Northern Trust

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Reaction to the Brexit Vote:

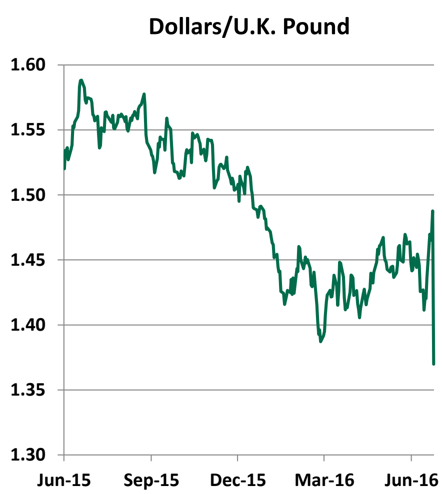
- **The Great Unraveling Begins; How Far Will It Go?**
- **After the Initial Shock, Markets Will Settle**
- **Central Banks Are Back on the Defensive**

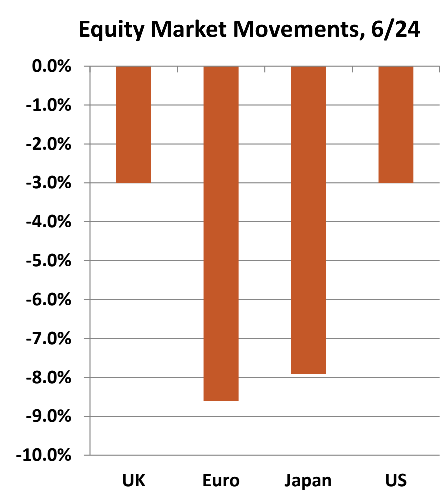
More than 2,000 years ago, the Greek general Pyrrhus fought fiercely to keep the Roman Empire from subsuming his country. While largely successful in preserving sovereignty, he suffered heavy casualties in his campaigns. The phrase "Pyrrhic victory" has been used ever since to describe triumphs tempered by heavy losses.

Some have described the Roman Empire as the first true European Union. Its modern-day successor now faces an existential challenge in the wake of The United Kingdom's vote to take back some of its sovereignty. The "Leave" campaign has prevailed, but theirs may truly be a Pyrrhic victory.

It's very soon after the voting, and much is still unknown. But here are some early reads on the meaning of the outcome.

- Details of departure will take some time to develop, but uncertainty over the design and timing of separation is with us now. European companies were already hesitating to invest and hire prior to the vote, and this conservative mantle is likely to become even more pronounced in the months ahead. The growth trajectory on both sides of the English Channel will have to be revised downward.
- Risk aversion had risen in the weeks prior to the balloting and reached extreme levels as the verdict became apparent. Equity markets corrected sharply; interest rates in developed markets hit new lows. The pound fell to a 30-year low against the U.S. dollar.





Source: Bloomberg

These initial corrections are, without doubt, somewhat extreme. It may be some time before we reach an adjusted equilibrium. But it seems likely that European currencies will remain under pressure as long as the contours of the economies underlying them are undefined.

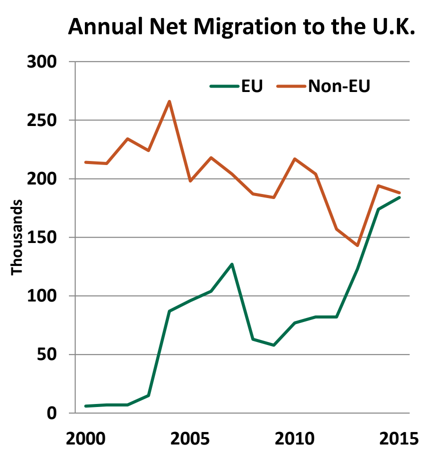
Interestingly, this will help both Bank of England (BoE) Governor Mark Carney and European Central Bank (ECB) President Mario Draghi in their efforts to reach their inflation targets. A weak euro and a weak pound may also assist the terms of trade for Europe. But Brexit certainly has the potential to increase the friction of transacting with and within the United Kingdom and the EU, offsetting any benefit from a cheap currency.

