ARTORIUS WEALTH

INVESTMENT OUTLOOK

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BREXIT risk

BREXIT is like Voldemort in Harry Potter - a 'Risk-Who-Must-Not-Be-Named'. The UK government is seeking to renegotiate its relationship with the European Union (EU) and by the end of 2017 the government has committed itself to hold a referendum on whether the UK should remain in or leave the EU. Whilst this has begun to receive some attention in political and even economic circles, the lack of impact on Sterling indicates that the market is burying its collective head in the sand. The British Prime Minister formally set out his four key objectives on 10 November 2015:

- To protect the Single Market for Britain and others outside the Eurozone.
- To 'write competitiveness into the DNA of the whole EU'.
- To exclude Britain from a commitment to an 'ever closer Union' and to instead strengthen the role of national parliaments.
- To restrict access to welfare payments for migrants

The Eurosceptic view of Brexit

EU momentum has generally been directed towards greater integration, both politically and economically, but sceptics decry this approach. Many see the EU working better as a free trade area, not as a federalist state.

The free movement of workers and open access to markets are widely acknowledged as beneficial principles, but at a more granular level, the critics argue that issues with bureaucracy and overregulation in the EU hold back small businesses. Despite a notional single market, businesses still face a vast array of local laws and taxes.

Eurosceptics believe that if the UK leaves, indigenous businesses will at least be free from the additional regulatory shackles that the EU imposes and will therefore benefit overall. As SMEs suffer the burden of regulation more than their larger counterparts, they should benefit disproportionately if there is a net reduction in regulation.

The pro-EU view of Brexit

Perhaps the most obvious advantage of EU membership is the size of the Single Market. EU businesses get direct access to a 500-million-strong customer base, the world's largest trading bloc measured by GDP, and can freely employ people from across the union. Such a platform allows small businesses to grow faster and further, and Brexit would mean a loss of these benefits, with no certainty about what might replace them.

Furthermore, Brexit would most likely result in a recession, given the attendant market turbulence – an unwelcome side effect, to be sure, and SMEs are more vulnerable to market dips. Combined with widespread upheaval in customer and supplier relationships, disruption to the employment of foreign nationals, and a potentially bumpy transition to new trade treaties, it is likely that a large number of SMEs would be put out of business if the UK decides to leave the EU.

In 2012, the UK economy made payments of £16.4bn, just over 1% of GDP, to EU institutions. On the other hand, the UK government received a rebate on its contributions to the EU budget of £3.1bn and £0.9bn in other receipts. The private sector received £2.9bn from EU institutions. So overall, the UK paid a net £9.5bn into the EU, about 0.6% of nominal GDP.

In addition non-EU members like Norway and Switzerland pay to be part of the European single market. On a per capita basis, Norway's financial contribution to the EU is 83% of the UK's payment and Switzerland's contribution is 41% as large. Therefore, if the UK were to adopt the Norwegian or Swiss models after leaving the EU, the fiscal savings of Brexit would be substantially less than 0.6%, according to analysis from the London School of Economics.

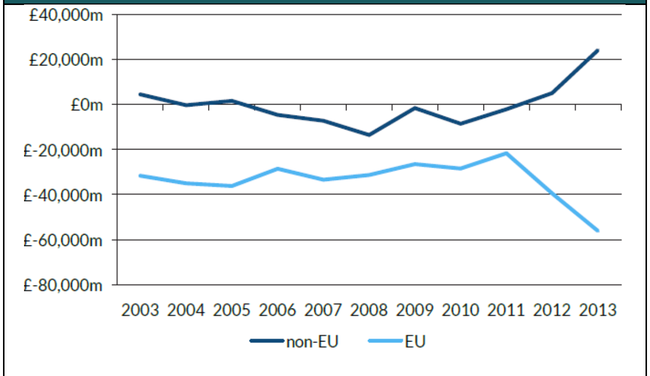
How to leave?

Were the referendum a surprise and result in an 'leave', the starting assumption is that the UK will avail itself of the procedures set out in Article 50 of the Treaty of the European Union. This is the only established legal way to leave the EU. Once triggered, there is no turning back, it excludes the UK from key decisions as well as the final vote and it leaves the EU in charge of the timetable during two years of negotiations, following which the UK could be presented with a 'take it or leave it' deal.

Trade with the EU

Britain is a 'small open economy' which is very reliant on trade, both in goods and, often overlooked, services. Currently, exports to the EU represent about 10% of UK GDP. And, despite the sharp rise in the proportion of trade accounted for by emerging economies, the EU still accounts for approximately half of UK trade.

