Brexit or Bremain? What to Expect from the European Union Referendum

Drew Mallory, CFA
Managing Director
Wealth Management Services

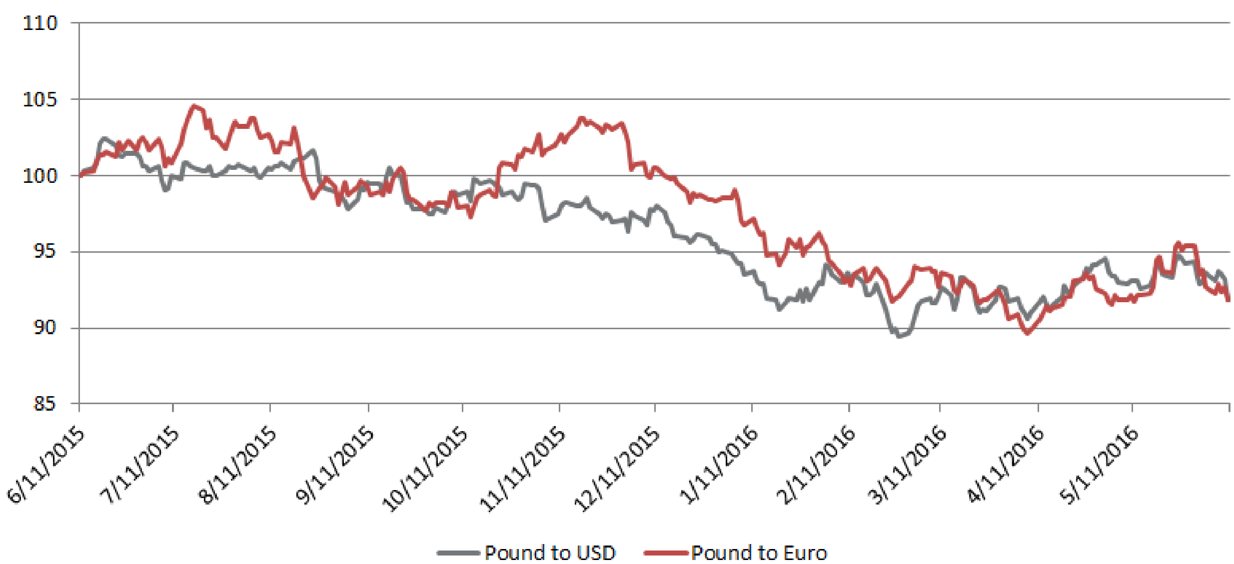
In an upcoming referendum across the pond, British citizens will head to the polls to decide if the United Kingdom (UK) will remain in or exit from the political-economic union known as the European Union (EU). Amid growing concern over the EU's control of regulatory, immigration, security and trade issues, the referendum is more nuanced and politically charged than a debate purely on the pros and cons of participation in the economic union. The June 23rd referendum will be the first since the UK voted to remain in the EU's predecessor, the European Economic Community (EEC), in 1975 and follows a campaign promise by Prime Minister David Cameron in 2015 for the British people to formally have a say in the UK's membership in the EU. Mr. Cameron is the leading proponent for the UK to stay within the EU. Amid a well-documented list of other global macroeconomic risks, the implications of a "Brexit" (a British Exit) have the attention of investors around the world.

The structure and cadence of a Brexit are not clear as the departure would require several years of complex, layered and likely contentious negotiations with the EU. Options for the UK post Brexit include joining the European Economic Area, negotiating custom terms with the EU or simply becoming a standalone member of the World Trade Organization. Each option has its own costs and sovereignty implications. In a perfect world, the UK would enjoy the benefits of the economic union without further political integration into the EU and would regain the ability to control its immigration policy. Unfortunately, other EU members strongly oppose the UK's desired special status and see it as a threat to the very existence of the EU. As a result, in the event of a Brexit, some EU members may seek punitive measures against the UK as a deterrent for other countries that are also experiencing a ground swell in anti-EU political sentiment. In addition to haggling with the EU post Brexit, the UK will need to negotiate new trade deals with countries outside the EU including the US and China without the negotiating power provided by the 28 country EU. The UK has limited experience and administrative infrastructure to effectively tackle this daunting process.

While it will take several years to establish new trade agreements post Brexit, the capital markets will adjust quickly. In the short-term, investors will require higher rates of returns on their British investments. Trade with and foreign investment in the UK will be curtailed. Consumer confidence will probably be rattled. Up against the referendum, the Brexit issue is already weighing on British markets, most noticeably in currency markets where the Pound has declined over 8% against the US Dollar and Euro over the last twelve months. British equities have also lagged broad domestic and international indices over the last twelve months. Yields on UK Gilts (equivalent to US Treasuries) have remained low. Longer term, a Brexit would curtail foreign investment, reduce trade between the UK and the EU, increase costs and complexity in facilitating trade and tighten immigration policies. All of these issues will serve to produce meaningful headwinds to long run British GDP potential as the opportunity for innovation and productivity gains are reduced. Against the backdrop of slower economic growth and an anticipated accommodative monetary policy response by the Bank of England, yields on UK Gilts would be expected to further decline.

Pound Has Declined Over 8% Against the US Dollar and Euro Over the Last 12 Months

1-year Performance of Pound Relative to US Dollar and Euro



Source: Bloomberg as of 6/11/2016

The economic theory of comparative advantage is built on the notion that economic gains are realized through free trade when goods and services are produced by the country with the lowest opportunity costs. We continue to believe growth prospects for the UK and global economy will be improved by free trade arrangements that encourage efficient resource allocation. In a growth challenged world, a Brexit would likely serve as yet another contributor to global economic sluggishness.

British membership in the EU, along with sound economic policies, has contributed to the UK's economic success relative to many of its EU counterparts. Indeed the UK's unemployment rate, positive and consistent GDP growth and healthy inflation levels are the envy of many countries around the globe who are engaged in ever more creative ways to conjure up economic growth through monetary accommodation. The Brexit vote is an untimely source of uncertainty for the UK given the Eurozone's slow and fragile economic footing and could serve to derail recent economic improvements in the UK and the EU. As an island, the UK is physically separated from continental Europe. As an economy, the UK's future economic well-being is inextricably intertwined to its EU friends across the English Channel.

In advance of the referendum, we will expect to see more volatility in the Pound and British equities and fixed income. More apocalyptic and unlikely prognostications will likely emerge leading up to the referendum as the financial press continues to drive Internet traffic and newspaper sales. Ultimately, we do not believe a Brexit represents a systemic shock risk to the global economy, but do believe it will inflict the most economic pain on the UK itself. Should the decision be to "Bremain" (Remain in the EU), which is our expectation, we would likely see a relief rally in the Pound and in British and European stocks. We continue to favor and emphasize high quality US equities in our portfolios relative to international equities. However, despite lingering issues in international markets, we see attractive long-term value opportunities in international stocks and remain committed to maintaining some global orientation to our equity exposure. Given our US centric positioning and diversified international allocation, direct exposure to UK stocks is less than 3% of our total equity exposure. At a recent client event, following a polished and data rich global economic update from a well-read economist, an attendee posed a simple yet powerful question, "But what do we do?" Like the famous British World War II era tag line, the best answer is likely to "Keep calm and carry on." ■