The Week Ahead: Brexit vote aftershocks to dominate; uncertainty to remain high

Economics Team

Monica Malik, Ph.D.
Chief Economist
+971 (0)2 696 8458
Monica.Malik@adcb.com

Shailesh Jha
Economist
+971 (0)2 696 2704
Shailesh.Jha@adcb.com

Contents

Global: Uncertainty to drive market volatility

The Brexit vote has provided a significant shock to markets and global confidence. Volatility is expected to remain high, as markets digest the implications of the vote. The immediate global economic impact will flow almost entirely through financial channels, as the structural implications for the UK and Eurozone will take time to develop. Global growth forecasts are being reduced for 2016 and beyond as a result of the market moves, heightened risk aversion, expected tightening in financial conditions and rise in political risk. In the UK, we expect a sharp cutback in corporate spending until the trade and investment implications are understood. A number of global firms based in the UK are evaluating options to move part of their operations to the Eurozone and have put hiring on hold. Consumer spending will be impacted by the uncertainty and weaker GBP causing a rise in imported inflation. We see a high probability of the UK entering a technical recession in 2H2016, a slowdown in Europe and a deceleration in GDP growth elsewhere.

Global: Monetary policy main tool and shock absorber

The Brexit shock is a game changer for the monetary policy trajectory of major central banks. Some may announce measures to provide liquidity and soothe market concerns, ahead of scheduled meetings. We see a high risk of the BoE cutting interest rates (and suspending its inflation targets), while also possibly announcing a programme of corporate bond purchases (like the ECB). There is a strong likelihood of the ECB expanding its asset purchases programme. The ECB might re-start its OMT programme to support sovereign yields if a sell-off in sovereign debt (Spain and Italy likely) escalates. Japan is likely to intervene to weaken the JPY. If the CPI data for May or 2Q Tankan surveys (both due 1 July) disappoint, the BoJ could ease monetary policy ahead of its 28-29 July meeting. This could include an expansion in the asset purchase programme of around JPY10-20 trillion (currently JPY80 trillion) and a cut in interest rates (targeting lending programmes). In the US, we now expect the Fed to remain on hold until there is global market stability and signs that the US economy has weathered the storm. We do not expect a rate hike before December at the earliest, with greater risk of the next rise coming even later.

Global: EU summit and US personal spending data

The key event this week will be the EU summit (28-29 June), where the EU's position on the UK's exit process will be discussed. Initial comments from the EU have shown a desire for a quick conclusion, to limit uncertainty. Meanwhile, Fed Chair Janet Yellen and ECB President Mario Draghi are due to participate at an ECB forum (27-29 June). We expect them to reiterate their commitment to stabilise markets. The key data release this week will be US personal spending and PCE inflation data for May, with consensus expecting a moderation in both from the April figures (Fig. 9).

I. Recent Data and Events

A. MENA Economies

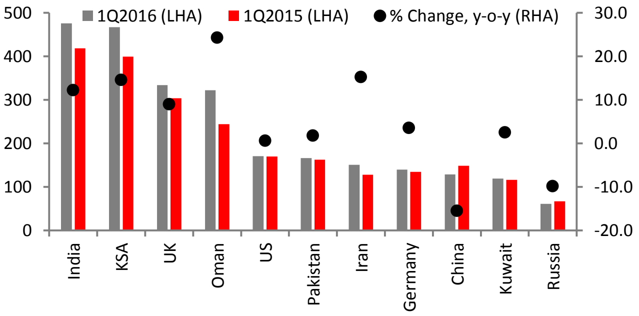
GCC: Impact of Brexit via financial channels – FX and oil

UAE and Saudi central banks highlight limited direct links to GBP and EUR

Both the central banks of the UAE and Saudi Arabia announced over the weekend that they did not anticipate their financial institutions to be greatly affected by the Brexit vote. The Central Bank of the UAE highlighted that there is “limited interconnectedness between the UAE and UK financial systems”, while SAMA noted the limited exposure of the banking system to the GBP and EUR. SAMA also indicated that it had made some adjustments to assets denominated in GBP and EUR as a “precautionary stance".

