Economic Analysis

U.S. after Brexit: Shaken, not stirred

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- **Brexit acts as an additional downward risk in an already highly uncertain environment**
- **Financial stress likely to recede as central banks react by injecting liquidity**
- **Negative effects on U.S. economic activity will be modest**
- **Outlook for monetary policy normalization tilts further to the downside**

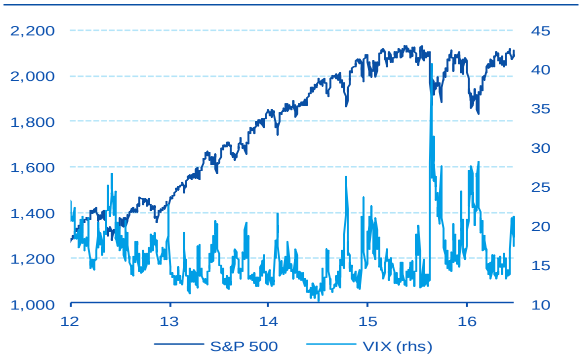
An extremely close contest left everyone stunned on Thursday as the U.K. voted to leave the European Union. Now, with Brexit not just a hypothetical but a reality, we are faced with assessing the potential impact on the U.S. economy.

Financial markets

Stocks in the U.S. fell sharply as investors looked for safe havens in gold, treasury bonds, and other stronger currencies. The S&P 500 fell 3.6%, the Dow Jones fell 3.4%, and the Nasdaq dropped 4.1%. By sector, financials contracted the most (-4.7%) followed by materials (-4.6%), information technology (-4.3%) and industrials (-4.2%). Despite these adjustments, the level of "panic" seems to be lower than on previous occasions, at least according to the VIX, which was up 49.3% from yesterday's levels but still below the high reached back in February. Meanwhile, the yield on U.S. Treasuries dipped to 1.40%, near historical low levels in early trading. However, yields edged back up to 1.56% in the afternoon.

The adjustment in U.S. financial markets appears to have happened in an orderly manner. This suggests that investors may have started to assimilate the effects of Brexit before the referendum. However, further volatility cannot be ruled out given that there are several analyses on the economic consequences of Brexit and that the political process surrounding the exit is highly uncertain. This is true not only for Britain but also for what may happen in other countries and in the EU integration process itself. Still, the probability of further "panic selloffs" from Brexit may decline as governments and central banks reassure confidence and more information emerges about how the U.K. and the EU will manage the transition. As the effect of the Brexit shock eases, market attention will turn to the Fed's pending actions, the quality of U.S. economic data, global economic conditions, and the electoral process in the U.S.

Chart 1
S&P500 and VIX Index



Source: BBVA Research & Bloomberg

Chart 2
Corporate Spreads, Basis Points

Source: BBVA Research & Bloomberg

Chart 3
Impact of Brexit on Financial Markets

% Change	Brexit	Chinese Stock Market Crash	Lehman Brothers Collapse	1997 Mini-Crash	1987 Stock Market Crash
Equities (Dow Jones)	-3.4%	-3.6%	-4.4%	-7.2%	-22.6%
VIX	49.3%	45.3%	23.5%	0.8%	N/A
Fed Funds Futures Yield (Dec 201	-28.3%	-11.2%	N/A	N/A	N/A
10YTN	-10.6%	-1.1%	0.1%	-0.3%	-2.6%
Corporate Spreads (AAA)	0.0%	1.4%	2.3%	0.7%	3.7%
Corporate Spreads (BBB)	11.1%	-1.0%	5.9%	N/A	N/A
USD Index	2.0%	0.6%	-1.9%	0.1%	1.4%
Gold	4.7%	-0.5%	9.0%	-1.8%	-0.4%
Oil Prices (Brent)	-4.9%	8.2%	2.3%	2.1%	N/A
Commodities (GS Index)	-3.1%	-1.7%	-0.6%	-0.4%	N/A

