Schroders

Brexit

Assessing the impact of Brexit on emerging markets

Before even considering what impact Brexit will have on emerging market equities, we need to try and be clear what Brexit means. Unfortunately we cannot, because a lot is uncertain. Here is what we do know.

24/06/2016

Allan Conway

Head of Emerging Market Equities

Unstructured Learning Time

The Prime Minister, David Cameron, has resigned with effect in October. In the meantime there will be a leadership contest before a new prime minister takes over. The British system does not require a general election in this case (although Parliament could decide to have one).

Under European treaties, countries that wish to leave the EU submit a notice to do so under Article 50. After that there is a two year period of negotiation on the terms of exit. If no agreement is reached the country leaves without an agreement, unless there is unanimous agreement amongst the remaining members to extend negotiations.

At present the "Leave" campaign has said it wants an extended period of negotiation before submitting its notice, so as not to get caught by the two year deadline. The conclusion for all this is that the UK is not leaving the EU in the immediate future. The actual leaving date may be closer to 2020. This is not certain however. For example premature action on immigration and free movement of labour by the UK could accelerate the process.

Although the UK is not likely to leave straight away, there is great uncertainty about the UK's economic relations with the rest of the world. Markets do not like uncertainty. Nor do businesses thinking of investing, or consumers thinking of making large purchases. So Schroders expects the UK to lose 0.9% of GDP by the end of 2017 and narrowly avoid recession.

The same effect on confidence will be evident in Europe, although to a lesser degree. Europe also has a number of political events coming up, including an election in Spain on Sunday, an important referendum on the constitution in Italy in the autumn and a French election next year. Political risk premia in general in Europe have increased as eurosceptic parties in various countries press for similar action to that of the UK.

The further away from Europe the fewer the effects. Schroders' economics team estimates that a Brexit is a marginal effect on global growth. However the risks of stagflation/deflation and weak growth have clearly increased.

Many emerging economies enjoy strong domestic demand

Countries in emerging markets trade predominately with each other and the US. The EU is not insignificant at about 20% but will not dominate trade or growth figures. In addition emerging countries are supported by generally strong domestic demand.

In terms of specific emerging countries we do not expect substantial economic effects. Clearly countries closely tied to the EU (or actually in the EU) will be worst affected. That means the CE3 of Hungary, Poland and the Czech Republic (3% of the MSCI Emerging Markets index and primarily via their trade links to Germany) and Turkey (1.5% of the MSCI Emerging Markets index). Such a small part of the index should not affect overall levels too much.

Global risks have risen

However, economic effects are only part of the story. Clearly global risk has gone up. Although the overall global GDP effect is small, the chances of a meaningful recovery from an extended period of lacklustre growth are reduced.

Given increased risk to the global growth outlook and increases in risk premia, markets may struggle to make headway from here. Despite more intra emerging market trade, emerging markets are still a key beneficiary of a pick-up in global activity. In addition, increased risk invariably acts to strengthen the dollar as a global safe haven, and that is usually bad for emerging markets. As usual, countries running large deficits such as Turkey and South Africa would be relatively more vulnerable if this were to happen.

On the other side, policymakers are unlikely to stand idly by and we could see further easing from central banks and fiscal authorities as well as a receding prospect of any rate rises from the Federal Reserve.

In summary, markets have had a large one off move already but any significant prolonged bounce from these levels is unlikely. However, looking further out, global growth and deflation fears have increased but emerging economies are likely to be relatively less impacted than developed markets due to strong trade with each other and domestic demand support. For the time being a defensive bias seems sensible.

Schroder Investment Management Limited
Registered in England and Wales 1893220. Registered office: 31 Gresham Street, London, EC2V 7QA
Authorised and regulated by the Financial Conduct Authority