Fig. 1. Dubai: Visitors from Western Europe account for 23% of the total in 1Q2016; UK the third largest market

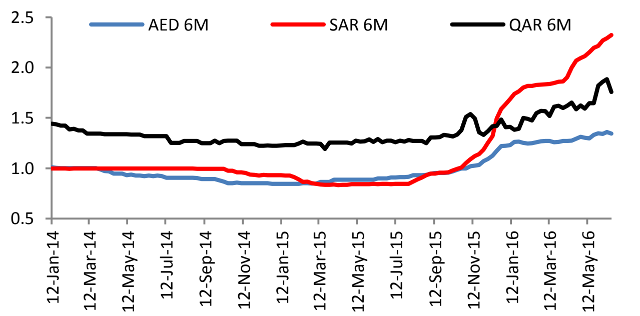
‘000 visitors (LHA); % change y-o-y



Source: Dubai Tourism

Fig. 2. GCC: Tightening in foreign funding would increase reliance on domestic sources

Interbank rates, %



Source: Bloomberg

UAE – main impact through tourism and real estate channels

Indeed, we expect the main impact on the GCC to be through the global market volatility, especially the weaker GBP and EUR outlook. The UAE is expected to be the most impacted via the tourism and real estate channels. Western Europe was the second-largest source of tourists to Dubai by region, accounting for 23%, led by the UK (8% of the total) and Germany (3%). Meanwhile, UK citizens accounted for 7.4% of Dubai real estate transactions in 2015, the second highest number of foreign buyers after Indians. The weakening in the oil price has been contained so far, compared to some other asset classes. However, the risks are to the downside, and a sharp fall would have implications for GCC fiscal and current account deficits. A tightening in global financial conditions would also be significant given the greater focus on external funding in 2016 to cover regional fiscal deficits. For further details, please see our note – **GCC: Brexit to impact region via financial market volatility and heightened global economic risk**, published on 24 June 2016.

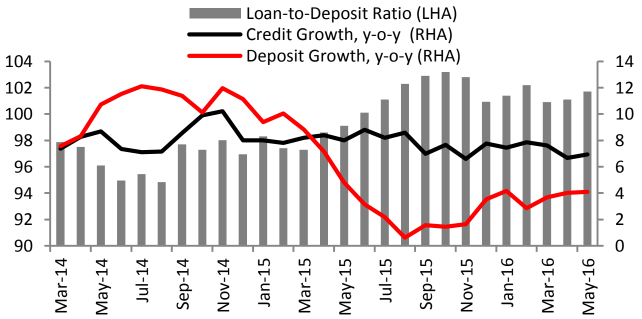
UAE: Private sector credit growth moderating, reflecting softer economic backdrop

May government deposits likely supported by higher oil prices

Banking sector liquidity continued to tighten in May, as credit growth outpaced that of deposits. Reflecting this, the loan-to-deposit ratio rose to 101.7% in May, up from 101.1% in April and 100.9% in December 2015. Banking sector liquidity remains tight and interbank rates continue to rise. However, the increase in interbank rates has not been as steep as in 2H2015, with gradual deceleration in credit growth, generally higher deposit growth YTD and limited expectations of a US rate hike. System-wide deposits rose by 4.1% y-o-y in May, supported by non-resident deposits (up 26.3% m-o-m) although these only account for 12.1% of total deposits. Moreover, there was a robust monthly jump in government deposits (up 11.7% m-o-m), likely supported by high oil prices. All other categories of domestic deposits declined.

Fig. 3. UAE: System-wide loan growth continues to outpace increase in deposits

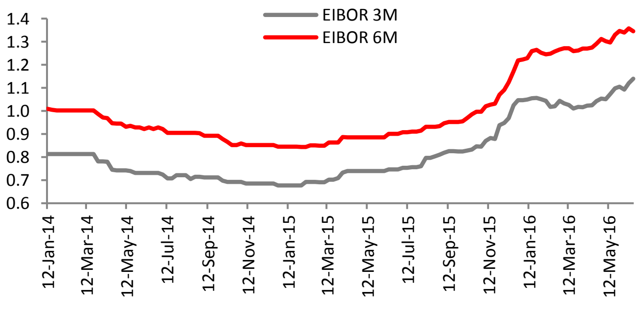
Ratio (LHA); % change y-o-y (RHA)



Source: Central Bank of UAE

Fig. 4. UAE: Interbank rates continue to rise, albeit at more moderate pace than in 2H2015

%



Source: Bloomberg

Both corporate and personal credit growth slowing

Total credit growth decelerated gradually in May to 6.9% y-o-y, from 7.8% in December 2015. We believe that this reflects the softening economic backdrop, which is leading to weaker credit demand. The moderation in credit growth was particularly notable in the private sector component, with both corporate and personal credit growth softening. Job cuts, and greater uncertainty over jobs and wages are contributing to weaker confidence and spending by individuals. Meanwhile, corporates are streamlining their spending. We expect further deceleration in private sector credit growth in 2016, reflecting the higher market interest rates, weaker loan demand and tightening credit standards.

