Market Bulletin

29 February 2016

Brexit: What investors should consider

In brief

- Though we anticipate a vote in favour of remaining in the European Union (EU), a "no" vote in the coming UK referendum is a distinct possibility and is something that investors should be prepared for. Long term, both the costs and the potential benefits of Brexit to the UK economy are probably exaggerated by commentators and campaigners on either side of the argument. But the transition to a new set of arrangements would be messy and potentially very costly, not just for the UK but also its closest trading partners.
- We do not believe that UK government bonds would come under serious pressure in this scenario, but investors should expect sterling to weaken significantly, equities and possibly prime London real estate prices to fall, and both economic growth and interest rates to be somewhat lower in the next one to two years than if the vote was in favour of the status quo.
- We would expect these macroeconomic effects to fade gradually, as the post-EU landscape became clearer. At that point, microeconomic factors would take over, with investors needing to consider carefully how individual sectors and companies were positioned for the new environment. The financial services sector probably has most to lose and—potentially—UK homebuilders. Manufacturing firms and domestically oriented services companies might see some long-term benefits or be little affected.

BRITAIN'S PLACE IN THE EU AND THE PRE-REFERENDUM LANDSCAPE

Uncertainty over the EU referendum has already affected the UK economy via a sharp decline in the exchange rate since the start of 2016 and—probably—some delay in planned investment in the UK by domestic and foreign businesses. Investors can expect these forces to intensify in the weeks leading up to the vote on 23 June. The more important question is what happens after that.

In the week the referendum date was announced, betting markets were suggesting that a majority would vote for Britain to remain in the EU on 23 June. This was also the message from telephone polls, which are seen as being more reliable than the internet polls. But pollsters have had a poor record of predicting the outcome of recent UK referendums and general elections. Although the percentage of people approving Britain's membership in the EU has risen (**Exhibit 1**), the probability of a "leave" vote is at least 35%, and certainly higher than when the prime minister first committed to hold the vote, at the start of 2013.

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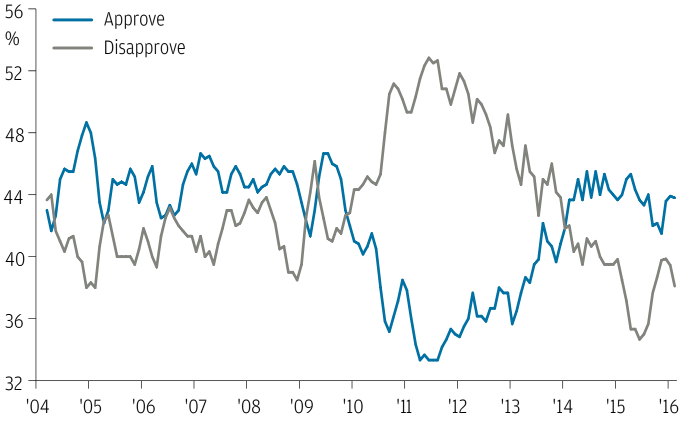
EXHIBIT 1: RESPONSES TO "OVERALL, DO YOU APPROVE OR DISAPPROVE OF BRITAIN'S MEMBERSHIP IN THE EU?" SURVEY

Three-month moving average



Source: Essex Continuous Monitoring Survey, What UK Thinks, YouGov, J.P. Morgan Asset Management. Essex Continuous Monitoring Survey data: 2004 to January 2015, YouGov data: February 2015-August 2015, average polls from YouGov, ICM, Survation and ComRes: September 2015-February 2016. Data as of 25 February 2016.

Even with a "remain" verdict, the uncertainty over Britain's long-term place in the EU is unlikely to be resolved if the campaign to leave the EU garners significantly more than 40%. In that case, there seems to us a strong chance of another referendum within 10-15 years, one which the pro-EU side may find more difficult to win if closer integration of the eurozone has made the EU less hospitable to the UK and/or popular concerns about immigration have not subsided.

It has been suggested that another referendum could happen after a vote to leave the EU, with voters in that second referendum, in effect, voting whether to accept the terms of Britain's exit. This cannot be ruled out, though it is of the nature of these campaigns that before the vote, the pro-EU side must insist it is impossible. The larger point is that it is impossible to know what will happen after a vote to leave—or what the "deal" for Britain and its businesses would ultimately be.