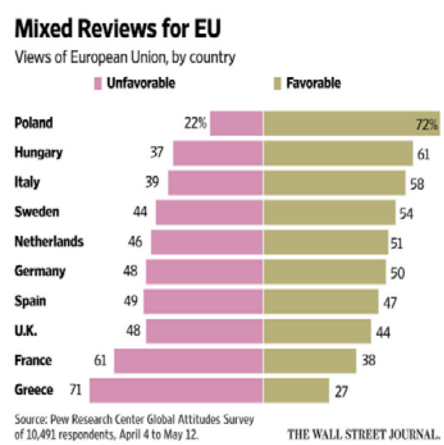
- Redefining Britain's relationship with the EU and other trading partners will be a challenging process. Prime Minister David Cameron has resigned, indicating that his successor will be the one to trigger the clause in the EU treaty that begins separation negotiations. That will likely occur this coming October. Britain has no trade negotiators, as Brussels has handled such talks on behalf of the whole EU. Many analysts think it could take two years before Britain's relationship with the rest of Europe is formally redefined.

Negotiations for exit could take two years or more.

There are those who think the EU will seek to be very punitive in the discussions, to send a lesson to others who might be tempted to leave. But it is in the two parties' mutual interest to find some common ground, as each benefits greatly from association with the other. The terms of the discussion, especially around migration, will be closely watched by other EU countries that might like to exert a little more control over their own borders.

Immigration was certainly a factor in today's outcome. Urgency around the issue increased in the last year because of Europe's new arrivals from the Middle East and North Africa. But a considerable number of non-natives come to the United Kingdom from other EU countries and from former members of the British Empire. Fluid labor markets were among the EU's goals, so that workers could go where business was best. EU citizens now in Britain face something of an uncertain future.





Sources: ONS, Pew Center, Wall Street Journal

- Immense speculation has swirled about the potential for additional separations since the outcome became clear. Scotland greatly values its EU membership and might be willing to split from the rest of the United Kingdom to sustain it. Populist groups on the continent – from the National Front in France, the Alternative for Deutschland and the Party for Freedom in Holland – have all called for similar referenda in their countries. There has even been some talk about an Irish reunification in the wake of Northern Ireland's overwhelming support for remaining in the EU.

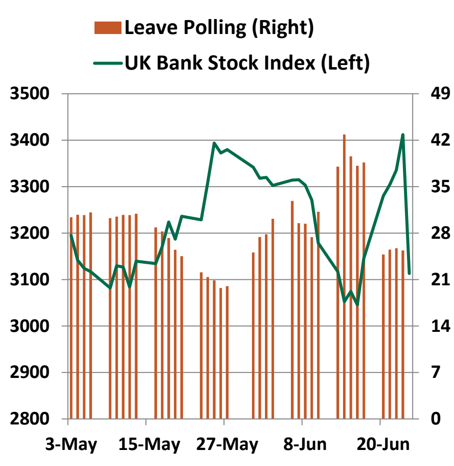
  Perspective is called for here. There is strong sentiment in the core of Europe for the European project, and the consequences of separating might be more severe for members of the currency union (which the United Kingdom never joined). The cultural and economic complications of reuniting the two halves of Ireland are too many to enumerate here. But the mere fact that these possibilities are being mentioned will not help confidence within the economy or the financial markets.

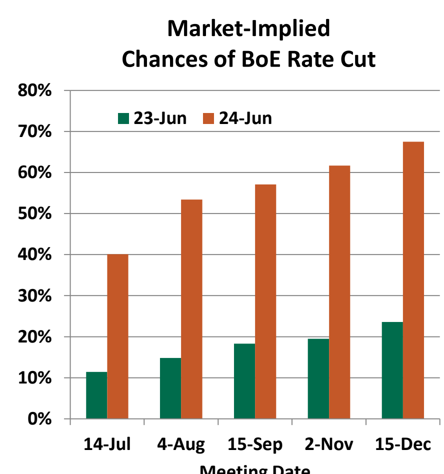
Predictions of mass EU defections are greatly exaggerated.

  The Scottish question is perhaps more interesting; an independence referendum failed there two years ago, partly the result of economic concerns. (Their continued use of the pound was a point of contention then and still is.) But the Brexit vote clearly demonstrates that most voters are not performing cold financial calculus.

  Yesterday's outcome is a clear rebuke to the bureaucrats in Brussels. They did a poor job of highlighting the benefits of association and consequently are blamed for some of the economic dislocations that occurred in the past few years.

- U.K. bank shares did poorly in the initial hours after the decision became apparent. Ratings agencies placed several on negative watch. Their fortunes were viewed as closely tied to the referendum outcome; London's primacy as Europe's financial capital is now at risk.





