Heading for the Brexit? 1st March 2016

Equity markets have suffered over the past few months from Chinese devaluations, slowing growth, European banking fears and a collapse in the oil price, all of which made January 2016 the worst start to a year for investors since 2012. Then David Cameron announced a deal in Europe and a visit to the polls on 23rd June to decide our future European destiny.

Ever since the announcement, the nation's gaze has been turned unavoidably to the prospect of Brexit. Whilst membership of the EU has long divided opinion in political parties the concept of Brexit is a relatively new phenomenon, with the referendum forming part of the Conservative manifesto last year in an effort to deter the rise of defections to UKIP.

Now that the shackles have been removed by David Cameron and all politicians are free to air their own views on the subject, we thought it appropriate to look at what is at stake from an economic perspective and how that might impact on markets both in the short and medium term.

So what is the European Union?

The European Union was formed under its current name in 1993 but can trace its roots back to the European Coal and Steel Community (ECSC) and the European Economic Community (EEC) which were formed in the 1950's to create unity between Germany and France. In 1951 there were only six members but over time this number has grown and at present there are 28 members.

The European Union operates a single market which allows free movement of goods, capital, services and people between member states.

What are the possible outcomes?

The voting papers will simply ask whether the electorate wishes for the UK to Remain or Leave the European Union:


SCHEDULE 4 Regulation 83
FORMS

Form 1 – Form of ballot paper
Front of ballot paper

Referendum on the United Kingdom's membership of the European Union
Vote only once by putting a cross ☒ in the box next to your choice
Should the United Kingdom remain a member of the European Union or leave the European Union?
Remain a member of the European Union ☐
Leave the European Union ☐

There is a reasonable amount of scepticism around the credibility of opinion polls following last year's general election but they do at present point to the voters favouring 'Remain', with the Remainers on average enjoying a five-point lead in polls this year and the bookies making 'Remain' a firmer favourite at 4/11 against 'Leave' at 9/4.

A recent YouGov poll of 1,735 people however showed that 42 percent of Britons would vote to leave compared to 38 percent who wanted to stay - a 4 percentage point gap that is the largest in favour of a British exit since YouGov started these polls in October 2014. But then who really trusts the polls these days anyway?

Who favours what outcome?

Whereas with the Scottish independence vote there was a clear divide between the differing political parties, when it comes to Brexit the leaders of the main parties are united in their view that the UK should remain within the EU and they will campaign under the name '**Stronger In**', albeit with differing enthusiasm.

The same cannot be said of the individual MPs within each of their parties or indeed the cabinet. At present there are 129 Conservatives (seven cabinet members), seven Labour, one UKIP and eight DUP MPs who are in favour of the UK leaving the EU.

Why, when leaders are united, are the MPs of differing parties not called to order?

The Conservatives have been divided on the issue of Europe for decades and David Cameron has decided to allow a free vote on the issue rather than risk a long-lasting split in the party. Frustratingly for him, the charismatic and popular Boris Johnson has decided to campaign to leave and he will garner significant media attention as a result. Cynics will argue that Mr Johnson is feathering his own nest by switching to the 'Leave' campaign, the suggestion being that if Brexit takes place, Cameron may resign leaving Johnson in a strong position to take up the leadership. If not then he may still win the race anyway when Cameron does eventually stand down, based on his stance on Europe.

One hurdle for the 'out' crowd is that the Leave campaign is unlikely to be united under a single banner or leader. Indeed, we are still awaiting confirmation as to whether '**Grassroots Out**' or '**Vote Leave**' will have the status of 'lead campaign' and therefore with it the increased spending limit of £7m rather than lower limit of £70,000 for other campaigns. Grassroots Out (GO Movement) is led by the unlikely union of Nigel Farage and George Galloway. Galloway recently tweeted about his relationship with Nigel Farage that "*we are not pals. We are allies in one cause. Like Churchill and Stalin...*" Curious bedfellows but at least united with a common aim.

Vote Leave, with a more neoliberal economic perspective, is being led by a more credible duo of Cabinet Ministers Boris Johnson and Michael Gove.

Economic Ramifications

Whilst there are wider issues surrounding national security, welfare and political sovereignty all of which we will hear plenty about over the next few months, we have chosen to focus on the economic arguments and whether or not leaving the EU will have a detrimental impact on growth in the UK.