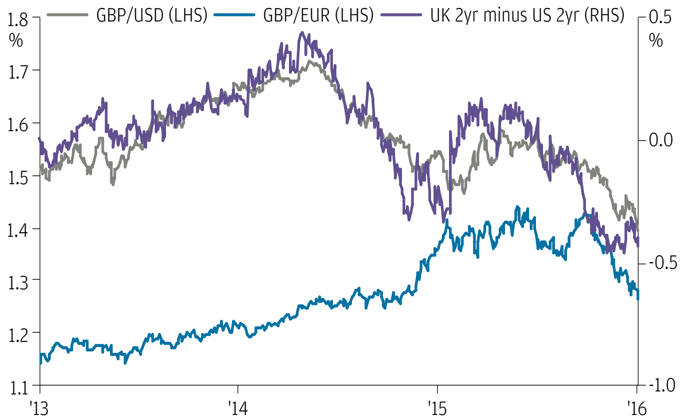
Investors cannot hope to predict the exact shape of the post-Brexit landscape. They can, though, think about the macroeconomic and microeconomic considerations that would come into play in such a scenario. Here we consider both, after a brief summary of the economic and market implications of the fact that the vote is being held at all.

SHORT-TERM IMPACT OF THE REFERENDUM VOTE – WHATEVER THE RESULT

In February's Bank of England (BoE) Inflation Report, Mark Carney suggested that investors are already demanding a Brexit premium to hold UK assets. That is clearly the case with the exchange rate, which is 6.4% lower on a trade-weighted basis than at the turn of the year. As **Exhibit 2** demonstrates, sterling has declined further than can be explained simply by the fall in UK rate expectations relative to the US since the end of the year. The cost of insuring portfolios and business activities against further sterling weakness has spiked to the highest level since 2010 and derivative markets are forecasting that sterling volatility will remain high well into the summer.

EXHIBIT 2: STERLING STUMBLES AFTER REFERENDUM ANNOUNCEMENT

GBP/USD, GBP/EUR, and 2yr government bond interest rate differential



Source: FactSet, J.P. Morgan Asset Management; data as of 25 February 2016.

The other key consequence of the referendum for the economy is likely to be reduced investment, as businesses inside and outside the UK defer projects until the outcome has been decided. Recent figures show that UK investment declined by 2.1% in the final three months of 2015, after growing by an average of 1.4% in the preceding nine months. We cannot know how much of this slowdown was due to referendum fears, but it underscores that this is an unfortunate time to be giving businesses something else to worry about. A 25% reduction in the volume of investment due to the referendum could theoretically knock 0.25 percentage points off the annualised rate of growth in the economy in the second quarter.

If Britain votes to "Bremain", we would expect most of this hit to investment to be reversed. Sterling might also retrace some of the ground it has lost. However, it is not obvious to us that sterling would return to the levels seen in mid-2015, given the country's still-significant current account deficit of just over 4% of GDP. On the basis of that external deficit, the International Monetary Fund (IMF) recently estimated that the UK currency was 5-15% overvalued at the end of 2015.[1]

[1] *United Kingdom 2015 Article IV Consultation*, IMF Staff Report and Statement, 24 February 2016.

So it would not entirely be business as usual after a vote to remain. But the direct macroeconomic impact would be modest and probably far outweighed by developments in the broader global economy. Indeed, with the immediate uncertainty associated with the referendum removed, investors might see the relative weakness of sterling as a reason for renewed interest in UK assets, at a time when the commodity sector is expected to be less of a drag on FTSE earnings than it has been in the past few years and the consumer side of the economy is still performing well. Many of these positives would also be there after a decision to Brexit, but it could be a bumpy road for UK assets in the immediate aftermath, as we discuss below.

WHAT IF BRITAIN VOTES TO LEAVE?

Short-term economic and market impact

Politicians on both sides are fond of pointing out that nothing would change the day after the vote, and that is true; every law and regulation that was in place the day before the vote would remain in place until the terms of Britain's exit from the EU were agreed, a process that is expected to take at least two years.[2] But we can be fairly confident in the short run that UK equity prices would not stay the same, and nor would the value of the pound. UK equities could see a further 2%-3% sell-off, in addition to perhaps a further 10% fall in the trade-weighted value of sterling. If the polls begin to point to a clear "No" majority, much of this would have occurred before the vote itself.

