Brexit or No Brexit
The Real Worry Is Long-Term Uncertainty

Oct 2019 | Kurt Winkelmann, Raghu Suryanayaranan, Ferenc Szalai

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Why This Matters?

Whatever the form of Brexit (including no Brexit), our models suggest that markets are pricing in the prospect of a prolonged period of near-zero growth, higher macro uncertainty, and relatively high inflation. Investors should think about Brexit scenarios in the context of their potential effects on long-term growth and inflation. Our models can help investors think through the potential consequences of alternative scenarios on returns and portfolio decisions.

Who Should Read This Paper?

The issues in this paper are important for managing the long-term risk of public and private assets, and should be of interest to the risk and investment strategists, and asset allocators.

Introduction

With the United Kingdom slated to leave the EU by October 31st, investors have been assailed by bombastic and conflicting views about the form of exit and its near term (12-month) consequences. How should investors make sense of Brexit and its impact on returns? And, what are the consequences for their portfolio decisions?

In our view, the issue plaguing investors is assessing the real long-term risk. To gain clarity, investors should focus on the drivers of long-term macro uncertainty. Brexit or no Brexit, markets are pricing in a prolonged period of low(er) long-term growth - driven by near-zero growth in total factor productivity (TFP) - and higher inflation relative to historical standards. In turn, our models suggest that potential stagflation also means low(er) inflation-adjusted bond yields and equity returns, and higher nominal bond yields. In this context, investors are well advised to review their portfolio decisions with changes in macro uncertainty.