Given that no member has chosen to leave the EU previously, the economic impact in the event of Brexit is largely a guesstimate and the two campaigns will offer differing data to support their own argument. Economists and investment managers are divided on the issue:

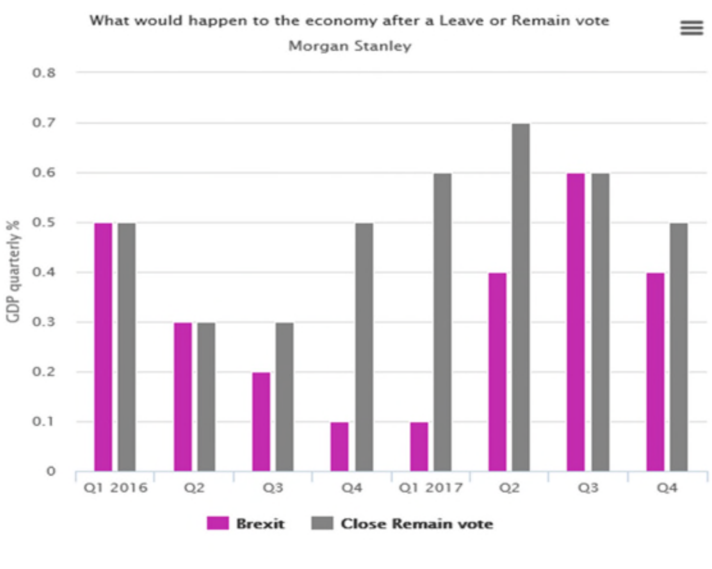
"Although the economic impact of Brexit on the British economy is uncertain, we doubt that Britain's long-term economic outlook hinges on it" – Woodford IM & Capital Economics 2016

"The referendum will not make any major difference to 2016 views. However, a no vote would lead to a sharp drop in growth in 2017" – Gavyn Davies – Chairman of Fulcrum Asset Management

"No economic player likes uncertainty. They don't invest, they don't hire, they don't make decisions in times of uncertainty" – Christine Lagarde Feb 2015

Analysis by the London school of Economics concurs with a pessimistic view, suggesting that in a best case scenario, Brexit reduces UK income by 1.1% of GDP and in a pessimistic case, UK income falls by 3.1% or circa £50 billion per year.

Morgan Stanley are of the view that the UK will flirt with recession in 2017 if we were to vote to leave:



Nobody knows for sure what the real economic impact of Brexit will be because it's never before been tested.

What are the touted advantages and disadvantages of a Brexit?

Advantages

⇒ Less onerous regulation

⇒ Better, re-negotiated trade deals

⇒ Savings on European Union contributions

⇒ 'Adjusted' migration policy

⇒ Control of Britain's sovereignty

Disadvantages

⇒ Loss of access to the European single market

⇒ Likely tariffs on EU exports and imports

⇒ Reduced foreign direct investment

⇒ Major banks relocate to Frankfurt

⇒ Legal wrangling and re-written legislation takes ten years to iron out

Trade agreements are the single most important economic factor to consider in a Brexit

When the UK joined the European Economic Community in 1973, just over 30% of UK exports went to the EU. Now over 50% of UK exports are to EU countries and a further 13% of exports are directly linked to other countries due to our European Union membership. As such if we were to vote to leave the single market there will be significant pressure to negotiate favourable trade agreements with both the EU and other global economies in the two year cooling-off period.

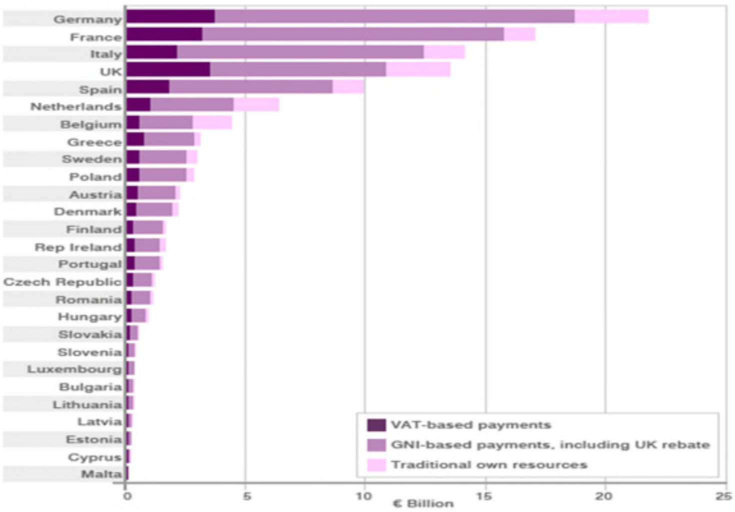
There will be comparisons with Switzerland and Norway, given that they both lie outside of the EU but yet have negotiated free trade agreements giving them access to the single market. It is unclear however if Britain would be in a position to negotiate similar terms, given that both Switzerland and Norway put terms in place at a time when the EU was being formed. If the process was made easy for us now then this sets an uncomfortable precedent and might lead others to look to follow in Britain's footsteps. On the other hand, it is ridiculous to suggest that Europe will not trade competitively with the UK on a point of principle.

