OBSERVATION

TD Economics

June 24, 2016

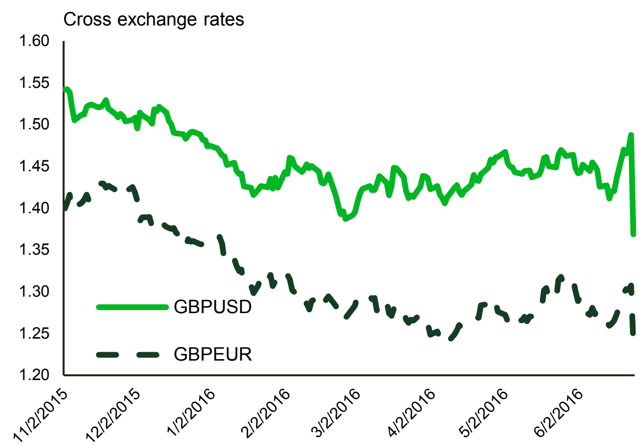
AND NOW FOR SOMETHING COMPLETELY DIFFERENT: UK VOTES TO LEAVE THE EU

Highlights of the EU Referendum Results:

- The UK voted 51.9% in favour to leave the EU, with 72.2% voter turnout.
- Scotland and Northern Ireland voted strongly in favour of remaining as part of the EU (62% and 55.8% respectively). England and Wales voted to leave by a relatively narrow margin. Voter turnout in these four nations was strongest in England (73%), followed by Wales at 71.7%; both Scotland and Northern Ireland saw voter turnout below 70%, lower than the 84.6% during the 2014 Scottish referendum.
- The GBPUSD at one point plunged by more than 10% relative to the previous day's UK close, but has since recovered and is holding near 1.38 (-8.5%).
- The risks to the global economic outlook are squarely to the downside. With the UK's economy weighing in at only 2.4% of world real GDP, the primary channel for transmission stems from the intensification of market volatility and deterioration in business confidence in a global economy that sits on a thin foundation.
- There is little doubt that UK economic momentum will be revised down: some will mark estimates into recession territory, and others, like ourself, anticipate growth at roughly half the previous pace.
- In terms of the U.S. and Canada, trade linkages with the UK are small (5% and 3%, respectively). This is not the main driver or concern. Under a straight forward model simulation, financial and confidence spillovers could shave real GDP estimates by 0.5 percentage point or more in the second half of this year. It is early days. Central bank and government responses to quell market concerns are critical at this stage to the economic projections.

Yesterday UK voters rejected remaining as part of the EU. Given the unprecedented nature of this outcome, there is an extraordinary amount of uncertainty as to what will happen next. Nevertheless, what follows is our best guess of what the Leave result implies for the UK and global economic outlook.

CHART 1: POUND STERLING & EURO ARE BOTH DOWN SHARPLY AGAINST THE U.S. DOLLAR



Source: Bloomberg, TD Economics. Last observation 6:30 a.m. EST June 24 2016.

A new Prime Minister for the UK is certain and will be responsible for turning the referendum result into a formal request to leave the EU

- A parliamentary shuffle is anticipated, as Prime Minister David Cameron and head of the Remain campaign will step down as leader of the Conservative party and be replaced by a leader of the Leave campaign within the next few months, before the Conservative Party Conference in early October. Moreover, while there is no legal pretext for recognition of

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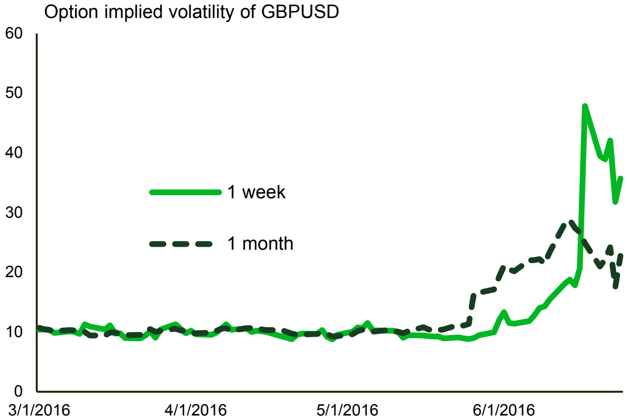
CHART 2: GBPUSD VOLATILITY REMAINS HIGH REFLECTING UK ECONOMIC UNCERTAINTY



Source: Bloomberg, TD Economics. Last observation 6:30 a.m. EST June 24, 2016.

the UK referendum result, the UK will legally remain part of the EU until the government notifies the EU of its desire to withdraw from the union, as per article 50(2) of the Lisbon Treaty. The timeline for this action is uncertain, but possible parliamentary approval and notification of the EU is expected to happen under a new Prime Minister. It's still unclear as to when exactly the UK will cease to be a member of the EU, but Article 50(3) of the Lisbon Treaty places a maximum time limit of two years after notification for a nation to withdraw formally from all EU treaties.

