June 29, 2016 | Andrew J. Nelson, Chief U.S. Economist

SPECIAL ISSUE: Brexit Wounds – Painful but not Fatal

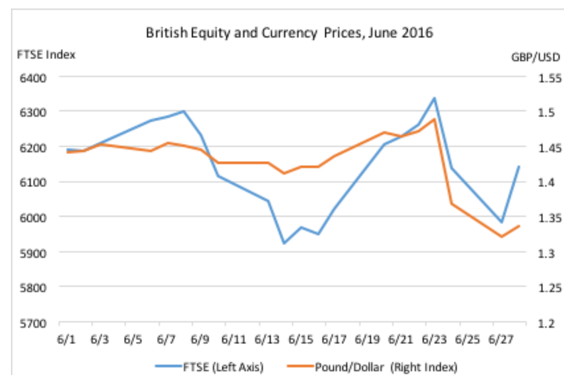
As by now thoroughly reported in the global financial press, British citizens voted last week to "exit" the EU. The political significance of Brexit vote will likely be profound, but the economic consequences are far less certain. My colleagues in the U.K. issued a statement on Friday highlighting the uncertainties for the U.K. at this early date. My goal here is to present my own views and insights, focusing on potential impacts on the U.S. economy and property markets.

Beyond the immediate hit to financial markets, the direct impacts on the actual economy should be limited, even in the U.K., but especially for the U.S. The greater danger lies in the intermediate term as the 70-year consensus over the benefits of trade liberalization may be unraveling, to the detriment of global trade and ultimately economic growth, if this vote serves as a harbinger of worldwide shifts to isolationism and protectionism.

For the U.S. property markets, the most likely outcomes include the following:

- Another Fed hike is now off the table for this summer and maybe for the rest of the year, but any hikes this fall will be "data dependent," as the Fed waits for signs of renewed job growth and inflation while gauging potential financial market contagion related to Brexit.
- The U.S. dollar should strengthen, which may well hit U.S. exports and manufacturing, but should prove positive for U.S. property asset values once the immediate investor anxieties fade.
- Overall property transaction volumes – already down significantly from 2015 – can be expected to ease further in the second half of the year, though still remain at healthy levels relative to historical averages. However, U.S. property markets could benefit from potential capital flight out of Britain and Europe generally.

The Immediate Impacts



The reaction in the financial markets was predictably swift and severe, as currency and equity traders were collectively caught so wrong-footed. The pound dropped almost 9% relative to the dollar to a 30-year low in the first day of trading after the vote. [For perspective, daily rates rarely move by more than ½%.] Similarly, equity markets were also hammered on Friday and again on Monday, in part because prices had been pushing upward as the "smart" institutional money became convinced that Britain would reject the exit vote. But markets stabilized by Tuesday and started to regain ground. Despite this sell-off, the FTSE (Britain's key equity index) is higher now than 10 days ago. Meanwhile, investors piled into the safety of low-risk instruments, as the 10-year U.S. Treasury yield fell below 1.50%, the lowest level since 2012.

Of greater consequence, S&P stripped Britain of its coveted AAA bond rating, citing an unstable future. But at this early date, no one can state with much certainly how this will play out. There just is no precedent. Since trade liberalization began to spread after WWII, no country has ever left the EU, going back to its predecessor organizations formed in the 1950s. Indeed, I believe that no country in modern times has ever left a major trade alignment, except to go to a better one. Thus, we are very much in uncharted territory here.

I'll defer to my colleagues in the U.K. to outline the likely consequences for Britain, though most economists believe that the U.K. economy will take a hit. But I will at least point out here that Britain's exit from the EU will not be immediate. Under the EU's Lisbon Treaty Article 50, member countries face a two-year waiting period to exit, and the clock won't even start ticking for several months until Britain satisfies certain requirements. Of course, investors face no such waiting period and we can expect some capital flight from the U.K. to start almost immediately. Some analysts fear that London's ranking as a global financial center could be threatened, possibly to the benefit of Wall Street and Frankfurt, but any such moves will take years to play out.

Implications for the U.S. Economy and Property Markets

Regardless of any downturn in the U.K., the direct economic impact of any on the U.S. are likely to be more limited and gradual, though the near-term risks of economic slowdown have certainly elevated. The U.S. is a largely self-sufficient economy, with exports accounting for only 13.4% of our GDP. Though our 5th largest trading partner, the U.K. accounts for only 2.7% of our exports (or just 0.3% of our GDP). And it's not as if this offshore demand will simply disappear; at most it will slump. Still, economic growth in the U.S. has been weak this year already, and there is no doubt that our economy grows faster when we have stronger trading partners and more confident investors and businesses. All seem at greater risk now than last week.