UK runs a trade deficit with the EU, more than offsetting the surplus with the RoW



Source: Artorius Wealth, Thomson Reuters

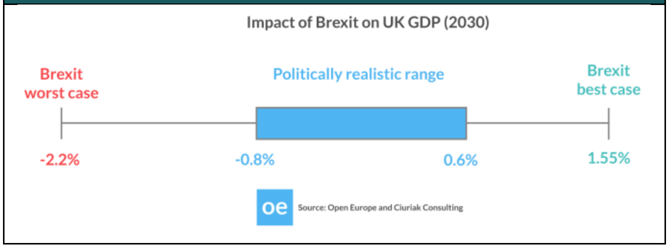
But, under most feasible scenarios, all this would still be the case after exit; UK membership of the World Trade Organisation means that tariffs on goods would remain fairly low. So the immediate direct impact of leaving the EU on trade might not be that great.

If the UK were to leave the EU, the UK might have more flexibility about some aspects of the regulatory framework. If we wanted to maintain access to the Single Market, however, we would have to continue to observe EU regulations in a number of key areas. So the flipside of securing the continued benefits of access to the EU market for trading purposes would be an acceptance that the UK remains bound by much, if not all of the EU's regulatory 'acquis'. Any flexibility would be limited, and likely subject to negotiation.

Potential Impact of leaving

Research in 2015 from Open Europe show a range of -0.8% (permanent loss) to +0.6% (permanent gain) to GDP by 2030. The gains require global free trade arrangements (including labour mobility) and extensive deregulation. Worse and best case scenarios lie beyond this central range, and in any case estimates at this point reflect a minimal disruption in the rest of the EU to the UK leaving.

A range of economic outcomes from a UK exit from the EU



Source: Artorius Wealth, Open Europe

In a worst case scenario, where the UK fails to strike a trade deal with the rest of the EU and does not pursue a free trade agenda, Gross Domestic Product (GDP) would be 2.2% lower than if the UK had remained inside the EU.

In a best case scenario, where the UK strikes a Free Trade Agreement (FTA) with the EU, pursues very ambitious deregulation of its economy and opens up almost fully to trade with the rest of the world, UK GDP would be 1.6% higher than if it had stayed within the EU. Given the degree of uncertainty around what leaving the EU would look like these best estimates may turn out to be incorrect. But the uncertainty factor is likely to result in downside risk, rather than a wave of new found economic optimism.

Open Europe's scenario analysis reflects three potential outcomes for the UK if a 'leave' vote prevails:

Beyond the border: Opening up the UK economy to trade with the rest of the world – including the USA, India, China and Indonesia – is essential to economic growth post-Brexit. However, this would mean exposing UK to new levels of competition from low-cost countries, and would therefore be politically very sensitive.

On the border: In order to be competitive outside the EU, Britain would need to keep a liberal policy for labour migration. However, of those voters who want to leave the EU, a majority rank limiting free movement and immigration as their main motivation, meaning the UK may move in the opposite direction.

Behind the border: EU rules have largely been incorporated into UK law, and would remain in force until the UK Parliament decided to amend or scrap them. Outside the EU, Open Europe estimate that a very liberally inclined UK government could in theory cut the cost of the most burdensome EU regulations by an amount equivalent to between 0.7% and 1.3% of GDP. However, on current evidence, Britain is likely to keep many of these EU rules, for example on climate change where it has gone further than the EU standard.

Credit Rating

A vote to leave the EU could hurt the UK's strong credit score, the ratings agency Fitch has warned. Fitch, which cut its rating on the UK to a notch below the top AAA level in 2013, said in December 2015 a vote for Brexit would be "moderately credit negative" for the UK, putting at risk its medium-term growth and investment prospects, its external position, and the future of Scotland within it.

S&P said: "A 'leave' vote is likely to hurt confidence, investment, and GDP growth, with likely negative effects on public finances. As a consequence, a UK departure from the EU would likely lead us to lower the rating."

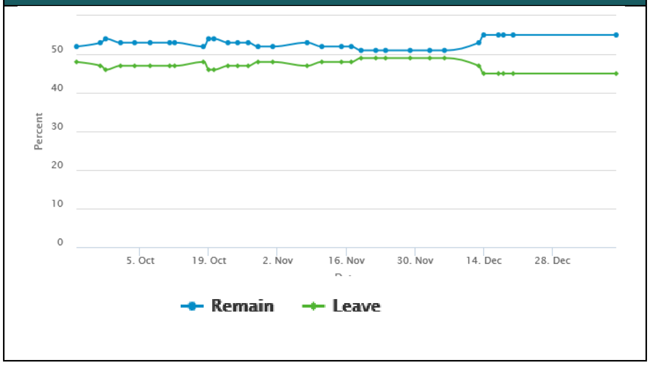
Who cares?