Volatility in financial markets has risen but calm will return

- Global financial markets reacted swiftly and violently before settling down as the Leave result gets priced into asset prices.
  - After plummeting briefly by more than 10% during the referendum count the GBPUSD has since settled at just about 1.38 or 8.5% below yesterday's London close. A further 10% leg down is possible from here, putting the GBPUSD down about 17% from the end of last November. Likewise, there has been a strong knee-jerk sell-off in risk assets, with UK markets leading declines (-5.1%), but the Nikkei and Dax down 7.9% and 6.9% respectively. In turn, money has flowed into safe haven bonds, with the German bunds falling 16 bps to -0.07 while U.S. 10yr government bonds falling almost 30 bps to about 1.5% as global uncertainty builds, likely leaving interest rates lower for longer in advanced economies. Peripheral Europe and emerging market bonds have sold off briskly, confirmation of a flight to safety of global capital. Broadly speaking, financial market moves are likely to be similar in magnitude as those observed earlier this year when fears of a global recession were gripping markets.
  - The risk-off sentiment is also hitting commodity prices, driving WTI crude oil down by 3.6% to $47.60 U.S. per barrel, putting further downward pressure on the Canadian dollar. Given the large amount of foreign exchange rate volatility, the Canadian dollar is highly vulnerable to a leg-down, particularly given its high reliance on external influences and previous lock-step moves to any downgraded expectations to oil prices.
  - Looking beyond today and early next week, we foresee some stability returning to financial markets particularly as investors start to take advantage of buying opportunities, however we expect a prolonged period of market volatility.
  - In addition, the anticipated tightening of global financial conditions similar in magnitude to that observed earlier this year, should force swift reaction

Table 1: Estimates For The Impact Of A Leave Vote On The Level Of UK Output (GDP)

	Short-Run Impact On The Level Of GDP	Long-Run Impact On The Level Of GDP
NIESR (2016)	-2.3%	-1.8% to -7.8%
HM Treasury (2016)*	-3.6% to -6.0%	-3.4% to -9.5% (15 yrs)
OECD (2016)	-3.3%	-2.7% to -7.7% (2030)
IMF (2016)**	-1.5% to -5.6%	-1.5% to -4.5% (2021)
TD Economics (2016)	-2.4%	-5.4% (15 yrs)

Source: TD Economics. Economics. * Short-run estimates assume no change in current state of monetary policy. ** Estimates reflect the limited uncertainty (EEA trade agreement with EU), and an adverse scenario (WTO trade relationship with EU).

CHART 3: CANADA AND U.S. HAVE MATERIAL FINANCIAL EXPOSURE TO THE UK

Source: Source: IMF, BIS, Haver Analytics, TD Economics.
Banking claims are year-end, investment assets as of June 2015. *Euro Area includes: Germany, France, Italy, Spain.

by policymakers to help soothe financial markets. G7 leaders will issue a joint statement later this morning, and the founding six members of the EU will meet tomorrow. We anticipate that any action will likely involve the extension of central bank swap lines to enhance foreign exchange liquidity as well as other measures intended to improve global liquidity in the near term. From the UK's perspective, the Bank of England has announced enhanced liquity provisions and will likely cut its policy rate by 50 bp by its August 4th meeting. Further easing measures, such as an asset purchase program, could possibly be on tap later this year if the domestic growth and inflation outlook continues to deteriorate.

This changes outlook for the UK and global economy

- Undoubtedly, this will have negative implications for the UK Economy. Although it is very early days, under the assumption that a persistence in uncertainty will culminate in reduced business and consumer spending over the two-year negotiating horizon, it could cut in half our current UK real GDP forecast for each year (prior estimates of 2016: 1.9%; 2017: 2.2%), and shave about 2.4% off the level of GDP over the forecast horizon. The long-run growth rate of the UK could also take a hit due to reduced labour input and less business investment. Overall, our estimates are similar to those provided by others for the impact of a leave vote on the level of GDP (Table 1). However, we are ultimately in wait-and-see mode in terms of central bank and political responses that could act to temper these downgrades.
- Looking abroad, we anticipate that the Leave vote will undermine already lackluster momentum in the second half of this year in many economies, leaving global growth next year closer to 3.1% instead of our 3.4% forecast.

Direct spillovers will hit Europe hardest

- The Eurozone will feel the biggest brunt of slower UK growth, as it sends roughly 16% of its total goods exports to the UK.
  - As this is an unprecedented event for the UK and the EU there are likely to be some offsetting impacts. News reports leading into the referendum vote confirm that although the EU will be hit hardest via trade channels, UK domiciled industry may seek to move or extend operations within the union as quickly as possible, boosting EU investment. Similarly, EU firms that have deep ties to the UK could relocate or expand operations into the UK, offsetting the decline in investment due to increased uncertainty. Nevertheless, the rise in business uncertainty would likely delay merger and acquisition activity between UK and EU firms.