B. G4 Economies

UK: PM Cameron resigns, Moody's downgrades credit rating outlook

Various layers of political risk and uncertainty

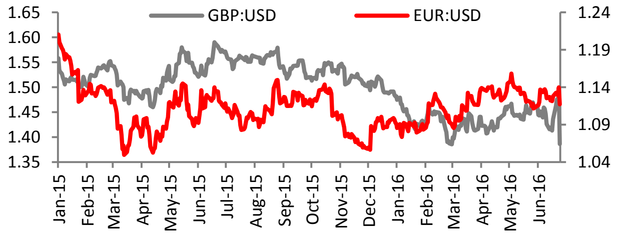
Prime Minister David Cameron resigned last week following the victory for the "Leave" campaign in the UK's EU referendum. However, he will remain in office as a caretaker prime minister until a successor is decided, aimed at before the Conservative Party Conference in October. We expect political uncertainty in the UK to remain elevated in 2H2016, as extremely divergent views within the ruling party on immigration, fiscal policy and negotiations with the EU are likely to weigh on the leadership succession. An added political concern is the rising likelihood of secession by members of the UK. Scottish First Minister Nicola Sturgeon has already announced formal negotiations with EU leaders to retain Scotland's position in the EU and has said there is a "high possibility" of a second referendum.

Moody's downgrades outlook to negative; S&P hints at downgrade

Unsurprisingly, major credit rating agencies have responded to these political risks with an unfavourable assessment of the UK's long-term economic outlook. Moody's changed its outlook on the UK's sovereign debt (Aa1 rated) to negative from stable, citing a "prolonged period of uncertainty" as the UK negotiates its exit. S&P has also hinted at a downgrade of the UK's credit rating by one notch from its current AAA, saying that the "top-notch" rating had become "untenable following the Brexit vote". We believe these developments could significantly widen UK corporate credit spreads close to levels last seen during the 2008-09 financial crisis. In the near term, this increases the probability of corporate defaults and a cutback in investment spending until 2019, when the EU exit formalities are expected to be completed. A sovereign credit rating downgrade could also hurt the government's efforts to stabilise its public debt and balance its budget by 2020.

Fig. 5. UK: GBP weakens sharply following Brexit vote; more downside implied by market positioning

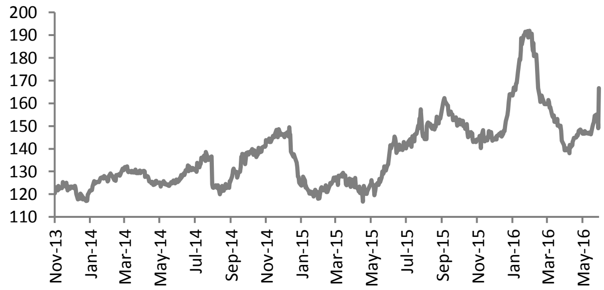
Spot GBP:USD (LHA); spot EUR:USD (RHA)



Source: Bloomberg

Fig. 6. UK: Credit spreads rise following actions and comments by rating agencies

bps



Source: Bloomberg

US: Change to our monetary policy outlook

Near-term rate hike off table

The key event in the US last week was Fed Chair Janet Yellen's testimony to the Senate Banking Committee (21-22 June). However, since the Brexit vote, we believe that focus of the Fed will have completely shifted towards global financial market developments and their feed through into the US economy. We see a change to the US's monetary outlook due to the heightened uncertainty and market volatility. We now see a possibility of a rate hike in December only (at the very earliest), but only if global markets stabilise and the US economy shows solid momentum. We see a risk of a further delay if financial conditions continue to deteriorate, which will also have implications for our 2017 and 2018 rate calls (two hikes in each year).

Comments broadly in line with post-FOMC conference

There were no major surprises or new information at Yellen's testimony to the Senate Banking Committee (21-22 June). The tone remained dovish and her comments were close to those of her post-FOMC meeting press conference. She highlighted that the Fed will remain cautious about interest rate increases until they are confident in the health of the job market. The weaker payroll data for April and May were highlighted. Moreover, Yellen noted the uneven growth in the economy, with the consumer and housing sectors outperforming relative to the external sector and business investment. On the international front, she pointed out concerns regarding Brexit and risks linked to the rebalancing of the Chinese economy. Nevertheless, Yellen remained positive about the economic outlook and played down the risk of a recession; she continues to see "further improvements in the labour market and the economy more broadly over the next few years". On inflation, the FOMC still expects to see it reaching 2% y-o-y over the medium term as transitory effects fade.

