Heartwood
Investment Management

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Investment Perspective

Brexit: The investment impact

- The European Union (EU) is clearly an important trading partner, accounting for nearly half of all UK exports. However, the EU's share of UK trade has fallen over the past decade as other economies have seen accelerated growth. Ultimately, the Brexit question comes down to bargaining power and whether the UK has the ability to act alone in the global economy.
- Given the seemingly close fought nature of this campaign, a higher risk premium is likely to build across UK financial markets between now and the referendum on June 23rd, with sterling most likely to absorb major price moves, which to some extent it already has done.
- We would expect a vote to stay in the EU to be seen as business as usual and a net positive for UK financial markets, especially given concerns around funding the UK's sizeable current account deficit.
- The consequences of the UK leaving the EU are, of course, more uncertain and would lead to short-term negative sentiment across UK assets. Sterling is likely to be most vulnerable on concerns of capital flight risk needed to fund the deficit, although its recent weakness has gone some way to reflect these risks.
- As investors digest the potential consequences of Brexit, we would expect UK gilts to benefit from a safe-haven bid and policy support from the Bank of England. Large-cap UK equities should weather the storm better than small- and mid-caps, which would, in the short term, be pressured by the resultant economic uncertainty.
- We expect subdued activity in property until the referendum, but overseas interest should pick up after the vote as investors take advantage of a potential fall in the value of sterling. This would be irrespective of whether the UK votes to stay or leave, as we see no significant, lasting damage to the UK economy.
- The financial repercussions of the UK's departure from the EU should be contained from the European perspective, although expect short-term headline noise questioning the validity of the EU project. German assets would probably be considered a safe-haven for euro-based investors, as equity and bond markets in periphery countries come under pressure.
- While we are cognisant of the risks of the UK leaving the EU, we are not re-positioning our portfolios in anticipation of such an outcome. Other global factors remain more significant drivers of performance – China rebalancing, Federal Reserve tightening and commodity prices. We are, however, maintaining our long-standing underweight exposure to sterling and UK equities, as well as a short duration position in UK gilts. In UK property, we would, in any case, expect to be reducing our exposure as the cycle matures.

If last year's UK General Election result tells us anything, it would be not to try and put any predictions around June's 'Brexit' vote. And in this instance, the electorate is likely to vote as much on emotion and matters of what it means to be British, as opposed to complex economic argument and conjecture. Opinion polls vary depending on whether they are telephone or internet based, but on balance most suggest that the 'remain' camp has the edge. 'Bremain' supporters, those arguing to stay in the European Union (EU), believe that Prime Minister Cameron's renegotiation with the EU accomplished largely what he set out to do in four areas – economic governance, competitiveness, sovereignty and migrant welfare payments (see right, The UK's new settlement with the EU); diehard sceptics were always unlikely to be wavered by whatever deal came their way.

This Investment Perspective does not attempt to provide any views on the politics surrounding Brexit; whether that be issues around sovereignty, defence or immigration, or indeed the legal consequences of the UK leaving the EU. Our focus is based purely on the financial market implications in the lead up to this referendum and thereafter, as we attempt to provide some sense as to the likely reaction of financial markets under the scenarios of either Bremain or Brexit. Before considering these outcomes, it is worth understanding the wider context, and in particular the UK's trading relationship with the EU.

How important is the EU to UK trade?

The UK's trading relationship with the EU is clearly significant, given that 45% of UK exports in 2014 were to the EU compared with one tenth of total EU exports bound for the UK market.[1] This significance does not diminish even if we were to strip out the 'Rotterdam effect', where the Netherlands acts as the intermediary for goods bound for non-EU countries. Arguably, the EU can be considered a more important trading partner for the UK than the UK is to the EU; however, the UK is also an important source of demand for many EU countries, since the UK runs large bilateral deficits against several member states, particularly in Eastern Europe.

Nonetheless, the shifting global economic landscape, with the rise of China and other large emerging economies, and the growing importance of services in global trade have meant that the share of UK's exports to the EU has actually declined around 10% over the past decade. The UK had a trade deficit of £59 billion with EU in 2014, which has wholly been attributable to the deficit in goods; services to the EU are in surplus. In contrast, the UK's trade balance with non-EU countries is in surplus to the tune of £28 billion, but again this is all due to services. It is noteworthy that the UK has the highest ratio of services exports to GDP in the G7 and also the largest share of financial services exports: 27% versus the next largest market, the US, at 15%.[2]