Source: Bloomberg

BoE Governor Carney made a reassuring statement early this morning, noting that "The Bank (of England) will not hesitate to take additional measures as required as markets adjust and

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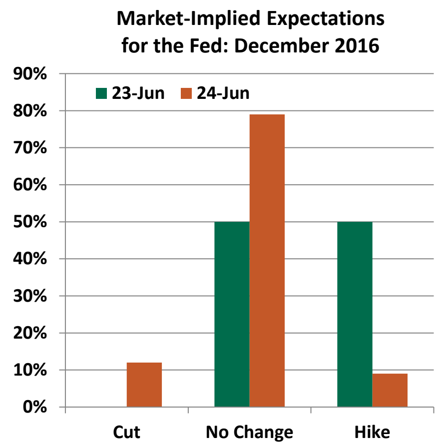
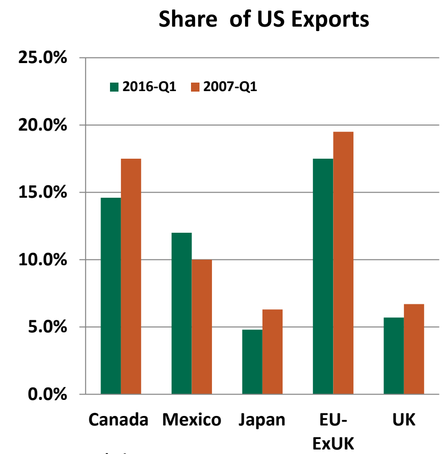
the UK economy moves forward." In the market's mind, chances of a BoE rate cut rose dramatically in the last 24 hours. Hopefully, such a step will not be necessary.

Carney also highlighted the significant increase in capital levels at the large firms and the stress testing the BoE did on scenarios more severe than the one now at hand. In addition, he highlighted that the Bank stood ready to provide liquidity as a backstop if needed; no draws yet, but there is value in the availability, nonetheless.

Whenever trouble has arisen over the past eight years, some have automatically assumed that 2008 was recurring. But greater capital reserves and heightened oversight significantly reduce the likelihood of contagion proceeding through the banks.

- The chances of an interest rate hike from the Federal Reserve this year have greatly diminished. Markets have actually begun to allow for the possibility of a cut sometime in the next six months.





Sources: Bloomberg, Haver Analytics

Global monetary policy will have to stay easier for longer.

Interestingly, the poor May U.S. jobs report may have saved the Fed from making a decision that would have proven unfortunate. Had payrolls grown powerfully, there would have been strong support for taking the next step toward normalizing monetary policy at the June Federal Open Market Committee (FOMC) meeting, even with the Brexit vote looming.

Today's outcome creates uncertainty for the outlook and for the financial markets. The strengthening dollar will reduce imported inflation and inhibit U.S. exports. There could be adverse wealth effects if equity markets lose ground.

As mentioned earlier, the uncertainty surrounding the re-formed European Union could last for quite some time. Would the Fed stay on hold for two years awaiting the outcome of negotiations? Not likely. But U.S. monetary policy has become increasingly sensitive to events outside the country, and Brexit will serve to justify the FOMC's cautious nature.

- There are some broad themes that emerged from the Brexit campaign that may carry over to other markets.

The disparity between those who have done well and those who have done poorly since 2008 has grown dramatically, and those on the wrong side of that equation are angry. The disaffected have focused their antipathy on trade, immigration, austerity and government.

Those who live and work in cities among communities of the highly educated find it easy to dismiss these passions as irrational, but that doesn't make them less real. Confronted with a complicated issue, people will often boil it down to a simple essence and react viscerally. Supporters of immigration can offer reams of data on its benefits, but it does little to allay the concerns of those who feel threatened by outsiders.

Will there be contagion through the ballot box?

Candidates in other countries who fail to appreciate this sentiment could fall victim to it. In retrospect, Cameron made two critical miscalculations: offering the referendum in the first place (as it turned out, he needn't have made the promise to win re-election), and then expecting that policy-making by plebiscite would follow a rational process. It is not always better to move decision-making from the legislature to the ballot box.

Next on the election docket is the second-try vote in Spain this Sunday. But of more-major import is the balloting that will take place over the next 18 months in the United States, Holland, France and Germany.

The Brexit outcome was shocking but not surprising. Polling over the past several weeks consistently showed a close contest, with "Leave" often in the lead. Some comforted themselves with the standing of betting markets, which showed a much bigger plurality for "Remain." I sense that the wagering parlors did very well, indeed, yesterday.

Unfortunately, it was not a good day for world markets. The global economic network will not unravel as a result of today's decision; the benefits of free trade and capital markets are too significant. But there may be some cracks opening in the system. As they would say in the United Kingdom, we'll have to mind the gaps.