Close Brothers
Asset Management

The EU referendum
Investment considerations



This piece is not intended to express or take a view on the political aspects of the referendum itself and no such inference may be drawn from its content. This document is merely designed to be a discussion piece regarding some of near-term risks of the forthcoming EU referendum and is intended to highlight some of the key investment considerations.

Summary

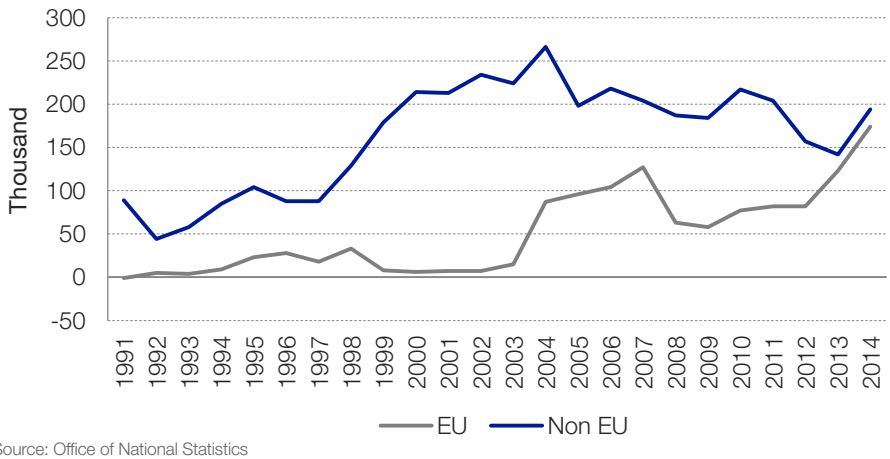
- Divining the investment impact of Brexit is fraught with uncertainty. Short-term, markets could fluctuate, especially in the run-up to the vote, but the longer-term outlook is much more complex and **could be favourable or unfavourable for the UK economy**, depending on the outcome of the negotiations with the EU and the ultimate fate and longer-term strength of the Eurozone construct.
- Market consensus currently expects a "Stay" vote to prevail. However, some risk has been priced-in, highlighted by a 6% fall in Sterling since the beginning of the year, as a vote to leave the EU could, at least in the short-term, have economic and market consequences. In case of a "Stay" vote, investors may breathe a collective sigh of relief (if only because it is one less uncertainty to worry about), and refocus attention on the manifold other issues affecting global economic conditions.
- The major short-term 'risk' considerations to Brexit are in the following areas: Trade, Cost of Business, Bank Passporting and Immigration. In the worst case scenario where negotiations are protracted or are seen not to favour the UK, growth in both the UK and Europe might be adversely affected. The financial environment could become more fragile, seeing further sterling weakness and an impact on Foreign Direct Investment (FDI) flows. Under this perceived 'worst case' scenario the UK credit rating could come under pressure. The sectors most affected in this scenario might be: financials, importers, leveraged companies and firms relying on cheaper EU labour. However, long-term effects are impossible to assess and might very well be favourable for the UK.
- Our investment strategy has not been to make major changes on the possibility of Brexit as the outcome is too uncertain at the moment. Having said that, we are not heavily exposed to the areas most vulnerable to near-term volatility around a Brexit decision. We focus on large cap shares and currently hold a relatively low exposure to Financials favouring Consumer Discretionary and Staples instead. We also continue to maintain positions in shorter duration bonds.
- In this piece, we focus on some of the near-term risks of Brexit, rather than taking a view on its longer-term impact.

In the run-up to the upcoming EU referendum on June 23rd, we wanted to share our thoughts on the possible economic and financial market consequences of Brexit. We should say upfront that market consensus expects a STAY vote to prevail. Hence the circa 6% weakness in Sterling since the start of the year may in fact be the only collateral damage of this momentous decision. On no "Leave", attention will refocus on the manifold other issues affecting global economic conditions.

However, a vote to leave the EU could, at least in the short term, have economic and market consequences. Hence, it is worth reviewing the permutations of possible outcomes. Our investment strategy has not been to make major changes on the possibility of Brexit as the outcome is too uncertain at the moment.

