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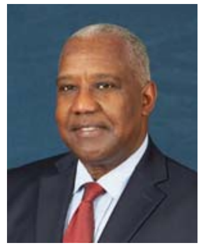

By Byron Shoulton

BREXIT

Global uncertainty soared following the British vote to leave the European Union. Rating agencies Standard & Poor's and Fitch downgraded the U.K.'s credit rating to AA from AAA. At least two years of negotiations between the U.K. and the EU will follow, once formal notification is given the EU of Britain's intent to leave. At a minimum, this development will force major adjustments affecting Britain's trade, investments, financial services and immigration policies. Scotland will likely feel compelled to revisit its inclusion as a part of the U.K. A wide majority of Scottish citizens voted to remain in the EU.

Whether or not Britain's exit represents a first step towards eventual EU disintegration is among the biggest risks. Several EU member states (including France, Spain, Netherlands, Denmark, Greece, Czech Republic, et al.) have growing segments of their populations with misgivings about the EU. Some countries could choose to follow Britain's example. France faces a harsh and divisive campaign in the lead up to presidential elections in May 2017. After the Brexit vote, it is hard to imagine that the future of the European experiment will not be at center stage in the French election campaign. According to a recent study by the Pew Research Center 61% of French citizens hold unfavorable views of the EU.

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Despite the widespread initial uncertainty, normal trade flows will continue in the immediate future between the U.K., the EU, the U.S. and the rest of the world. However, financial markets will seek assurances of political stability in the interim.

The U.K. is the EU's second largest economy (after Germany) and London's role as a premier financial center will now face major changes. The strength of the British pound (which fell by an initial 14% following the vote) will continue to face volatility, reflecting global confidence [or lack thereof] in Britain's new status as an independent country outside the EU. The U.K. economy will suffer initially from diminished confidence, as investments are put on hold and consumer spending will likely weaken. The weakened British pound will make exports from the U.K. cheaper in Europe and elsewhere. Imports on the other hand, will become more expensive. The U.K. imports much more than it exports.

The economic outlook for the U.K. has been revised down since the vote. GDP growth is projected at 1.5% this year [from 1.9% previously]. GDP growth for 2017 is now projected at 0.5% [down from 2.3% previously]. The 2016 outlook for the euro zone [which excludes the U.K.] is projected at 1.3% [down from 1.6% previously]. The already lackluster global economy will be further undermined by events in the U.K. and will likely trigger a downward revision of global GDP growth during 2016-2017. Policymakers are unified in their stance to act to stem further turbulence in global markets that may occur due to the prevailing sense of uncertainty.

The Bank of England has put in place generous access to funding and foreign exchange/dollar swap arrangements. The central bank also gave its assurance of the availability of surplus liquidity to backstop and safeguard the country's financial system, while providing the banking sector all the support it needs should there be a run on banks. These are strategic and significant assurances.

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Elections to replace the sitting British Prime Minister will precede the final roadmap to guide Britain's disengagement from EU membership. The ruling Conservative Party appears split over the leadership succession following the resignation of PM Cameron after the Brexit vote. Furthermore, it now appears that Britain's opposition Labor Party is also in the midst of its own leadership crisis. Selecting a new British Prime Minister to manage the vast changes expected over the next few years will itself be a challenge.

Attempts to minimize the many inevitable dislocations that Brexit will likely cause [within the U.K. and among EU countries], will contribute to the atmosphere of slow global growth and an uncertain economic outlook. Nonetheless, establishing firm new trade arrangements between the U.K. and the EU and with international banking and investment institutions is a top priority. Negotiating new rules and regulations beneficial to the U.K. and its various trading partners in Europe and beyond will also be crucial. It will take time to formally acknowledge that the U.K. is no longer an EU member state. Relocation of certain EU-related banking, financial services and investment banking activities out of London to an EU member-state will be complicated and a major focus of and a bonanza for lawyers. The U.K.'s membership in the EU earned London the reputation as an entry point for access to investment, trade and financial services across the wider EU market. That designation must now move elsewhere. It could result in the loss of many jobs and business in London.

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Banks operating in the U.K. are particularly concerned that they be allowed time to adjust to the many changes to rules and regulations that become applicable once Britain is out of the EU. Banks are already lobbying to avoid unnecessary disruptions and are anxious not to lose access to the EU single market. How much accommodation the EU will provide Britain or British-based entities is unclear at this stage. There are strong sentiments favoring no special consideration for the U.K. now that it has chosen to remove itself from membership in the regional economic bloc.

Separately, Eastern European member states of the EU [including Hungary, Poland, Slovakia, and Czech Republic] have warned EU executives since the Brexit vote not to push for deeper integration within the bloc. These countries fear such a push would create a two-speed Europe which would leave several countries behind and probably disillusioned. Meanwhile, the sudden future loss of British influence, perspective and participation in EU matters won't be insignificant.