The UK's new settlement with the EU

On February 18/19th, 2016, the UK Government agreed a new settlement with the European Union (EU). The proposed changes to the Treaty on European Union are:

- **Economic governance:** Recognition that the EU has more than one currency and that non-euro currency member states should not be discriminated against. Any changes to European Union banking union should be voluntary for non-euro member States and nor should these countries should be liable for any bailouts of euro currency member States. All member states, euro and non-euro, should be involved on any material eurozone discussions. Safeguards for the City of London would also be implemented to prevent the imposition of eurozone regulations.
- **Competitiveness:** A commitment on the part of the EU to reduce the regulatory burden on businesses and promote competitiveness.
- **Sovereignty:** An end to the UK's commitment of 'ever closer union'. Furthermore, a group of national parliaments representing more than 55% of the votes allocated can stop any new legislative proposal that they consider is incompatible with their national sovereignty.
- **Migrant welfare payments:** Newly arriving EU workers would no longer have access to in-work benefits for a total period of up to four years from the start of employment. This limitation is to be graduated from an initial complete exclusion and then allowing gradual access to benefits. Child benefit paid to migrant workers for children living overseas would be indexed to the cost of living in that country.

So the EU is an important trading partner, but perhaps less so than a decade ago. Essentially, the EU question probably comes down to bargaining power. Does the UK need to be part of a larger trading bloc of currently 28 countries to both maintain existing relationships with EU member states and leverage bargaining strengths with other global powers? Or, can the UK act alone in a global economy which has changed immeasurably since 1992, when the Maastricht Treaty went into force that created much of today's EU institutional framework? Needless to say, there is greater uncertainty and ambiguity around the second outcome - not to mention the constitutional implications that it would present for the UK itself.

[1] *Office of National Statistics*
[2] *All data Office of National Statistics*

Key Facts: The UK's trading relationship with the European Union:

Europe in the global economy	• The EU is the world's largest trading bloc, overtaking the US in 2003. However, the EU's share of global GDP was 24% in 2013, down from 30% in 2003.
Trade	• The European Union is the UK's major trading partner, accounting for 45% of exports and 53% of imports of goods and services in 2014. • The "Rotterdam effect" records trade as being with the Netherlands, which actually acts as the intermediary to non-EU countries. Even if we were to exclude the Netherlands, exports to the EU would still be 42% of goods exports and 46% of goods imports in 2014. • The UK's trade with the EU (both exports and imports) has fallen over the past decade with the rise of BRIC. Between 1999 and 2014, growth in non-EU exports has grown on average by 6.5% versus 3.6% to EU countries. • UK trade with the EU is dominated by goods, accounting for two-thirds of exports and three-quarters of total UK imports. • The UK had a trade deficit of £59 billion with EU in 2014 (0.6% of GDP) but a surplus of £24 billion with non-EU countries. The deficit with the EU is attributed wholly to goods; services to the EU are in surplus.
Foreign direct investment	• In 2014 EU countries accounted for 48% of total inward investment (£496 billion), compared with 24% for the US and 28% for all other countries. The EU had a 40% share of UK investment overseas in 2014.
Employment	• 3 million jobs are estimated to be directly or indirectly linked to trade with the EU. This is not the same as saying it is linked to membership since some of that trade with EU countries would continue to take place even if the UK withdrew from the EU.
UK's contribution to EU budget	• UK's net contribution to the EU budget is estimated at £8.5 billion in 2015 versus £4.3 billion in 2009 (although some of this increase has been distorted by changes to the UK rebate). The net contribution is forecast to be between £11.1 billion and £7.96 billion between 2016 and 2020.

Source: Office of National Statistics

What are our expectations for UK financial markets?

A higher risk premium across UK financial markets is likely to persist in the interim to June 23rd, with sterling most likely to be the lightning rod. We have already observed the UK currency's meaningful depreciation since David Cameron announced the new settlement with the EU, having fallen 6% on a trade-weighted basis since the start of the year. UK equities and gilts have remained fairly resilient so far, swayed more by global considerations: the US interest rate cycle, China and commodity prices. Nonetheless, Brexit headlines between now and June have the potential to create toxic vapour that are unlikely to be helpful to UK financial markets.

And what happens after 23rd June?

It is obviously difficult to predict the electoral outcome, but also since there is no precedent we should be wary of making sweeping statements about the potential financial market implications. The referendum in 1975 perhaps draws more political rather than investment or economic comparisons, in light of developments in the global economy over the past two decades.