A Martian able to listen in only on the intense political debate in Britain on the European question would imagine that Europe was an issue of burning public interest – perhaps the most important political question of the times, animating discussion around every kitchen table and intruding into every opportunity for social intercourse. The Martian would be wrong. According to all the evidence of opinion research, less than 10 per cent of voters normally place 'Europe' in the top three issues they care about. This unfortunately may say more about the priorities of the voters in the face of a potential significant political choice, rather than the usual accusation levied at politicians that the waffling of Westminster is irrelevant most of the time.

Given the inaccuracy of opinion polls in the 2015 General Election, the next paragraph may be treated with as much caution (or contempt) as a briefing from an economist…

When polled, the UK public tend to register a desire to stay in the EU, although there are polls that have shown a balance towards leaving the EU. Given that the date for a referendum is yet to be announced, or a UK deal with the EU arrived, we would suggest that the public's general awareness of the issues involved are at this stage are limited. The opinion polls may shift somewhat when the referendum campaign is fully launched, and messages sharpened.

Do I stay or do I go now? Poll-of-polls on 'In – Out' EU referendum



Source: Artorius Wealth, whatuthinks.org

The bias towards the status quo position increases markedly if Prime Minister Cameron was to be successful in negotiations with the EU around the four conditions set out at the start of the note. Post successful negotiations, polls suggest that 65% of UK voters would favour staying in the EU, compared to just 26% leaving. This 26% is close to the share of the vote UKIP received in the European elections in 2014, a potentially unpersuadable minority of hard-core Euro sceptics. However, if Cameron fails to obtain measures to ensure the UK will not be disadvantaged by decisions taken by the Eurozone states, support for remaining in the EU falls to 45% and support for leaving increases to 46%. Similarly, failure to restrict new EU migrants' access to in-work benefits for four years sees support for 'Remain' fall from 56% to 48% and support for Leave increase from 35% to 45%.

Analysis of polling suggests that young and/or better educated voters tend to support remaining in the EU, whereas those older and/or less educated tend to support leaving, but there is no gender split in attitudes.

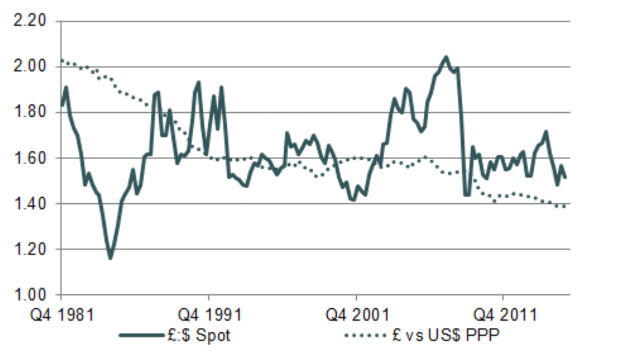
Portfolio thoughts

In the run-up to the referendum:

If polls were to remain close we anticipate that Sterling will continue to fall against major currencies. Our clients' portfolios benefit from the extensive exposure to non-Sterling assets especially within equities.

If polls suggest that the EU referendum will clearly present a 'Remain' vote then Sterling may rally, at which point the investment team may identify how to adopt a currency hedging strategy for selected non-Sterling assets.

Sterling still appears overvalued even against the US Dollar on a long term Purchasing Power Parity (PPP) measure



Source: Artorius Wealth, Thomson Reuters

Post referendum:

In the event of a 'Leave' vote, both Sterling and gilts are likely to fall sharply, depending on what had been discounted ahead of the vote. This may import inflationary pressure and erode the purchasing power for the domestic UK consumer. We think that within the equity market, the less domestically orientated companies would deliver better prospects in such a scenario.

Given the downside economic risk in the short-to-medium term of a 'Leave' vote, we think that this would lead the Bank of England to remain dovish and hold- off raising rates. However longer term, given the political sensitivity of the labour migration issue, it is hard to see how a 'Leave' vote would not result in much tighter curbs on migration to the UK. That reduced labour supply may exacerbate skill shortages and would eventually result in higher inflation, posing a major dilemma for the BoE. Higher interest rates be a challenge for the UK economy as UK households are still hugely indebted and highly sensitive to Bank Rate rises.

Status Quo

A vote to 'Remain' in the EU appears likely, given the present opinion polls readings, but also the evidence of the Scottish referendum and 2015 General Election. Pollsters may overestimate the vote for change. 'Remain': a bit like the vote for status quo in Scotland, may be treated with short-term relief but have no real impact, as in our view, it is what is being discounted.

Without a final agreement between the UK and EU a date for the referendum, or the start of the referendum campaign, this note may appear too early in gestation, but thoughts ahead of events will hopefully allow us, and you the client, to have investment scenarios prepared for potential outcomes, rather than reacting to events.

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