By most any reasonable expectations, the near-term impacts on the U.S. economy should be minimal, and potentially even positive, as the Fed is now certain not to raise rates this summer, no matter how strong the economic indicators. The likelihood of a hike this fall will depend on evidence of financial market contagion related to Brexit and the strength of U.S. labor markets and inflation. I think at least one more hike this year is still likely, absent major economic shifts.

Longer-term impacts will depend on how deeply the anti-globalization sentiment takes root. Free trade is the "global warming" of economics – settled orthodoxy except among politicians and extreme nativists. The near consensus is that trade liberalization after WWII has fueled economic growth globally, raised incomes, and reduced geo-political conflicts. U.S. companies and consumers have benefited richly from these trends, though sometimes at the expense of (some) U.S. workers and firms. All of this could be at risk with greater isolationism and protectionism. But any such forecasts now are obviously premature.

In the meantime, the U.S. economy is continuing to strengthen. And our economy wasn't as bad this winter as first estimated, with 1Q16 GDP revised upward for a second time to 1.1% -- not robust, but much better than the anemic 0.4% initial estimate. And the second quarter is almost certain to greatly outperform recent growth. The latest GDPNow reading from the Atlanta Fed forecasts 2.6% growth. Among other positive signs: consumer confidence surged to an eight-month high in June, on the strength of the improving job market, among other factors. Relatedly, consumer spending is anticipated to grow by an annualized rate of near 3% in 2Q16. However, it should be noted that these readings all preceded the Brexit vote, though I don't anticipate a material change as a result.

Meanwhile, property market fundamentals continue to improve as well, and the fallout from Brexit should do little to alter tenant demand. The impact on property transactions will be a bit more uncertain. Transactions already are down from their record-tying levels reached in 2015 though remain strong overall, and the Brexit volatility could well heighten investor caution. But the strong dollar, low interest rates, and strong property fundamentals – and ultimately compelling returns – should maintain investor interest and support asset values in 2016 and into 2017.

MORE BREXIT INSIGHTS FROM RECENT PUBLICATIONS

Many, many articles and commentaries on Brexit have been published in the last week. A small sampling:

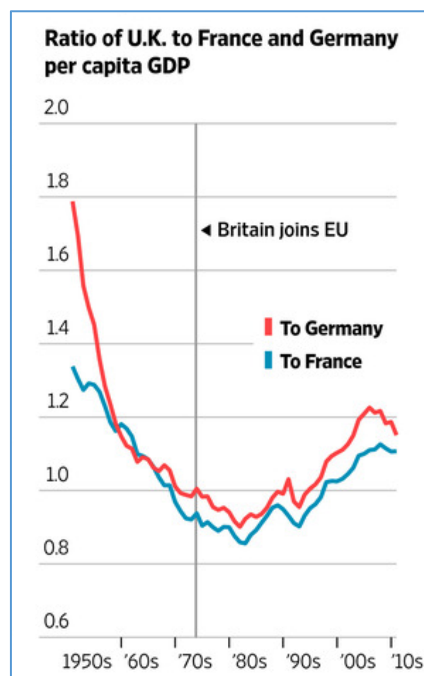
Brexit: The American View (PERE News) "U.S. real estate executives are cautioning against short-term reactions to Brexit, Britain's Thursday vote to leave the European Union. While Europe must contend with a host of short and long-term unknowns, conversations suggest that the private U.S. real estate market is preparing for some changes – not all of them negative – as a result of last week's decision."

'Brexit' Expected to Rattle U.S. Economy, Shake Its Influence (WSJ) "The United Kingdom's exit from the European Union is expected to jolt the U.S. economy, rattling restive markets and driving up the value of the dollar. It could also weaken U.S. diplomatic leverage in Europe and upend the corporate strategies of U.S. companies based in London. . . [T]he damage from the so-called Brexit alone isn't likely to be enough to nudge the U.S. into a contraction. But as skittish investors pull out of U.K. and European markets and pour into the safety of U.S. assets, a falling pound and euro could cause the dollar to surge, further suppressing demand for American exports."

How 'Brexit' Will Affect the Global Economy, Now and Later (The New York Times) A concise, non-technical overview of short-, medium- and long-term implications.

CHART OF THE WEEK

"The British economy was declining relative to France's and Germany's until it joined the EU in 1973. Margaret Thatcher became prime minister in 1979 and began loosening the state's grip on the economy. Since then, Britain's per capita income has grown as fast, or faster, than France's and Germany's."



Source: Angus Maddison Project via The Wall Street Journal