Existing home sales for May were strong, rising 1.8% m-o-m (April 17% m-o-m), to an annual rate of 5.53 million units (the highest level since February 2007). Low mortgage rates are supporting the recovery in the housing market. This data, alongside the recent retail sales data, point to private consumption-linked areas performing strongly. The short supply of existing homes should also provide support to residential construction activity.

Existing home sales reach post-crisis high

Europe: German Constitutional Court dismisses petition against ECB

The German Constitutional Court dismissed a petition from some citizen groups questioning the legitimacy of the ECB's Outright Monetary Transactions (OMT) programme last week. We believe that this is likely to reduce political opposition to extension of the ECB's QE programme, which is likely following the UK's Brexit vote. The judgment said that the purchase of sovereign bonds under the OMT and QE programmes does not exceed the ECB's mandate so long as the volumes of such purchases are specified from the outset. Furthermore, in another move supportive of the ECB's QE measures, the court refused to comment on the extent to which such purchases were affecting price-setting in the bond market.

Court decision supports possibility of ECB's QE programme being extended

C. Emerging Market Economies

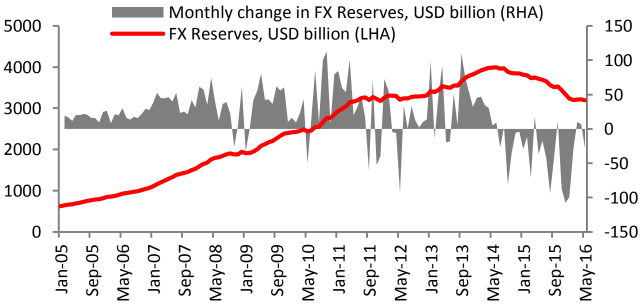
China: Capital outflows moderate; housing market likely peaking

Capital outflows from China slowed significantly in May, as Chinese banks sold just USD12.5 billion in foreign exchange (compared to USD148.5 billion in 4M2016). Furthermore, the bulk of the May sales were payments for forward contracts entered into when there had been significant uncertainty around the trajectory of the RMB. The May numbers also showed that Chinese banks bought more currency forwards than they sold (net +USD1.3 billion) for the first time in 18 months. We believe that this suggests some success by the PBoC in communicating its new currency-management framework and stabilising private-sector risk sentiment. However, we see heightened risks to capital outflows in 2H2016, away from EM assets post Brexit vote. Therefore, as hinted at by the PBoC in its communication, we expect gradual cuts to the reserve requirement ratio (RRR) in 2H2016 to keep domestic markets liquid in the face of capital outflows. We believe lending rate cuts are unlikely unless GDP growth falls below 6.5% y-o-y in 2H2016.

Weaker capital outflows reduce chances of near-term monetary easing

Fig. 7. China: FX outflows have moderated since March, hinting at easing capital outflow concerns

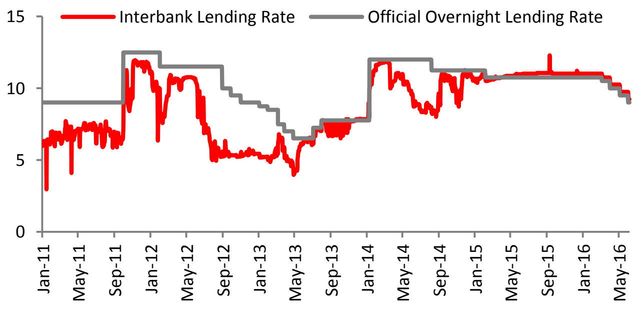
USD billion (LHA); change in USD billion (RHA)



Source: Bloomberg

Fig. 8. Turkey: Interbank rates continue to decline in response to overnight lending rate cuts

%



Source: Bloomberg

Higher property prices being led by mid-size towns

Meanwhile, data last week also revealed how government policies were having different impacts on prices in metropolitan and mid-sized towns. Residential property prices in May rose by 0.8% m-o-m (April: 1% m-o-m), with gains in second and third-tier cities strengthening for the second straight month. Mid-sized cities are benefitting from local authorities' measures to encourage bank lending to households. However, as we expected, the stricter residential mortgage eligibility rules announced in March had an impact on property prices in Beijing, Shanghai and Shenzhen. Looking ahead, as monetary stimulus to the economy becomes less supportive, we expect aggregate property prices to fall, mainly due to lower prices in big cities. At the same time, we expect active policy support for prices in mid-tier and small cities, in a bid to encourage urbanisation and clear excess housing inventories.