Having left the EU we would receive "Most Favoured Nation Status" (MFNS) according to longstanding World Trade Organisation agreements. This means that if no alternative terms have been agreed that the tariffs imposed on any exported good cannot exceed 5.4%, so there is at least a tariff cap, however this is a fairly high maximum high level. Exporters would hope that more favourable terms do not take as long as Canada's negotiations, which took more than seven years to finalise.

The Leave campaign is of the view that any short-term increase in EU tariffs can be more than offset by negotiating improved terms with global powerhouses such as China and India. At present we must negotiate terms alongside other EU members but outside of the EU we could look to put in place more favourable terms with those faster growing economies. That said the EU are currently negotiating new trade agreements with both the US and Japan which will save the UK consumer circa £6.3 billion a year.

In addition to improved trade terms with other countries, the Leave campaign believes that any short-term cost of increased tariffs could be offset by the savings made on the UK's current European Union contribution. In 2013 the UK paid £13.7 billion to the EU by way of a contribution and an additional £2.3 billion from VAT receipts. The net cost is reduced, to circa £10 billion (0.53% of UK national income) as each of the other 26 countries provide the UK with a rebate based on their Gross National Income (GNI).

A breakdown of contributions from the 27 states that were members in 2007 is shown below:



Brexit would not however lead to a complete removal of these payments as it is likely that to remain in the single market even outside of the EU we would be expected to make a contribution of sorts. By way of comparison Norway and Switzerland make a payment equivalent to circa 80% and 40% of the UK's current contribution respectively on a per capita basis for the right to participate in the single market. It's not cheap to obtain a seat at the table.

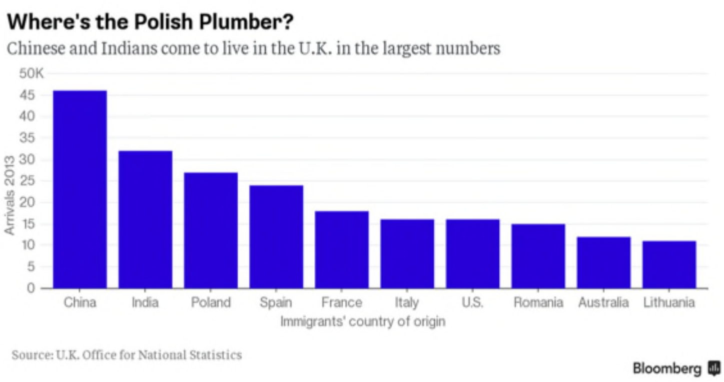
It is clear that if companies do delay or indeed cease investment it could have quite significant ramifications for GDP growth in the UK prior to any bilateral terms being put in place. The UK received the most Foreign Direct Investment (FDI) of any European country in 2011, and of all of the countries in the world only the US has higher inward FDI. One of the prime reasons that overseas companies have selected Britain for at least some of this FDI is that we act as a conduit into the EU and comply with their regulations. For example Swiss financial companies are unable to trade directly in the single market and have been forced to provide services through their London offices. Brexit would have significant ramifications for these and other UK financial services firms, hence why it seems to be playing an ever increasing part in the London Mayoral debates (cue flip-flopping on the subject from Eurosceptic turned reluctant Europhile Sadiq Khan).

Migration is an emotive issue that may sway the public

Not only does the UK's position within the EU lead to a high level of FDI at a corporate level but also from the perspective of net migration into the workforce. Recent figures from the Office for National Statistics estimated that net migration to the UK was 323,000 in the year to September 2015, half of which was EU citizens coming to the UK to work.

The Office for Budget Responsibility (OBR) calculated in 2012 that net immigration of 250,000 per year to the UK would add 0.5% annually to GDP. However, immigration on this scale would also add 0.4% to the population so growth in GDP per head would only be of the order of 0.1%.

Whilst David Cameron is still committed to reducing net migration below 100,000 by 2020 it is unlikely that Brexit could be a driver for this. Not only would the UK probably have to maintain free movement of labour to remain part of the single market, it should be considered that other countries outside of Europe, including China and India, are responsible for an ever increasing proportion of UK immigration.



Those in favour of Brexit believe that we could put in place a more tailored immigration policy with a focus on a more highly skilled workforce. This could however have consequences for low wage areas of the economy such as agriculture and manufacturing that are dependent upon migrant workers and thus lead to wage inflation and general inflationary pressures.

So from an economic perspective it seems that there is general agreement from both sides that Brexit will in all likelihood lead to a slowdown in UK growth in the short-term. However, the longer term ramifications are very dependent upon one's views of the economic strength of the Union or the UK's ability to negotiate better terms with both the EU and other trading partners in isolation. As above, the ability to re-negotiate trade agreements is absolutely key.

