Fargo Securities

Will the UK Take Down Other Countries?

The direct effects of a U.K. recession on the rest of the world should be limited.

What implications does a modest recession in the UK have for the rest of the world? Ireland, which sends 15 percent of its exports to its neighbor across the Irish Sea, could experience a significant amount of economic fallout from a recession in the UK. That said, the direct effects of economic weakness in the UK should be rather limited for the rest of the world as the British economy accounts for only 4 percent of global GDP. The UK takes in 7 percent of the exports of the EU-27 and it accounts for only 4 percent of American exports. A modest downturn in the UK should not directly lead to recessions in most other economies.[2]

The indirect effects of the Brexit referendum could potentially have more important global implications. Financial markets fell sharply in the first two trading days after the referendum, although they have stabilized and rebounded in recent days. If financial market tightness related to Brexit should return and remain persistent, however, then the outlook for other economies could darken. So what could cause tightness in financial markets to return? There obviously are a number of potential catalysts, but expectations that other European countries could follow the UK out of the EU could clearly cause financial market volatility to return.

However, the potential exit of other countries from the EU does not appear to be imminent. For starters, there are no EU referenda scheduled in other countries at this time. Although there are anti-EU political parties in most European countries, these parties would not be able to pass legislation removing their respective countries from the EU at this point because they are not in the majority. But there are some important elections coming up in the next year or so, and continued EU membership could be an important issue in some of these elections.[3] If anti-EU

[2] **For further reading see "How Would EU Countries Be Affected by Brexit?" (April 14, 2016).**

[3] **France, Germany and the Netherlands all hold national elections in 2017.**

parties come to power, then the possibility of other countries withdrawing from the EU in the next year or two would become more realistic. As noted above, however, a shattering of the EU in the near terms does not appear to be imminent.

Conclusion

In our view, uncertainty related to the economic relationship that the UK will have with the EU future will cause investment spending, which has already weakened, to contract in coming quarters. Employment in the affected sectors likely will weaken, which will weigh on consumer spending. The result should be a modest recession in the UK.

The direct effects of a U.K. recession on the rest of the world should be limited because the British economy accounts for only 4 percent of global GDP. There are also indirect effects to consider as well. That is, if the financial market volatility that was observed in the immediate aftermath of the June 23 referendum should return and intensify, then the outlook for other economies could darken. Expectations about a potential breakup of the EU could also be a catalyst for financial market volatility. To paraphrase Mark Twain, however, we think that expectations of the imminent death of the EU are greatly exaggerated. In sum, we look for a modest recession in the UK, but we expect that the global economy will continue to expand, albeit at a sluggish pace.

Wells Fargo Securities Economics Group

Name	Title	Phone	Email
Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Anika R. Khan	Senior Economist	(704) 410-3271	anika.khan@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Jamie Feik	Economist	(704) 410-3291	jamie.feik@wellsfargo.com
Erik Nelson	Currency Analyst	(212) 214-5652	erik.f.nelson@wellsfargo.com
Misa Batcheller	Economic Analyst	(704) 410-3060	misa.n.batcheller@wellsfargo.com
Michael Pugliese	Economic Analyst	(704) 410-3156	michael.d.pugliese@wellsfargo.com
Julianne Causey	Economic Analyst	(704) 410-3281	julianne.causey@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

Wells Fargo Securities Economics Group publications are produced by Wells Fargo Securities, LLC, a U.S. broker-dealer registered with the U.S. Securities and Exchange Commission, the Financial Industry Regulatory Authority, and the Securities Investor Protection Corp. Wells Fargo Securities, LLC, distributes these publications directly and through subsidiaries including, but not limited to, Wells Fargo & Company, Wells Fargo Bank N.A., Wells Fargo Advisors, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Asia Limited and Wells Fargo Securities (Japan) Co. Limited. Wells Fargo Securities, LLC. is registered with the Commodities Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. Wells Fargo Bank, N.A. is registered with the Commodities Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC. and Wells Fargo Bank, N.A. are generally engaged in the trading of futures and derivative products, any of which may be discussed within this publication. Wells Fargo Securities, LLC does not compensate its research analysts based on specific investment banking transactions. Wells Fargo Securities, LLC's research analysts receive compensation that is based upon and impacted by the overall profitability and revenue of the firm which includes, but is not limited to investment banking revenue. The information and opinions herein are for general information use only. Wells Fargo Securities, LLC does not guarantee their accuracy or completeness, nor does Wells Fargo Securities, LLC assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Such information and opinions are subject to change without notice, are for general information only and are not intended as an offer or solicitation with respect to the purchase or sales of any security or as personalized investment advice. Wells Fargo Securities, LLC is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company © 2016 Wells Fargo Securities, LLC.

Important Information for Non-U.S. Recipients

For recipients in the EEA, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority. The content of this report has been approved by WFSIL a regulated person under the Act. For purposes of the U.K. Financial Conduct Authority's rules, this report constitutes impartial investment research. WFSIL does not deal with retail clients as defined in the Markets in Financial Instruments Directive 2007. The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. This report is not intended for, and should not be relied upon by, retail clients. This document and any other materials accompanying this document (collectively, the "Materials") are provided for general informational purposes only.

SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE

WELLS FARGO SECURITIES