As global capital markets continue to digest Great Britain’s decision to leave the European Union, State Street Global Advisors Chief Investment Officer Rick Lacaille discusses the broader economic impact, what to look for in the coming weeks and what investors should be considering.

What will be the economic impact?
Those who dubbed the “Remain” campaign “Project Fear” are about to find out if those fears were justified. While the full economic impacts of Brexit have not yet been quantified, the vote has compounded the weakness and lower-for-longer returns we saw before the referendum and is likely to have a deflationary effect on both the UK and eurozone economies.

Our economic models show that the Brexit decision could reduce UK growth by 1.5% over the next 18 months (assuming that the fallout on private-sector spending is partially mitigated by the Bank of England cutting the Bank Rate to zero). Eurozone growth also suffers, but not nearly as severely as the UK, while US and global growth both edge down 0.1 percentage point next year.

Big questions remain around:
- What kinds of trade deals will the UK be able to negotiate outside the EU?
- How long will it take to negotiate them?
- To what extent will a delay adversely affect business and consumer confidence?

Central banks in the UK and Europe will be ensuring there is enough liquidity in the system, but they are running out of effective monetary tools. The European Central Bank’s asset purchase program will continue to try to push cash into the system, but the adverse impact of negative interest rates and very flat yield curves on insurers and banks in Europe have become increasingly evident.

The rational response would be to use fiscal tools, even if that is unthinkable in many parts of Europe. We need to have a counterbalancing fiscal stimulus from those countries that are strong enough to deliver it, which the markets would perceive as a very positive signal.

In the US, the Fed is likely to keep their rates on hold for longer now, amid patchy US data and ongoing uncertainties around China and other regions of the world.

What to expect in coming weeks?
Politically, we are at a delicate point, with potential knock-on consequences for the remaining members of the EU and elections scheduled for Germany and France next year. Spanish elections on Sunday provided a glimmer of good news as acting Prime Minister Mariano Rajoy’s center-right People’s Party was able to fend off more extremist candidates. Still, large questions hover over Scotland’s resolve to remain in the United Kingdom as well as over Northern Ireland, whose voters, like those in Scotland, overwhelmingly voted to remain within the EU.

In coming weeks three poles of influence will be opposing each other, determining how quickly we get clarity on the future:
- The pan-European camp of German Chancellor Angela Merkel and French President Francois Hollande and the European Union leadership itself, who want to resolve the UK’s departure relatively quickly and prevent other member countries from departing.
- EU member countries with electorates keen on holding their own referenda on whether to leave or remain.
- Business leaders, especially in countries like Germany, who have a strong incentive to reduce uncertainty and will not necessarily want a tough stance from the EU leadership when it comes to trade.

If Britain’s Tory leadership candidates announced that access to the single market was compelling enough for them to make compromises on the original Brexit promises to limit the free movement of people from the rest of the European Union, that could strongly reverse financial market sentiment.
Brexit Surprise Raises More Questions than Answers

WHAT SHOULD INVESTORS CONSIDER?

Amid this volatility and uncertainty, the question is whether investors are being rewarded for heightened risk. Given the degree of uncertainty, buying on the dips might not be justified until we have more information:

- Start bracketing outcomes by trying to envisage how bad new trade deals could be for German and British industry and understanding what the downside looks like. As earnings revisions move to that downside, the risk premium may start to decline.
- Review portfolio defenses in terms of volatility management strategies and allocations to assets such as gold and government bonds and defensive equity sectors; diversification is more important than ever.
- As volatility continues and spreads widen, some selective spread sectors, such as high yield and emerging market debt, might become more attractive.