Portfolio and Equity Market Ramifications

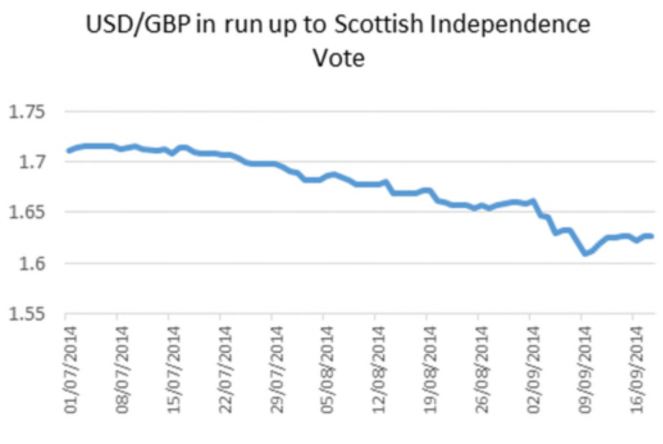
"Uncertainty is the enemy for sentiment — this kind of event doesn't happen very often." Alan Clarke, Economist, Scotiabank

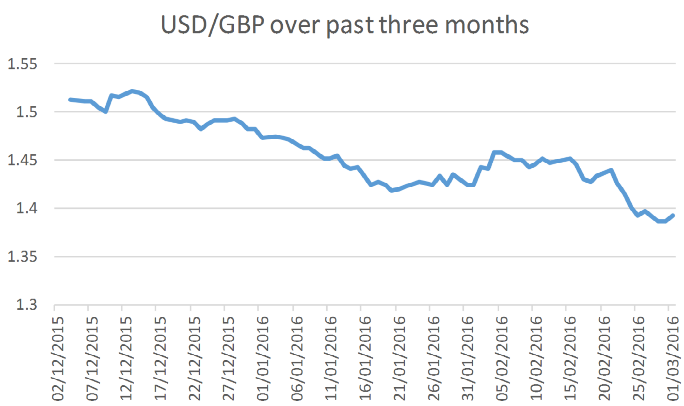
"We will continue to ignore political and economic forecasts which are an expensive distraction for many investors and businessmen" – Warren Buffet

It has become clear over both the past couple of months and in the lead up to the Scottish independence vote that the political and economic uncertainty created by such a public referendum will be most acutely felt in the currency markets.

The sell-off in sterling has now surpassed the sell-off in the run up to the Scottish Independence Referendum. In September 2014, the pound fell as much as 1.43% in one day against the dollar, after an opinion poll showed that Scots were increasingly in favour of voting "yes" to leave the U.K. That poll came 12 days before the vote and was the first to suggest that Scotland might vote for independence.

That decline was eclipsed by last Monday's slump in the pound, with sterling down by 1.6% against the dollar after Boris Johnson declared his support for the campaign to leave the European Union. This gathering sterling weakness has continued ever since and consequently the cost of buying options on the pound that can protect an investor against a fall in sterling have spiked to their highest price in over four years, too.





Looking back at price movements to when sterling was ejected from the European Exchange Rate Mechanism in 1992 suggests that both corporate and sovereign debt (Gilts) could suffer if there was a vote to leave, leading to yields increasing and values falling. This would stem from credit-rating downgrades and all three ratings agencies (Moody's, S&P and Fitch) have suggested that downgrades are likely following Brexit.

A vote in favour of Brexit would in all likelihood cause a drop in U.K. equity valuations at least in the short-term and it is likely that we would see a degree of underperformance of UK markets relative to global peers. There is a consensus view that it would be the more domestic focused FTSE250 and smaller companies' indices that would suffer the most due to a slowing growth outlook for the UK.

Whilst this reinforces our long-held view that it is appropriate to have a bias to overseas equities, we also believe that there will be opportunities for active managers in the UK mid and small cap markets to select companies with greater overseas earnings that are now looking even cheaper despite their operating environment being largely unchanged. Also, the UK has underperformed global equities (particularly the US) for many years, leaving most UK companies on much cheaper valuations than their US counterparts already.

Whatever your political views (and it is very clear that the issue of Brexit has been far more divisive than the Scottish referendum was), investors don't like the uncertainty caused by a potential leap into the unknown. Notwithstanding security and immigration, both hugely important and emotive issues, whether the UK will be better off economically in the long-term from a Brexit is arguable either way and impossible to properly assess. This point is a major issue for both campaigns but putting it to one side, we believe that it is undeniable that the short-term economic impact on the UK will be significant. The legal wrangling and haggling over trade agreements could run for years after a successful vote to leave and voters will need to consider this on the 23rd June. In the meantime, we can at least be thankful that the decision to call a referendum has led directly to the EU dropping plans to ban high powered kettles and toasters for fear of scaring the UK public into outright rebellion. Tea time, it seems, is safe – at least for now.