We assume that a vote to stay in the EU would be seen by investors as largely business as usual and greeted with relief, much in the same way as the post-relief rally following the Scottish referendum result in 2014. There could, however, be questions about a second referendum if the result is far from decisive, which could add to market uncertainty in the longer term.

Broadly, though, the proposed agreement with the EU does not appear to change the economic framework to any great extent, nor does it appear likely to significantly impact the inward flow of European labour, which has helped to keep UK wage growth relatively modest, to the benefit of the corporate sector. Overall, therefore, a vote to remain within the EU on renegotiated terms would be taken as a net positive by the markets, especially in light of the UK's current account deficit of 4.2% of GDP and the UK's high dependence on foreign capital flows to fund it.

We expect some of the risk premium being built into UK assets, particularly sterling, to unwind. The UK gilt market may sell off moderately, particularly if there has been a risk off trade in advance of the decision, but longer-term economic fundamental dynamics will continue to drive bond yields, which should be ultimately positive for gilts, and in particular there would be no clouds overhanging the UK's sovereign credit rating. The UK economy is performing adequately, and the recent weakness in sterling will go some way to improving the terms of trade, which clearly deteriorated in recent months as sterling, on a trade weighted basis, appreciated. Investors will also, as ever, prefer the certainty of the new regime over the current uncertainty, which, all other things being equal, should help the bid for sterling assets, including gilts and equities. Finally, UK property assets should also enjoy continued support from overseas investment flows.

What if the UK votes to leave the EU?

The consequences of leaving are of course more uncertain, both in terms of the mechanism of leaving (which has not been tested) and the length of time to achieve it; although two years is timetabled, it is open to question as to whether this is achievable. The negotiations could be messy and protracted, and the EU will want to maintain a firm hand to avoid encouraging other potential exit candidates. Furthermore, we would expect UK economic growth to contract if external demand for services weakens and confidence is undermined, resulting in slower consumption that might hurt growth, employment and wages.

Sterling

The price action of sterling is largely driven by monetary policy and capital flows and on this basis we would expect the UK currency to stay weak on concerns about Bank of England deferring interest rate hikes, concerns of capital flight and uncertainty on the credit rating outlook. As these concerns are assuaged and depending on the level of sterling reached, we would have a more optimistic cyclical view of the currency over the longer term, as ultimately we see no significant lasting damage to the UK economy.

UK Fixed Income

In theory, an 'Out' result would be negative for the UK gilt market since there will be questions around the UK's ability to maintain its AAA sovereign credit rating (although ultimately we do not believe this to be a significant factor) and the threat of capital flight, given the UK's rather sizeable current account deficit which needs to attract foreign buyers.

However, in reality, there will probably be few places to hide among UK assets, and gilts may offer the safe haven, risk-off trade, particularly if Bank of England interest rate hike expectations are pushed back as a result. The gilt market is a predominantly domestic-owned market, notwithstanding that foreign ownership currently stands at an all-time high. We expect the Bank of England to counter the negative effects of any potential international selling of gilts as it has the capacity to absorb non-domestic-owned bond sales through a new round of quantitative easing. Such action could be justified on the basis of

Summary of investment views

	Scenario 1: Bremain	Scenario 2: Brexit
Sterling	Expect some of the risk premium to unwind.	Negative sentiment could pressure sterling in the short term on capital flows concerns, which are needed to fund the current account deficit. We are more optimistic on a longer-term cyclical view, as we see no significant lasting damage to the UK economy.
UK Fixed Income	Immediate relief rally, but expect moderately higher yields in the longer term, as economic fundamentals drive yields.	Negative in the short-term, but as investors reassess the implications of Brexit, UK gilts could benefit from safe-haven flows and potentially further Bank of England easing action.
UK Equities	A relief rally given that there are no changes to the underlying UK economy. With greater economic certainty, overseas investors might be attracted to the UK in the longer term, given the fall in the value of sterling.	Short-term negative sentiment, particularly for financials and exporters to Europe. However, large-caps are driven more by global factors and have less exposure to the sterling exchange rate. Domestically-exposed small-/mid-caps would be more vulnerable on the economic uncertainty.
Property	Subdued activity until the referendum, although expect flows to pick up as overseas investors take advantage of the fall in the value of sterling.	Investors are likely to take advantage of the fall in the value of sterling on the view that any exit will take time and is unlikely to prove damaging to UK asset values in the long term.

the need for central bank support to lower funding costs through the transitional period of the UK leaving the EU.

From a yield curve perspective, shorter-dated bond yields could outperform as the risk premium at the long end increases on the overall business and economic uncertainty, a weaker sterling and the potential for the UK to return to its more inflationary past.