Turkey: Another policy rate cut but pause likely in 2H2016

CBRT to remain on hold in 2H2016

The Turkish Central Bank (CBRT) cut the overnight marginal funding rate by 50 bps last week for the fourth time this year. The benchmark repo and reverse repo rates were kept unchanged at 7.5% and 7.25% respectively. The CBRT's present strategy to simplify the monetary policy framework by cutting overnight policy rates so long as benchmark repo rates are kept stable is constructive for the long term. This is likely to limit interbank interest rate volatility in the long term and improve the efficacy of monetary transmission. Nevertheless, believe that inflation and external funding dynamics will not offer the CBRT much leeway in cutting policy rates further. With a significant rise in global risk aversion post the Brexit vote, we assign a low probability to a rate cut by the CBRT for the rest of this year.

II. Economic Calendar

Fig. 9. Upcoming events and data releases

Time*	Country	Data point	Period	Prior	Survey
Expected this week					
	Saudi Arabia	GDP Constant Prices, y-o-y	1Q	3.6%	--
	UAE	Dubai Airport Cargo Volume, y-o-y	May	4.8%	--
	UAE	Dubai's June Real Estate Sales, YTD y-o-y			
	UAE	June Dubai, Abu Dhabi Home Prices by Cluttons			
	Kuwait	CPI, y-o-y	May	2.9%	--
Monday 27 June					
27-29 June	Eurozone	ECB conference in Portugal			
12:00	Eurozone	M3 Money Supply, y-o-y	May	4.6%	4.8%
17:45	US	Markit US Services PMI	Jun P	51.3	51.9
17:45	US	Markit US Composite PMI	Jun P	50.9	--
Tuesday 28 June					
16:30	US	GDP Annualized, q-o-q	1Q T	0.8%	1%
16:30	US	Personal Consumption, q-o-q	1Q T	1.9%	2%
18:00	US	Consumer Confidence Index	Jun	92.6	93.4
28-29 June	Eurozone	EU Leaders Hold Summit in Brussels			
Wednesday 29 June					
03:50	Japan	Retail Trade, y-o-y	May	-0.9%	-1.6%
10:00	UK	Nationwide House Prices, m-o-m	Jun	0.2%	0%
10:00	UK	Nationwide House Prices NSA, y-o-y	Jun	4.7%	4.9%
12:30	UK	Mortgage Approvals	May	66.3K	65K
13:00	Eurozone	Consumer Confidence	Jun F	-7.3	-7.3
16:30	US	Personal Income, m-o-m	May	0.4%	0.3%
16:30	US	Personal Spending, m-o-m	May	1.0%	0.4%
16:30	US	PCE Core, m-o-m	May	0.2%	0.2%
16:30	US	PCE Core, y-o-y	May	1.6%	1.6%
18:00	US	Pending Home Sales, m-o-m	May	5.1%	-1.1%
Thursday 30 June					
03:50	Japan	Industrial Production, m-o-m	May P	0.5%	-0.2%
03:50	Japan	Industrial Production, y-o-y	May P	-3.3%	1.9%
12:30	UK	GDP, q-o-q	1Q F	0.4%	0.4%
12:30	UK	GDP, y-o-y	1Q F	2%	2%
13:00	Eurozone	CPI Estimate, y-o-y	Jun	-0.1%	0%
13:00	Eurozone	CPI Core, y-o-y	Jun A	0.8%	0.8%
16:30	US	Initial Jobless Claims	25-Jun	259K	267K
21:30	US	Fed's Bullard Speaks in London			
	Egypt	GDP Constant Prices, q-o-q	1Q	-3.2%	--
Friday 1 July					
03:30	Japan	Jobless Rate	May	3.2%	3.2%
03:30	Japan	Job-To-Applicant Ratio	May	1.3	1.4
03:30	Japan	Natl CPI, y-o-y	May	-0.3%	-0.5%
03:30	Japan	Natl CPI ex-Fresh Food, y-o-y	May	-0.3%	-0.4%
03:50	Japan	Tankan Large Mfg Index	2Q	6	4
03:50	Japan	Tankan Large Non-Mfg Index	2Q	22	19
03:50	Japan	Tankan Large All Industry Capex	2Q	-0.9%	5.6%
05:00	China	Manufacturing PMI	Jun	50.1	50
09:00	India	Nikkei India PMI Mfg	Jun	50.7	--
12:30	UK	Markit UK PMI Mfg SA	Jun	50.1	50.1
13:00	Eurozone	Unemployment Rate	May	10.2%	10.1%
18:00	US	ISM Manufacturing	Jun	51.3	51.4