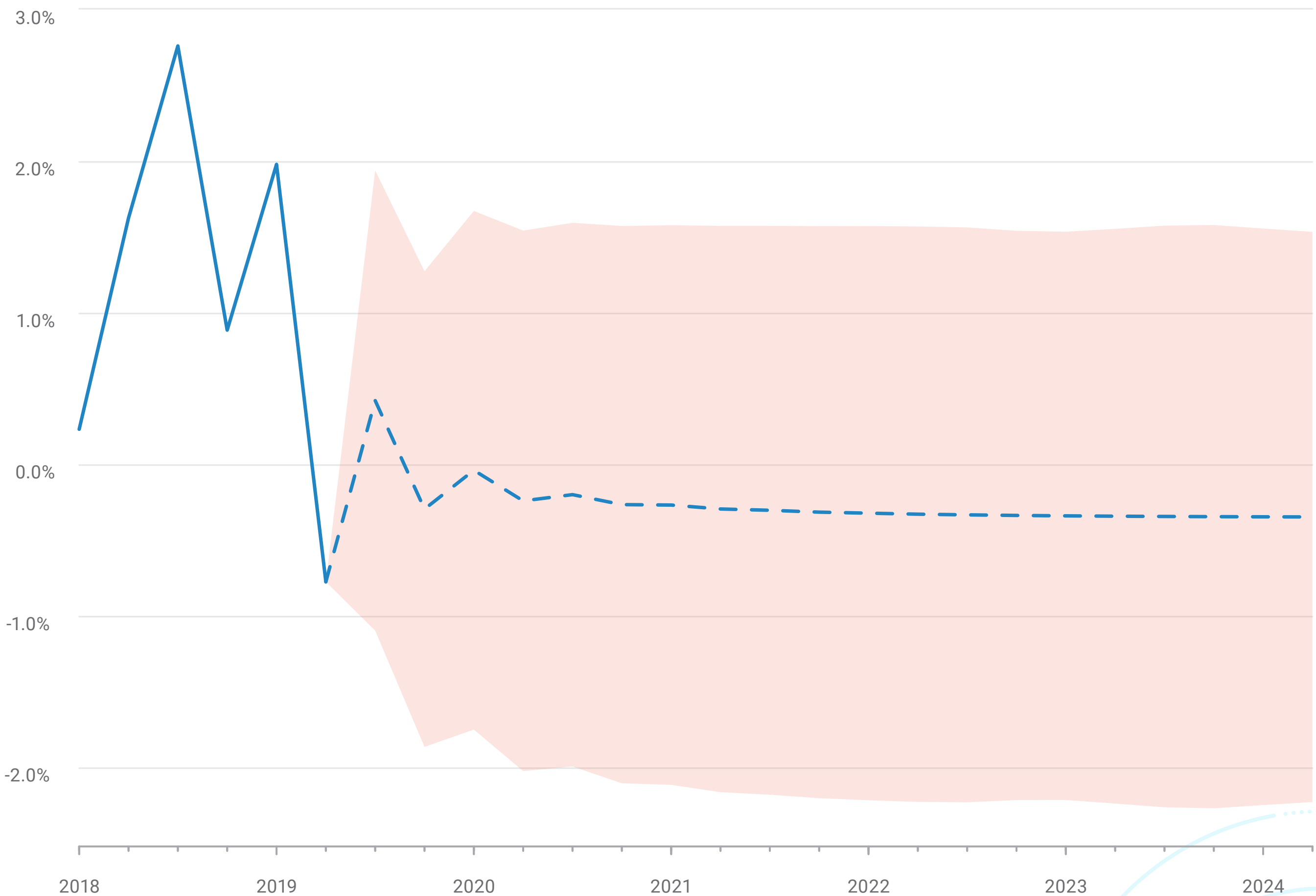
High Risk of Recession

To grapple with the potential economic and financial consequences of Brexit, let's first examine the UK's growth prospects. Exhibit 1 depicts the Navega model baseline scenario for UK real GDP growth, together

with (one standard deviation) confidence bands around the baseline. Our baseline scenario incorporates both fundamental macro data and information from the inflation-linked bond (index-linked gilt) market.

Exhibit 1 - High Risk of Recession in the Next 12 Months

Quarterly Real GDP Growth (Annualized, %)