As it turns out, however, we are not heavily exposed to the areas most vulnerable to a Brexit decision. We believe, moreover, that given the international nature of the UK index, with over 45% of its shares exposed to international as opposed to domestic factors, that what happens in China, the commodity complex, and with US growth are at least as, if not more important than, the outcome of the June 23rd referendum.

Figure 1: Net migration to the UK by EU and Non EU Citizens



Source: Office of National Statistics

Of course over the longer-term, the implications of a "Stay" vote depend on the course of the EU and how the single currency union develops. Conversely, the implications of a "Leave" vote would vary greatly depending upon the terms that the UK can negotiate with its European trading partners. We note that Article 50 of the Lisbon Treaty provides for negotiations up to two years (or extended if necessary) for any country that wishes to leave the EU. Some form of modified free trade relationship is likely to be the outcome as it is in the interests of both sides to maintain current economic interdependencies. The EU is an important trading partner of the UK accounting for 44% of UK exports and 53% of UK imports (2014 data). Indeed the UK runs a current account deficit in goods with the EU. Thus both sides have an incentive to find a new way forward in the event of Brexit.

However, an extended period of uncertainty may accompany the ensuing months of exit negotiation, both positive and negative, as positions important to the UK are achieved.

Areas of economic impact

There is a lot of doom-mongering amongst forecasters on the exact impact of a "Leave" vote. What we can say with some certainty is that a leave vote would bring heightened uncertainty and market volatility to a year already fraying on investor nerves. Clearly the issue of greatest concern vis à vis the equity market is the extent to which the UK can protect its free trading access to the European market whilst allowing its banks to passport services to the EU, i.e. not be forced to open European offices to conduct business. Immigration is also an important issue as access to labour from the EU has been largely beneficial to the UK, but comes with a cost as well. The fiscal cost of EU membership seems more of a balanced issue, as the UK's contributions are unlikely to fall to zero if we continue to seek preferential trade access.

All of these issues will need to be re-examined, if not completely renegotiated in light of a Brexit vote. Negotiations could be protracted, exacerbated by EU concerns that a light touch deal for the UK will encourage other EU separatist movements. Any resurfacing of Eurozone 'break-up' concerns would further destabilise the situation.

Each of these issues are reviewed in more detail in the following paragraphs.

Trade: The EU's biggest single advantage is the barrier-free common market. The EU takes 44% of Britain's Exports (or 63% if one takes into account all the benefits from the trade deals which are in place through the EU). Britain is not a negligible trading partner either, as it takes 10% of the EU's exports (circa 9% of each of Germany's and France's exports). The negotiations of a new deal, should a "Leave" vote prevail, will be made with a consideration of both balances in mind.

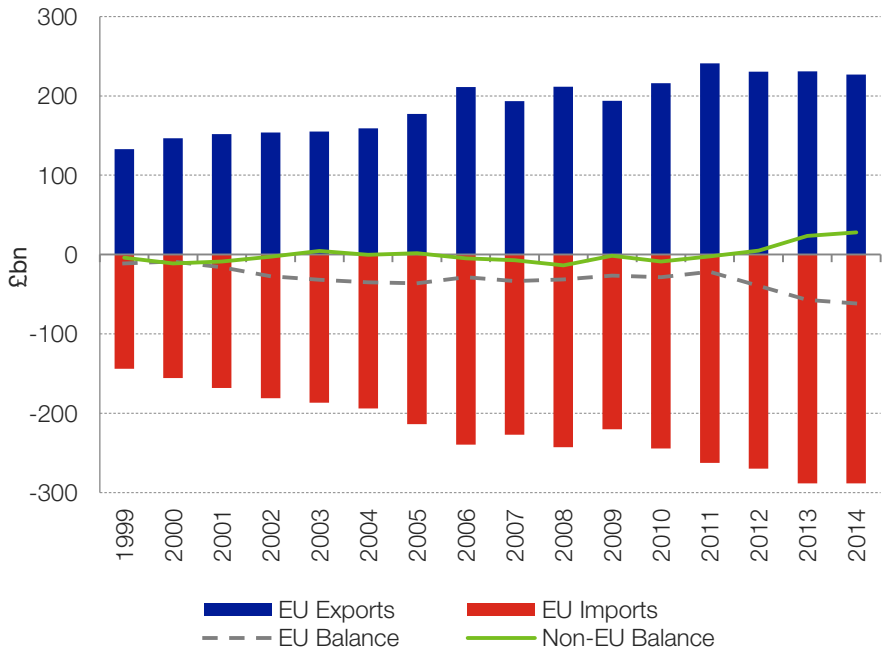
The UK will also need to negotiate its terms of access to EU trade deals.