The Canadian and U.S. economies are not immune

- Outside of Europe, direct trade spillovers are relatively small: Canada sends about 3% of its annual goods exports to the UK, while the U.S. sends about 5%.
  - The Canadian regions most likely to feel the brunt of reduced UK demand are Newfoundland & Labrador, which ships about 8% of its total annual goods exports to the UK, and Ontario, which sends about 6% of its annual goods exports to the UK.
  - In the U.S., the states who sell more than 5% of their annual goods exports to the UK include New York, California, Texas, Utah, South Carolina, and Washington state.
- Although spillovers via direct trade channels are small, financial and confidence spillovers could exact a larger toll on the Canadian and U.S. economies from the deterioration in stock market wealth and the rise in global economic uncertainty.
  - In addition, the UK is a popular destination for Canadian and U.S. firms investment, with about 9% of total annual Canadian foreign direct investment

(FDI) directed into the UK, and about 11% of total annual U.S. FDI invested in the UK.

- The UK is also a popular destination for portfolio investment for both Canada and the U.S., with about 7% of Canada's total foreign portfolio investment (FPI) flowing into the UK annually, and about 14% of U.S. annual total FPI invested in UK portfolio assets.

- Based on our model simulations, we estimate that confidence and financial spillovers from a leave result could shave about 0.5 to 1.0 percentage point off GDP growth for the U.S. and Canada in the second half of 2016, driven mainly by an expected reduction in business investment growth as a result of a rise in global economic uncertainty.
  - The negative impact on real GDP growth for Canada would be amplified if today's events foreshadow a prolonged slump in commodity price growth and any further drag from slower foreign demand. A more prolonged slump would likely delay any plans by the Bank of Canada to increase its interest rate target.
  - In response to the financial market turmoil, we believe the U.S. Federal Reserve would delay any interest rate increases until financial conditions eased substantially. This dramatically lowers the probability of a hike this year.

Trade negotiations will become the immediate focus of the government

- Once the UK notifies the EU that they plan on leaving, trade negotiations with the EU will commence in earnest. Although the ultimate nature of the type of trade agreement with the EU will depend on the success of negotiations, comments this week by EU member nations reveal that the EU would prefer a trade agreement similar to those negotiated with Norway and Switzerland. This is similar to the view held by many in the Leave campaign, who aim for the UK to remain a member of the European Economic Area and join the European Free Trade Area in a similar capacity to that of Norway and Iceland. In the case of third-country trade agreements (EU trade agreements with non-EU member nations) the government may try to invoke a general presumption of continuity, which is believed by some authorities to be part of international law. Under this presumption, the UK would be able to continue to trade with non-EU member nations under the terms agreed to with the EU, buying time for the government to negotiate new treaties.
  - The Comprehensive Economic Trade Agreement (CETA) negotiated between Canada and the EU and scheduled to take effect in 2017 would no longer apply to trade between UK and Canada after the UK leaves the union. Similarly, the Transatlantic Trade Investment Partnership (TTIP) currently being negotiated between the U.S. and the EU would no longer include the UK in talks once it leaves the EU.

Long-run risks and unanswered questions

- The Scottish National Party will push hard for a referendum to separate from the UK and remain part of the EU. This will add to economic uncertainty, keeping downward pressure on the pound, and could act to prolong financial market volatility.
- The EU referendum vote itself has already opened the door to EU-sceptic parties in Europe to push for similar referendums elsewhere in the union. The success of the Leave campaign in Britain will likely bolster populist EU-sceptic parties in the polls, adding to the rising uncertainty about the future viability of the EU, at least in terms of its current incarnation.
- There is moral hazard in the EU offering greater concessions to the UK in order to encourage a second UK referendum. Doing so raises a clear risk of encouraging other states within the union to challenge the status quo.
- The big unknown is what will happen to the UK financial industry. We highlighted the potential implications of a leave vote on the UK financial services industry in our note earlier this year (Box 2). The speed of negotiations and the type of trade agreement with the EU will largely dictate the ultimate impact on the UK financial sector. With at best European Economic Area membership, the UK will no longer be able to engage in unrestricted trade in financial services with the EU, and will be forced to comply with the EU financial regulatory framework without having any input into its evolution. The UK exports more than 40% of its financial services to the EU. On a positive note, the strengths of the UK that motivated the growth in the sector in the first place – namely the legal system, English language, and global exposure – should continue to work in favour of many financial firms maintaining a presence in the UK.

Moreover, the removal from the reach of EU regulators would leave the UK financial sector with the ability to tailor its regulations to ensure the global competitiveness of the sector, and could also help fast-track efforts to negotiate trade agreements for financial services with other globally important financial hubs located in the U.S. and Asia.