* UAE time

Source: Bloomberg

Fig. 10. Last week's data

Time*	Country	Data point	Period	Prior	Consensus	Actual
MENA Data						
	Saudi Arabia	CPI, y-o-y	May	4.2%	--	4.1%
	Saudi Arabia	Non-Oil Exports, y-o-y	Apr	-11.2%	--	-9.1%
	Bahrain	GDP Constant Prices, y-o-y	1Q	2.8%	--	4.5%
Monday 20 June						
03:50	Japan	Trade Balance	May	¥823.2B	¥70B	-¥40.7B
03:50	Japan	Exports, y-o-y	May	-10.1%	-10%	-11.3%
03:50	Japan	Imports, y-o-y	May	-23.3%	-13.8%	-13.8%
Tuesday 21 June						
13:00	Germany	ZEW Survey Expectations	Jun	6.4	4.8	19.2
Wednesday 22 June						
15:00	US	MBA Mortgage Applications	17-Jun	-2.4%	--	2.9%
17:00	US	FHFA House Price Index, m-o-m	Apr	0.8%	0.6%	0.2%
18:00	Eurozone	Consumer Confidence	Jun A	-7	-7	-7.3
18:00	US	Existing Home Sales	May	5.43M	5.55M	5.53M
Thursday 23 June						
	UK	EU Referendum				
06:00	Japan	Nikkei Japan PMI Mfg	Jun P	47.7	--	47.8
12:00	Eurozone	Markit Eurozone Manufacturing PMI	Jun P	51.5	51.4	52.6
12:00	Eurozone	Markit Eurozone Services PMI	Jun P	53.3	53.2	52.4
12:00	Eurozone	Markit Eurozone Composite PMI	Jun P	53.1	53	52.8
16:30	US	Initial Jobless Claims	18-Jun	277K	270K	259K
17:45	US	Markit US Manufacturing PMI	Jun P	50.7	50.9	51.4
18:00	US	New Home Sales	May	586K	560K	551K
18:00	US	Leading Index, m-o-m	May	0.6%	0.1%	-0.2%
Friday 24 June						
12:00	Germany	IFO Business Climate	Jun	107.8	107.4	108.7
16:30	US	Durable Goods Orders, m-o-m	May P	3.3%	-0.5%	-2.2%
16:30	US	Durables ex-Transportation, m-o-m	May P	0.5%	0.1%	-0.3%
18:00	US	U. of Mich. Sentiment	Jun F	94.3	94.1	93.5

* UAE time
Source: Bloomberg

This report is intended for general information purposes only. It should not be construed as an offer, recommendation or solicitation to purchase or dispose of any securities or to enter in any transaction or adopt any hedging, trading or investment strategy. Neither this report nor anything contained herein shall form the basis of any contract or commitment whatsoever. Distribution of this report does not oblige Abu Dhabi Commercial Bank PJSC (“ADCB”) to enter into any transaction.

The content of this report should not be considered legal, regulatory, credit, tax or accounting advice. Anyone proposing to rely on or use the information contained in the report should independently verify and check the accuracy, completeness, reliability and suitability of the information and should obtain independent and specific advice from appropriate professionals or experts regarding information contained in this report.

Information contained herein is based on various sources, including but not limited to public information, annual reports and statistical data that ADCB considers accurate and reliable. However, ADCB makes no representation or warranty as to the accuracy or completeness of any statement made in or in connection with this report and accepts no responsibility whatsoever for any loss or damage caused by any act or omission taken as a result of the information contained in this report.

Charts, graphs and related data or information provided in this report are intended to serve for illustrative purposes only. The information contained in this report is prepared as of a particular date and time and will not reflect subsequent changes in the market or changes in any other factors relevant to their determination. All statements as to future matters are not guaranteed to be accurate. ADCB expressly disclaims any obligation to update or revise any forward looking statements to reflect new information, events or circumstances after the date of this publication or to reflect the occurrence of unanticipated events.

This report is being furnished to you solely for your information and neither it nor any part of it may be used, forwarded, disclosed, distributed or delivered to anyone else. You may not copy, reproduce, display, modify or create derivative works from any data or information contained in this report.