Source: BBVA Research & Bloomberg

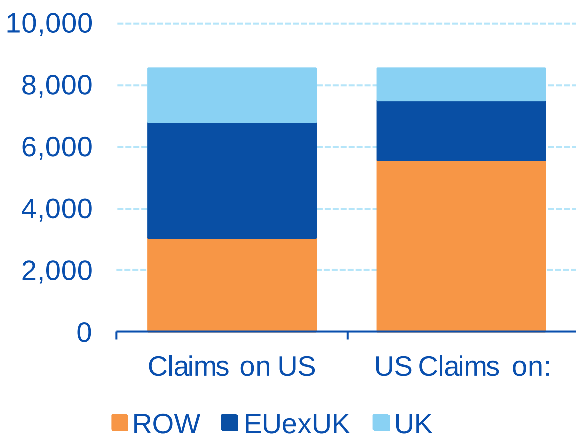
Trade

Although the U.K. has always been an important partner for the U.S., the impact of Brexit on U.S. foreign trade flows will be modest. In 2015, the U.K. was the 5th largest importer of U.S. goods, behind Canada, Mexico, China, and Japan, accounting for 5.5% of total U.S. exports of goods and services. In addition, U.S. imports of goods and services from the U.K. represented around 4% of total.

Although in theory the pound sterling devaluation triggered by the Brexit referendum should boost U.K. exports and suppress their imports, the actual outcome can be complicated. The effect of the weakening yen during the "Abenomics" years may provide some insights on the consequences of a weakening sterling. In 2013, the yen depreciated 12% from under-90 against the U.S. dollar to above-100. Despite the dramatic change in the value of the currency from 2012 to 2013, the value of U.S. exports to Japan only decreased from $70bn to $65bn while imports decreased from $146bn to $139bn. In other words, trade flows between the U.S. and Japan remained remarkably stable despite substantial yen depreciation. Given the highly complex input-output structure of the global economy, we expect the trade between the U.S. and U.K. to remain stable under volatile foreign exchange rates.

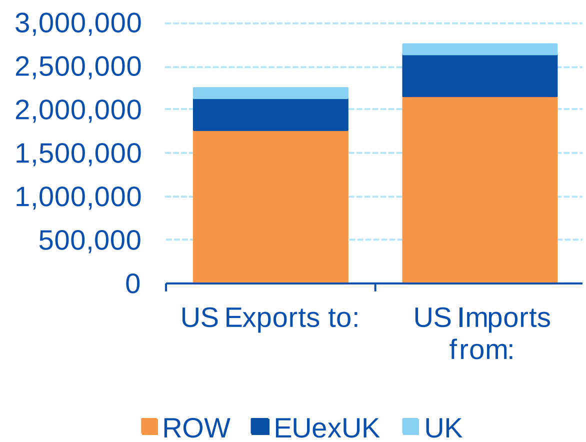
In terms of capital flows, the impact of Brexit could be more significant given the relative importance of the U.K. in global finance. However, the effects may not be large if the transition occurs in an orderly manner whereby most financial advantages remain in place. Data from 2015 reveals that U.K. banks' claims on the U.S. accounted for 21% of total while U.S. banks' claims on the U.K. amounted to 12% of total U.S. claims abroad. In addition, foreign direct investment (FDI) between the U.S. and the U.K. is likely to slow, at least in the short-term, although the share of U.K. FDI flows to the U.S. is just 5% of total. This is quite lower than U.S. FDI to the U.K., which accounts for almost 10% of total U.S. FDI outflows.

Chart 4
Consolidated International Claims of BIS Banks
Foreign Claims + Other Potential Exposures, US $Bn