UK equities
More than half of the UK equity market is owned by overseas investors and it could be vulnerable to weaker sentiment in the short term, particularly among financials and exporters to Europe. That said, large-cap UK indices are driven more by global factors and heavily skewed toward cyclical sectors, such as mining and energy, which are in aggregate beneficiaries of a weaker sterling. Over the longer-term, uncertainty is likely to weigh on the financial sectors, as investors struggle to understand any new regulatory regime.

Further down the market-cap spectrum, domestically-exposed small and mid-cap stocks could see more pressure on the basis of the economic uncertainty presented by a Brexit scenario. In addition, import costs for these companies could rise, due to the deteriorating terms of trade, which would squeeze profit margins.

Property
In the coming months, we would expect a period of subdued activity as overseas investors wait to see how the referendum campaign evolves. However, post June we would expect flows to pick up as international investors take advantage of the fall in sterling, and on the view that any exit will take time and is unlikely to prove damaging to UK asset values in the long term.

What is the likely impact of Brexit from a European perspective?

Clearly if the UK were to leave the EU, we would expect headline noise questioning the validity of the overall EU project. German assets would most likely see a safe-haven bid for euro-based investors in the short term, as equities and bond markets in periphery countries (for example, Spain, Italy and Portugal) could be vulnerable, although a weaker euro could prove beneficial over the longer term to the euro-area's external economy.

There must be some possibility that discussion over Brexit creates the domino effect of other countries seeking to leave the EU, though this is not our central case. However, we do think that a Brexit outcome might create an opportunity for countries to advance their own individual agendas and renegotiate their own terms of membership with the EU. Overall, we are not expecting the EU to fracture as a result of Brexit, but it could well raise tensions within Europe. At the same time, however, the UK's exit could strengthen the European Parliament's hand in leaning towards further progress in areas such as fiscal integration, regulation, taxation, subsidies or investment programmes.

The UK's potential departure would create a funding gap that would have to be filled by other countries. In 2014, the UK's net contribution to the EU's budget was €4.93bn, or 19% of total net contributions. Current net-contributing nations may push for expenditure cuts, while net receivers may ask other countries for greater contributions. Future budget negotiations would therefore have a further layer of complexity. These issues could raise questions around the impact on funding costs of EU supra-national borrowers. For example, could a potential UK departure and the associated loss of UK guarantees lead to ratings downgrades for the EU and the European Investment Bank and thus increase their borrowing costs? It is possible, but in the current climate we expect the impact may be marginal.

Brexit would likely have far smaller financial repercussions compared with the exit of a eurozone country, since the UK has its own currency and fast outflows of bank deposits would be far less likely. With much of the UK exposures most likely funded in sterling and therefore hedged against the currency risk, it would take a very large and persistent swing in the exchange rate, and potentially large-scale defaults in the UK, to actually create a significant impact negative on the rest of Europe.

Finally, how are we positioning portfolios?

While we are cognisant of the risks of the UK leaving the EU, we are not specifically re-positioning our portfolios in anticipation of such an outcome. Other global factors remain more significant drivers of financial market performance – China rebalancing, Federal Reserve tightening and commodity prices.

In any case, we have for some time maintained an underweight exposure to UK equities and to sterling. Our view on sterling was based on expectations of UK interest rates staying low, the higher valuation of sterling after a period of significant strength, and the relative interest rate differential with the US that was likely to favour the US dollar. In the gilt market, we are maintaining a short duration position based on our longer-term expectations for inflation and the Bank of England interest rate cycle.

We have also held a long-term positive view on the UK commercial property market, which has benefitted from supportive supply/demand dynamics and low interest rates. The property cycle is maturing and we would, in any case, expect to be reducing our exposure to this sector through the year, and headline noise surrounding Brexit is also likely to prove a headwind.

Of course, it remains a possibility that UK financial markets could become overly negative about the referendum result in June. In this case, we would view it as an opportunity to potentially bring money back into the UK.

In summary, our positioning in assets most exposed to Brexit risks is:

- Underweight sterling, not solely on Brexit but in response to global factors including Federal Reserve tightening and the significant appreciation that sterling has experienced over the past year or more.
- Maintain short duration position in UK gilts, with a bias towards shorter-dated bond maturities.
- Underweight UK equities from an asset allocation perspective, but within UK equities we are holding higher exposure to large-caps versus small- and mid-caps.
- Maintain exposure to UK commercial property, but with a view to reducing this allocation to reflect the maturing cycle, rather than as a reaction to Brexit.

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