

UK VOTE: OUT OF EUROPE

June 24, 2016

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- ▶ The UK vote to leave the European Union (EU) sets in motion a long period of political, economic and market uncertainty for the UK and EU.
- ▶ We see sell-offs in global risk assets creating buying opportunities.
- ▶ The vote does not change BlackRock's management of client assets in Europe. We do not foresee any disruption to how we manage portfolios.

The UK's momentous decision to leave the EU brings long-lasting political and economic consequences. We expect European leaders to focus on fending off domestic populist movements emboldened by the British exit and on preventing the entire EU edifice from falling apart. This points to a tough negotiating stance toward the UK and less focus on much-needed structural reforms. We expect attitudes on immigration to harden, and see the risk of a protracted standoff feeding uncertainty.

David Cameron has announced he will resign as UK prime minister by October, setting the stage for a Conservative leadership election this summer. This race will likely be dominated by Leave supporters, increasing uncertainty and the risk of emotive exit negotiations. We see a Scottish independence vote as back on the table.

We expect the UK divorce to be messy, drawn out and costly. It involves unpacking UK and EU laws, and striking trade deals with a spurned EU and the rest of the world. We expect potential losses in services exports and investment flows to overwhelm any benefits of lower payments to EU.

We see a weaker euro over time and pressure on European shares, credit and peripheral bonds such as Italian government debt due to likely European job losses and lower growth. We expect limited pressure on government budgets, however, as high-quality government bonds are in demand in a low-rate world.

The Bank of England's first priority will be to provide ample liquidity to avoid any funding stresses, in our view. The magnitude and volatility of the British pound's fall will likely dictate further responses. We expect the central bank to cut its 0.5% policy interest rate to zero soon, and see it returning to quantitative easing rather than pushing rates into negative territory. We expect credit rating agencies to quickly adopt negative outlooks for UK government bonds, with downgrades to follow.

We see the vote leading to declines in global shares and other risk assets. Yet indiscriminate selling could translate into opportunities. U.S. and Asia markets are only marginally affected by the UK's exit from the EU, and are supported by a mix of easy monetary policy and economic growth. In the UK, we expect the large-cap FTSE 100 Index to outperform the more domestically focused FTSE 250 Index. A UK currency drop benefits large companies with overseas earnings, whereas domestic sectors such as homebuilders, retail and financials look vulnerable.

Commercial property values could fall around 10% over the next year, led by declines in oversupplied central London, we believe. We expect sharply reduced tenant demand and a shift toward shorter lease terms. Overseas investors are set to demand a larger risk premium, or more compensation, for holding UK assets. We see little risk of debt-forced sell-offs, however, as developer financing is mostly long term.

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