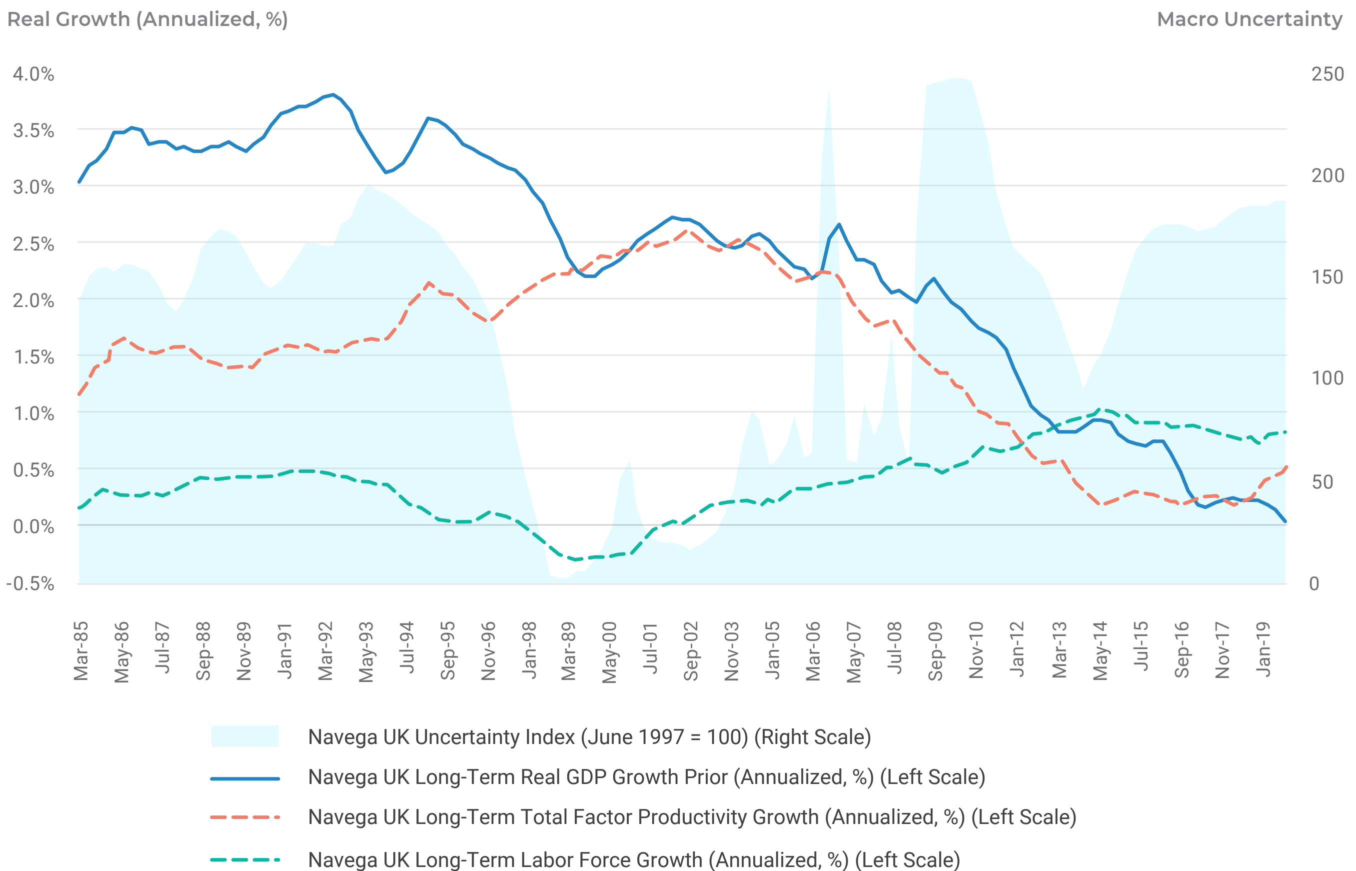
SOURCE: NAVEGA STRATEGIES LLC RESEARCH

It is clear from Exhibit 1 that, the UK is teetering on the brink of recession, with nearly zero growth projected for the year ahead, down from 1.2% over the past year. In fact, according to our model baseline scenario, there is a high chance of the UK entering a recession (80%) in the next 12 months.

Moreover, the striking conclusion from Exhibit 1 is that the UK risks being trapped in a prolonged period of near-zero real economic growth, at least through the next five years. To frame this long-term forecast into historical context, average trend growth in the UK from 1975 to 2007 was about 2.7%!