The EU has 53 trade deals mostly with major global trading partners such as the US, China and India. All of these will have to be negotiated again, from a UK only vantage point.

Of course a lot of the trade deals with Europe could be upheld, as is the case with Switzerland and Norway. However, for these two countries to have free movement agreements with Europe, they adhere to the common market rules and make regular payments to the EU budget. Hence, free trade and market access will continue to come with a cost.

Cost of business: In the unlikely case that border controls or tariffs with the EU emerge, this would increase the cost of cross-border business. While for other countries this is the norm, the terms of devolution from the current status quo for the UK will need to be addressed. It is not clear that companies in a Brexit world will be free from all EU rules and regulations. Meanwhile whilst there is uncertainty around new rules this may come with an additional cost on those businesses selling into the EU.

Figure 2: UK trade balance with the EU



Source: Office of National Statistics

Bank passport: The UK runs a service surplus with the EU; currently around 40% of UK financial services are exported to the EU. This trade reality means the impact of Brexit on financial services is potentially the most significant area to be addressed. EU members may no doubt wish to improve their importance and status in this important market segment.

The UK will aim for reimplementation of EU Single Market Passport rights. Passporting means that a British bank can provide services across the EU from its UK home. It also means that a Swiss or an American bank can do the same from a branch or subsidiary established in the UK. Both Goldman Sachs and JP Morgan have testified before the Parliamentary Commission on Banking Standards regarding the importance of the UK's EU membership in providing a base from which non-EU businesses can passport across the EU.

Passporting into the EU from the UK will need to be agreed through negotiation. If passporting were not achieved, financial services businesses wanting to continue to provide services across the EU would have to establish subsidiaries in mainland Europe.

Immigration: Annual net migration from Europe to the UK has doubled since 2012, reaching 183,000 per annum in March 2015. At the current juncture, an estimated 2.3 million EU citizens live in the UK. Similarly, 1.3 million British citizens live in the EU. Questions around domicile and travel will need to be resolved.

Many companies, including major listed names in the retail space, rely on cheaper labour from EU countries with lower living standards. Immigrants are fiscally net contributors to the UK's budget and have supported an unprecedented housing boom, especially in London. On the other hand, significant fiscal savings could be achieved by a reduction in benefits. The major consideration will be the UK's ability to negotiate immigration terms that provide the labour we need as an economy at an affordable cost.

Fiscal: The British government contributes net £10bn annually to the EU's budget. Saving that money could reduce the fiscal deficit by c.10%. However, losses from lower migration and potential economic disruption could minimise the impact of these savings. As mentioned, access to the EU market in any form, such as that Norway or Switzerland, will still entail some sort of fiscal contribution.

Possible "short-term" economic consequences of a decision to leave:

The UK has two years to negotiate a new way forward. In the short-term, uncertainty will prevail. Investors will be concerned about negative consequences in the following areas:

- **UK and European growth:** Uncertainty about a positive resolution could undermine confidence and investment leading to a slowdown in growth. Some city forecasters have predicted that the UK could experience a growth shock of 1-1.5% on Brexit. Europe will no doubt also be hurt as its large trading market becomes detached. Possible Eurozone 'break-up' contagion concerns could further exacerbate a slow down in Europe. Hence, Brexit in the short-term could impact growth in the UK and EU, already threatened by a range of global macro-economic factors.
- **Financial fragility:** The UK currently runs a current account deficit of 4.2% of GDP, and maintains a high dependence on foreign capital for financing it. Any deterioration in the terms of trade could increase UK financial vulnerability.
- **The currency** would likely head lower as investors flee uncertainty, a position exacerbated by likely Bank of England liquidity injections if financial conditions threaten the fragile economic recovery. Lower sterling could well force import prices higher.
- **Credit rating:** Various rating agencies have warned that they could cut the UK's AA+ sovereign credit rating in case of a "Leave" vote. This means that the UK government and British companies could see their costs of finance rise.
- **Foreign direct investment (FDI):** at least in the short-term, FDI flows may come under pressure if foreign investors choose to invest in other EU countries to gain unrestricted access to the single market.