Source: BBVA Research & BIS

Chart 5
U.S. Foreign Trade in Goods and Services
US $Bn, 2015



Source: BBVA Research & BEA

Growth and inflation

Brexit adds to the existing downward pressure already exerted on our baseline scenario for the U.S. economy. While there may not be a significant direct impact on growth, the indirect influence from heightened economic uncertainty biases our projections to the downside, particularly when it comes to the already-sluggish contributions from investment and net exports. Increased financial market volatility limits the upside for economic confidence, and the expected appreciation of the U.S. dollar will reduce global demand for U.S. exports (as was the case in 2015 and 1Q16). Although the dollar depreciated throughout 2Q16, we expect that the trend will be reversed again starting in 3Q16, heading back toward the highs reached earlier this year. In turn, this reverses our prior expectation for an improvement in U.S. exports. Furthermore, given that domestic demand remains relatively healthy, import growth will likely be positive, widening the trade balance even more. Moreover, the probability of policymakers taking action on the fiscal side to counteract downward cyclical pressures and potential damage from Brexit seems low for the foreseeable future, so we cannot expect a big boost in government consumption. Still, the magnitude of the overall impact will depend on the negative effects on GDP growth in the EU as well as the collateral damage from foreign exchange rate movements on China’s currency and GDP growth.

When it comes to inflation, the stronger U.S. dollar will limit the modest upward trend that has been ongoing throughout 2016 thus far. As a result, it will likely take longer than previously expected to reach the Fed’s 2% inflation target. However, the primary drivers of core inflation (i.e. shelter and medical care) will be largely unaffected by Brexit and the subsequent strengthening of the U.S. dollar, so core services inflation is expected to remain near healthy expansionary levels around 3%. The problem stems from the commodities side, which will ultimately impact the Fed’s confidence on the future pace of inflation.

Monetary policy

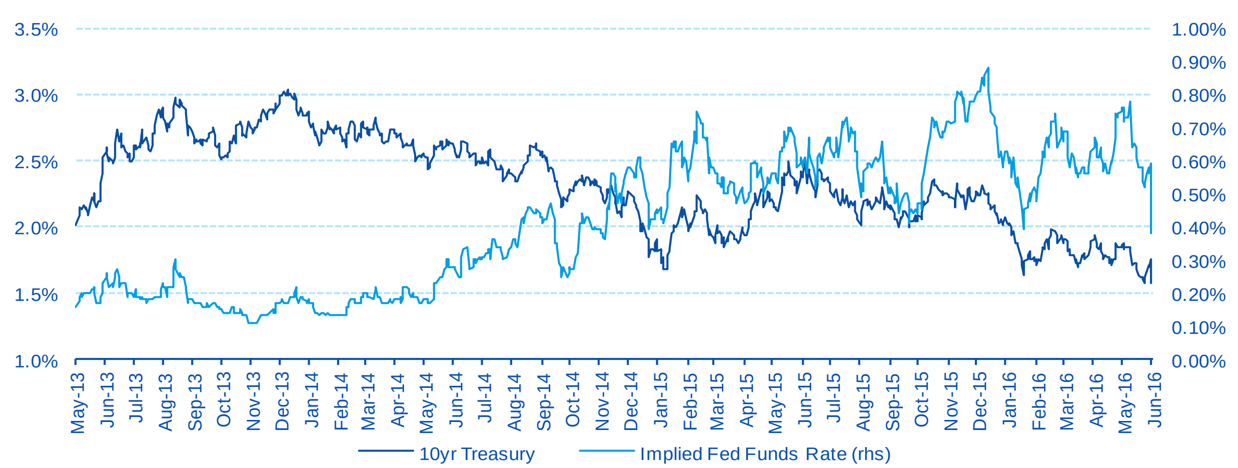
As is the case for all major central banks, the Fed will be closely monitoring financial market conditions following Brexit under the assumption that they will act to offset pressures on foreign exchange rate markets if needed. This happened in December 2007, for example, when the Fed authorized dollar liquidity swap lines with the ECB and the SNB to provide liquidity in U.S. dollars to overseas markets, and subsequently authorized similar lines with 12 other central banks. Although those arrangements terminated on February 1, 2010, in May of that year the FOMC re-authorized liquidity swap lines with five major central banks, and converted these agreements to standing arrangements in October 2013.