Near-Zero Long-Term Trend Growth

Exhibit 2 - Near-Zero Long-Term Real Economic Growth



SOURCE: NAVEGA STRATEGIES LLC RESEARCH

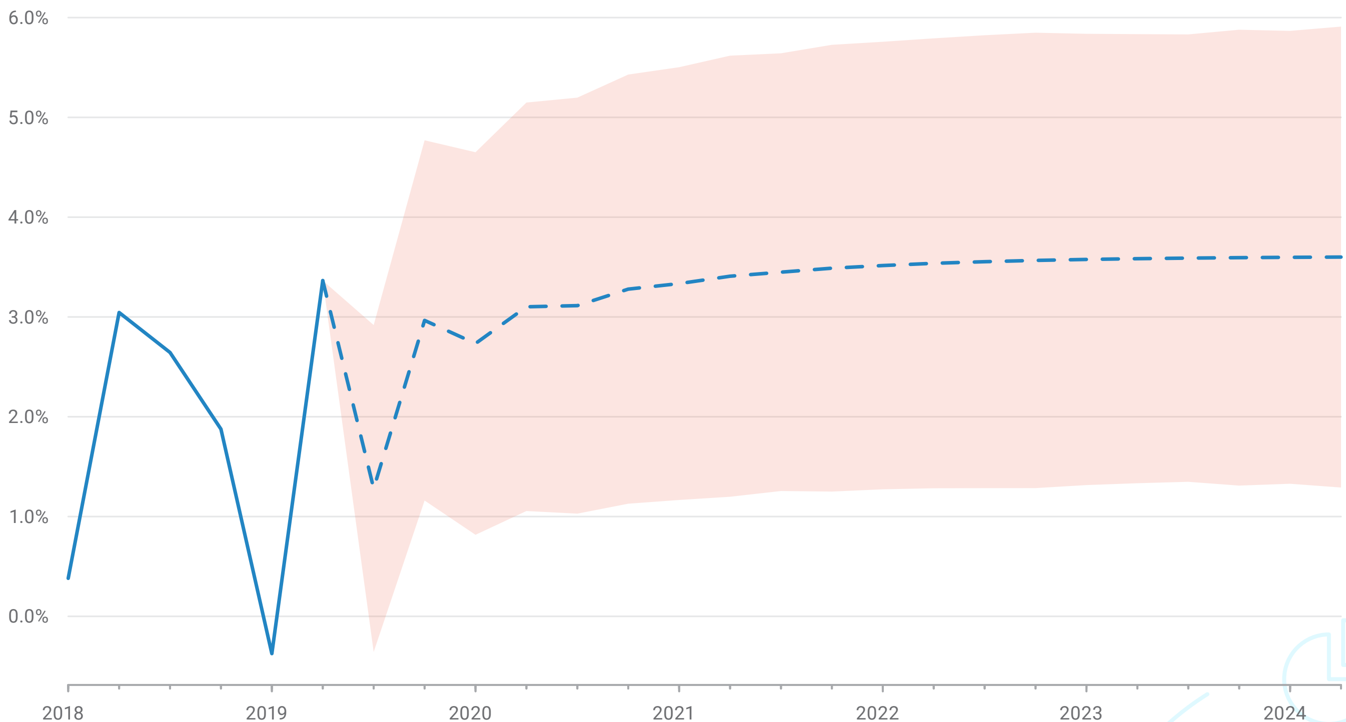
Interestingly, the model projections do not embed any specific assumptions about the outcomes of Brexit negotiations with the EU and deliberations in Westminster, including no-deal, further delay, or even no Brexit at all. In fact, the concern is that the sources of the projected long-term stagnation go far deeper. Exhibit 2 shows the evolution of the Navega priorfor long-term growth influencing our long-term forecasts, together with its two drivers: growth in the labor force, and growth in total factor productivity (TFP). TFP growth has been slowing down since the early 2000s. And growth in the labor force has been stagnating since 2015. In turn, it is no surprise that our prior for long-term growth has also been declining since 2000, stagnating near-zero more recently.

As also shown in the Exhibit, another concern for investors is the continuation of uncertainty. According to our models, macro uncertainty increased in 2008, corresponding to the onset of the Global Financial Cri-

sis. After decreasing for five years, the index reversed direction in 2014 and has remained high since then, consistent with market pricing of a continuation of low(er) trend growth for a prolonged period.