However, the U.K.'s role in global affairs including trade, security, diplomacy, financial services and political stability will not disappear because Britain is no longer an EU member. The U.K. will remain a member in the North Atlantic Treaty Organization (NATO) which is committed to an alliance of western security arrangements. The U.K. will continue to participate in the United Nations, the World Bank and several other major international institutions. Nonetheless, with the U.K. out of the EU it now appears that the course of post-World War II financial, economic and political architecture, aimed at a more unified Europe, is inextricably altered.

Turkey

Turkey apologized to Russia for the shooting down of a Russian jet over Turkish territory last November. Both countries indicated an interest in pursuing closer economic and diplomatic ties going forward. Moscow promised to examine lifting sanctions imposed on Turkey for downing the Russian warplane. Both countries pledged to work to restore mutually beneficial bilateral cooperation in trade and economic relations.

Russian sanctions included a ban on charter flights and tour groups to Turkey. Moscow also imposed a partial trade embargo and restrictions on Turkish construction companies operating in Russia. The lifting of sanctions would be a major boost to Turkey's struggling tourism industry at a time when it has been hurt by a string of suicide attacks in the country over the past year. The sanctions have been particularly damaging to tourism. In 2014, 3.3 million Russian tourists traveled to Turkey, providing an important source of income for the sector. Figures recently released revealed a 92% fall in Russian visitors so far in 2016.

Russia also was a major market for Turkish goods, ranging from vegetables to clothing to construction materials, as well as a source of remittances from Turkish workers and small entrepreneurs in Russia. In the first four months of 2016, bilateral trade fell to $4.8 billion, down 45% compared with the same period in 2015.

It is believed that Turkey will be forced to pay a price financially and politically for détente with Moscow. Russia has repeatedly demanded compensation for the downed jet, and could use its leverage over Ankara to force a shift in its policy in Syria. Turkey backs rebels battling the Syrian regime, while Moscow supports the Syrian leader.

Turkey also rekindled friendly relations with Israel following six years of coolness between both nations, following Israel's attack on a Turkish flotilla attempting to deliver aid to Palestinians in Gaza. The normalization of Turkish-Israeli political and diplomatic ties will possibly pave the way for lucrative Mediterranean gas and oil deals. These are seen as potentially extremely beneficial to Israel and could provide a needed spur in economic activity for Turkish entities.

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Both of these moves by Turkey toward rapprochement with key countries send a message that Turkey is anxious to normalize relations with countries playing powerful roles of influence in Middle East affairs. It is also driven by economic and trade opportunities that have been missed by all sides during their respective estrangements.

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China

Foreign business leaders attending the World Economic Forum meeting in China were given needed assurances by the Chinese Premier that China will take all steps necessary to avoid upsetting capital markets. This comes as private investment in China is decelerating and markets have been rattled by Britain's vote to leave the EU. Foreign firms operating in China have complained of increasing difficulties working in the country, including loosely defined laws, perceived protectionism and industrial overcapacity. A recent survey by the European Union Chamber of Commerce reported an all-time high in business pessimism in China.

Forecasters expect Chinese second-quarter GDP growth will fall below the 6.7% achieved in the first quarter (already the slowest pace since the global financial crisis). The Chinese Premier vowed to prevent foreign investors from experiencing roller-coaster rides in their dealings in China.

He acknowledged that China faces two principal problems: its vulnerability to the global slowdown and various internal inefficiencies, including the need to improve the implementation of policies. In addition to having difficulty getting deals approved by local officials, foreign businesses operating in China cite the country's protracted anti-corruption campaign as a factor that has held back decision making. The anti-corruption campaign has made many officials afraid of unwelcome attention.

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Business leaders in heavy industry, software, online learning programs and other high-tech sectors, were told that going forward China will reduce the role of state-owned companies in those sectors. However, it was made clear that this process will be gradual. The Chinese leader said China is committed to embracing innovation, cloud computing and "big data" and stressed that China needed more links between its internet and the rest of the world, while still maintaining control given the country's level of development.

Britain's exit vote from the EU could slow the record surge in acquisitions of European companies by Asian buyers. The consensus is that Asian investors will take a wait-and-see approach while some deals currently in the pipeline will be delayed. Mergers and acquisition activities by Asian buyers in Europe ballooned in 2016 in the run-up to the British referendum, with Asian investors buying up 298 European companies valued at a record $104.3 billion, a 68% increase from the same period in 2015. Chinese investors have been the most active and account for 21.8% of European acquisitions so far in 2016.

By Byron Shoulton, FCIA's International Economist
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FCIA's Deals Of the Month

Single Buyer Non-Cancelable Limit Policy:
$15mm limit of liability in Auto Sector, USA

Key Accounts Non-Cancelable Limits Policy:
Policy supporting sales to key buyers in the steel sector, obtained for risk mitigation on non-payment by buyers, US and Canada

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