Aside from trying to contain financial market volatility, the Fed will likely reassess its economic outlook. Even if financial markets return to more normal conditions, there will be a modest impact on growth and inflation through a stronger U.S. dollar and weaker foreign trade flows. If financial stress is more protracted and the spillover effects into confidence and real activity is deeper, the Fed will be more inclined to take a more aggressive stance. In any case, it is important to consider that even before the Brexit vote, most FOMC members were already leaning toward a more dovish stance as a result of weaker labor market conditions and higher uncertainty regarding the long-term outlook (productivity growth, the equilibrium level of real interest rates, potential output, and the long-term unemployment rate). In addition, the Fed was also debating the implications of muted inflationary pressures and the low level of inflation expectations. Therefore, it seems very unlikely that the Fed will raise rates two times before year-end, although we should not be surprised if the communication continues to point in this direction.

Long-term interest rates

The combination of higher risk aversion, a slower pace of monetary policy normalization, weaker growth, and lower inflation will exert downward pressures on the U.S. yield curve. This plays into the scenario for a prolonged period of flight-to-safety investor attitudes, keeping the 10-year Treasury yield relatively flat between 1.5% and 2.0% at least throughout the next year. In the long-run, we may only see the 10-year Treasury yield rising by a few hundred basis points rather than returning to near pre-crisis levels.

Chart 6
12-Month Implied Fed Funds Rate & 10YTN
% Rate & Yield

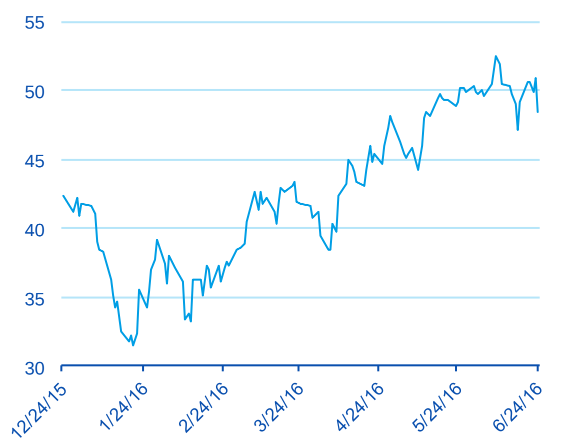


Source: BBVA Research, CME, & FRB

Oil

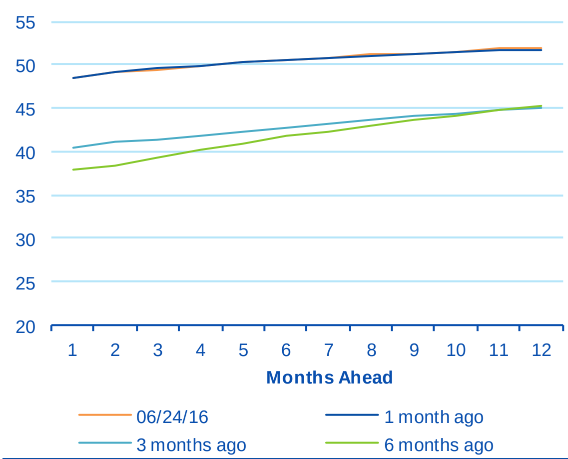
Oil prices reacted to the downside with substantial volatility. The Brent has traded as low as $47.54 a barrel, 7% below yesterday's prices. The adjustment has been sharp; however, prices hit these levels as recently as June 16th when markets assessed a more uncertain economic environment and the expectation of a rebound in U.S. crude oil production. As of today, the Brent is 71.4% above its last bottom in January and 34.8% above the bottom reached during the Great Recession. Going forward, Brexit could affect oil prices through its impact on the exchange rate and global demand. If the dollar continues to appreciate relative to the pound and other currencies, oil prices may decline further. Likewise, slower global growth would mean weaker energy demand and thus downward pressures on oil prices. However, if the effects of Brexit are short-lived, oil prices could bounce back somewhat.

Chart 7
Brent Crude Oil Prices
$ per barrel



Source: BBVA Research & Bloomberg

Chart 8
Brent Crude Oil Futures
$ per barrel



Source: BBVA Research & Bloomberg

Bottom line

Despite the immediate volatile reaction to Brexit, it will take time before knowing the final impact of such a historical event. Not surprisingly, heightened uncertainty is most likely to prevail in the short-term. However, the uncertainty should fade away as the reactions of all the agents involved become clearer over time.