The Bank of England has made it clear that access to funding and liquidity will increase in the case of a no vote and no doubt Draghi could resort to stepped-up quantitative easing, so as to assuage these affects. Investors will remain concerned, however, as they have been in 2016, about the efficacy of monetary policy to prevent a growth slowdown and possible renewed disinflationary pressures.

Financial consequences

In the short-term, any or all of the following might transpire as a result:

- Rise in equity risk premium across UK and European financial markets.
- Decline in the value of the pound sterling against the Euro and USD.
- Decline in valuations linked to concerns around earnings.

However a weaker sterling could be helpful to exporters, particularly companies exposed to the still growing US market. If swift progress is made on key economic negotiations, moreover, a sharp decline in risk assets could well be followed by a rebound in growth and share prices, as reality turns out to be much better than worst-case expectations.

Sectors most affected

In the equity space we have identified four major areas that could suffer from a Brexit vote: financials, importers, leverage and labour.

- **Financials:** While several major banks have declared that they do not intend to change their headquarters, clarity on passporting could affect UK based financial shares with business in the EU.
- **Importers:** the fall of the Pound could deal a blow to companies which import finished goods.
- **Leverage:** The potential of credit downgrades from rating agencies could have an adverse effect for highly leveraged companies and smaller capitalisation ventures that need financing.
- **Labour:** We could see weakness in certain retailers whose businesses rely on cheaper labour from EU countries. A fall in labour supply from the EU could reduce labour productivity and increase wage costs to the detriment of the corporate sector, but longer-term affects may also be positive as well.

However, lower sterling could be net positive for exporters as they could benefit from an increase in sales volumes due to more competitive pricing from overseas markets. More defensive sectors, with exposure to internal demand should also suffer less, so we expect relatively better performance from sectors such as healthcare, utilities and certain consumer names.

Our strategy:

The outcome of a "Leave" vote is not yet fully priced in, so we would avoid any speculative positioning in the run-up to the referendum. Moreover, while market volatility on a Brexit vote will affect UK equities, stock selection still remains key, as business mix, balance sheet construction and currency exposure will determine the longer-term outlook for shares.

Our current positioning should also benefit from:

- **Large capitalisation focus:** A focus on large, liquid shares as opposed to smaller or mid cap as the dominant component of portfolio positioning. We think the risk of Brexit favours the larger UK equity shares over mid and smaller cap names.
- **Relatively low exposure to financials:** Due to growth uncertainties and recent investor concerns over the impact of negative interest rates and enhanced credit issues associated with the energy sector and parts of the emerging world, we have already chosen to hold a lower exposure to this sector.
- **A higher exposure to consumer discretionary and staples** could be both more defensive and benefit from weaker sterling in the months up to/around the Brexit referendum. Companies' translation effects particularly with exposure to sales in the US will likely benefit from weaker GBP/USD.

We might need to reduce exposure to shares **exposed to cyclicality** in the UK and or Europe if the growth effects become more than transitory in nature.

In summary:

Overall, a vote to leave the EU could bring short-term economic and financial risks, the severity of which depends upon the fate of exit negotiations.

Over the medium-term, the impact might well be muted and advantageous to the UK. Investors can see both positives and negatives and the ultimate outcome is impossible to predict.

We feel our current strategy of not being highly exposed to the most vulnerable areas on a Brexit vote could assuage any short-term impact. As active investors (who are constantly reassessing the situation) we may make further adjustments to portfolios.



Sources:

Office of National Statistics

Bank of England

Bloomberg

Credit Suisse

Société Générale

J.P. Morgan

Capital Economics

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