Increased Risk of Stagflation

Exhibit 3 - Increased Risk of Higher Inflation

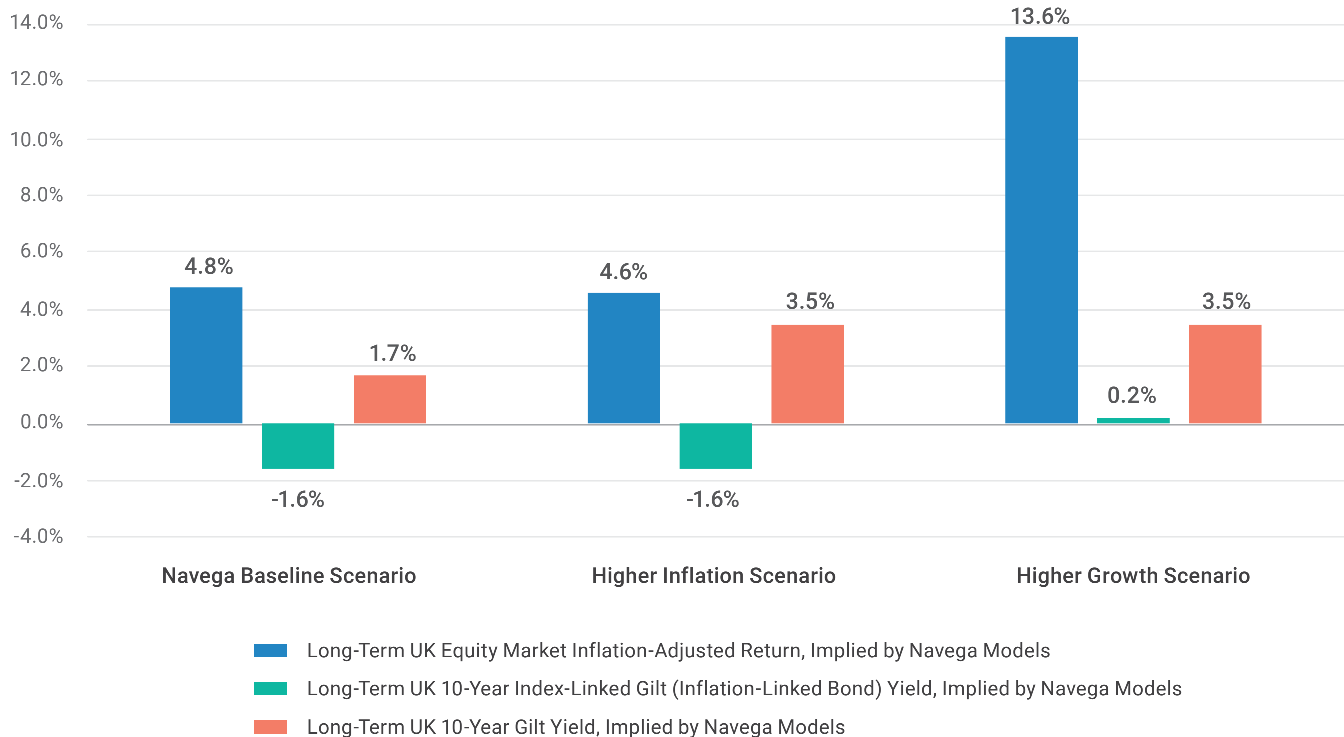


SOURCE: NAVEGA STRATEGIES LLC RESEARCH

What about inflation prospects? Exhibit 3 shows the Navega model baseline scenario and confidence bands for UK inflation. Unlike its G7 counterparts, inflation in the UK increased following the 2016 referendum from 1% on average to about 2.3% (mostly due to a depreciation in the sterling affecting the price of imported goods and services). According to our baseline scenario, driven by our prior reflecting government bond market prices and government finances, inflation is projected to further increase over the next 5 years, averaging about 3.3%. This rate is close to the historical average since 1960. However, combined with near-zero long-term trend growth, it signals an increased risk of stagflation.

Low(er) Long-Term Equity Returns and Real Bond Yields

Exhibit 4 - Long-Term Equity Returns and Gilt Yields Under Alternative Scenarios



SOURCE: NAVEGA STRATEGIES LLC RESEARCH

These growth and inflation trends and risks matter for investors because they affect markets and portfolios in the long run. In our models, changes to growth and inflation trends affect returns via their impact on interest rates and cash-flows. Exhibit 4 shows our modelimplied long-term expectations of UK equity market real return, real and nominal bond yields under our baseline scenario, and two alternative scenarios. The first scenario envisions higher inflation (up from 3.3% to 5.1%), while the second scenario envisions higher growth (up from -0.3% to 1.5%). In our models, near-zero trend growth and high uncertainty translate into negative real yields, low nominal bond yields, and on balance, low real equity return relative to history. Nominal bonds lose in value in the higher inflation scenario, as yields rise. While inflation-linked gilts and equities offer a hedge with yields and returns about unchanged. Both real and nominal yields rise in the high growth scenario, with long-term equity returns nearly back to their historical pre-2008 average.

Lessons for investors from Brexit uncertainty

Whatever the form of Brexit (including no Brexit), our models suggest that markets are pricing in the prospect of a prolonged period of near zero growth, higher macro uncertainty, and relatively high inflation. Investors should think about Brexit scenarios in the context of their impact on the drivers of long-term growth - TFP and labor force growth - and inflation. Our models can help investors think through the potential consequences of alternative scenarios on returns.

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