How would this directly affect the economy? Research by colleagues at J.P. Morgan Chase[3] estimates that a negative result could take around 1 percentage point from the growth rate in the 12 months after the vote—a significant hit, given the baseline growth forecast of around 2% in 2016. Monetary policy would likely be even looser in this scenario, with the first interest rate rise from the BoE deferred even further into the future.

Growth and investment in the rest of the EU would also be negatively affected, with countries such as Ireland seeing the largest impact given its heavy reliance on trade with the UK. The UK is the eurozone's single largest trading partner, with exports to the UK accounting for 2.5% of GDP, on average, but that figure is more than twice as high for Belgium, the Netherlands and Ireland. The same J.P. Morgan Chase analysts see a hit to eurozone GDP on the order of 0.2-0.3 percentage points over 18 months following a Brexit vote. Eurozone inflation might well be slightly lower on this scenario, due to the greater strength of the euro against sterling. The reverse would be true in the UK.

Longer-term consequences

Along with this macroeconomic reaction, we can expect a microeconomic response on the part of businesses inside and outside the UK, as finance directors and other managers take stock of their supply relationships and consider how their costs, trading relationships, customer base and—in some cases—even their legal status might be affected by the decision. This is where the transition costs of moving to a post-EU regime would be felt most keenly and for many it will not provide much reassurance that it could take several years for the nature of that regime to be clear. That merely means businesses will be living with the uncertainty that much longer.

With more than 40% of Britain's trade going to other EU countries, the new relationship with the EU will be crucial to the impact for individual sectors. This is where the political economy gets tricky, because in practice there is a trade-off between sovereignty and market access—even if the supporters of Brexit suggest that the UK can have access to the single market without all the rules and regulations that come with it.

Exhibit 4 illustrates the range of potential outcomes. The closest to the current arrangement is the Norway option—membership of the European Economic Area (EEA), making a contribution to the EU and abiding by all single market rules including free movement of people. This is unlikely to appeal to those who want to see Britain break free of Brussels, since it involves all of the regulation that Britain has today but none of the influence. But this is important for the financial sector because only EEA membership would guarantee the continuation of "passporting" rights for UK financial services firms to do business in the EU.[4]

The least onerous option, but also the least favourable from a business standpoint, would be to fall back on the mutual market access available to all members of the World Trade Organisation. This is also unlikely to be satisfactory, given the significant constraints it would impose on trade relative to the status quo. Outside the EU, the UK would also have to try to at least replicate the 50-odd trade agreements that the EU has negotiated with other parts of the world. This would be no small matter and would add to the uncertainty for businesses.

Most likely, the UK would end up with its own arrangement, somewhere between these two extremes. As **Exhibit 3** shows, Britain has an enormous traded goods deficit with the rest of the EU, which has been widening recently, with imports from other parts of the EU growing much faster than imports from the rest of the world.

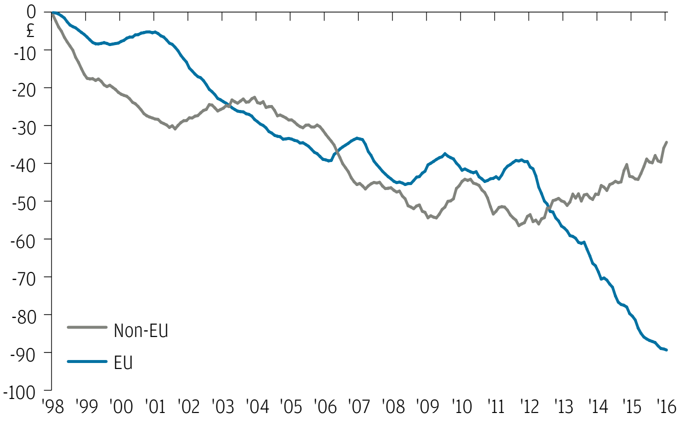
[2] In the case of Greenland, the only other territory to have left the EU, the negotiations took three years.

[3] *Brexit: What impact might uncertainty have on UK GDP?,* J.P. Morgan Chase Economic Research, 19 February 2016.

[4] This is particularly important for UK asset management firms that hold a significant proportion of their retail investor assets in UCITS (Undertakings for Collective Investment in Transferable Securities) structures.

EXHIBIT 3: CUMULATIVE TRADE BALANCE IN GOODS

GBP billions, 12 month rolling sum

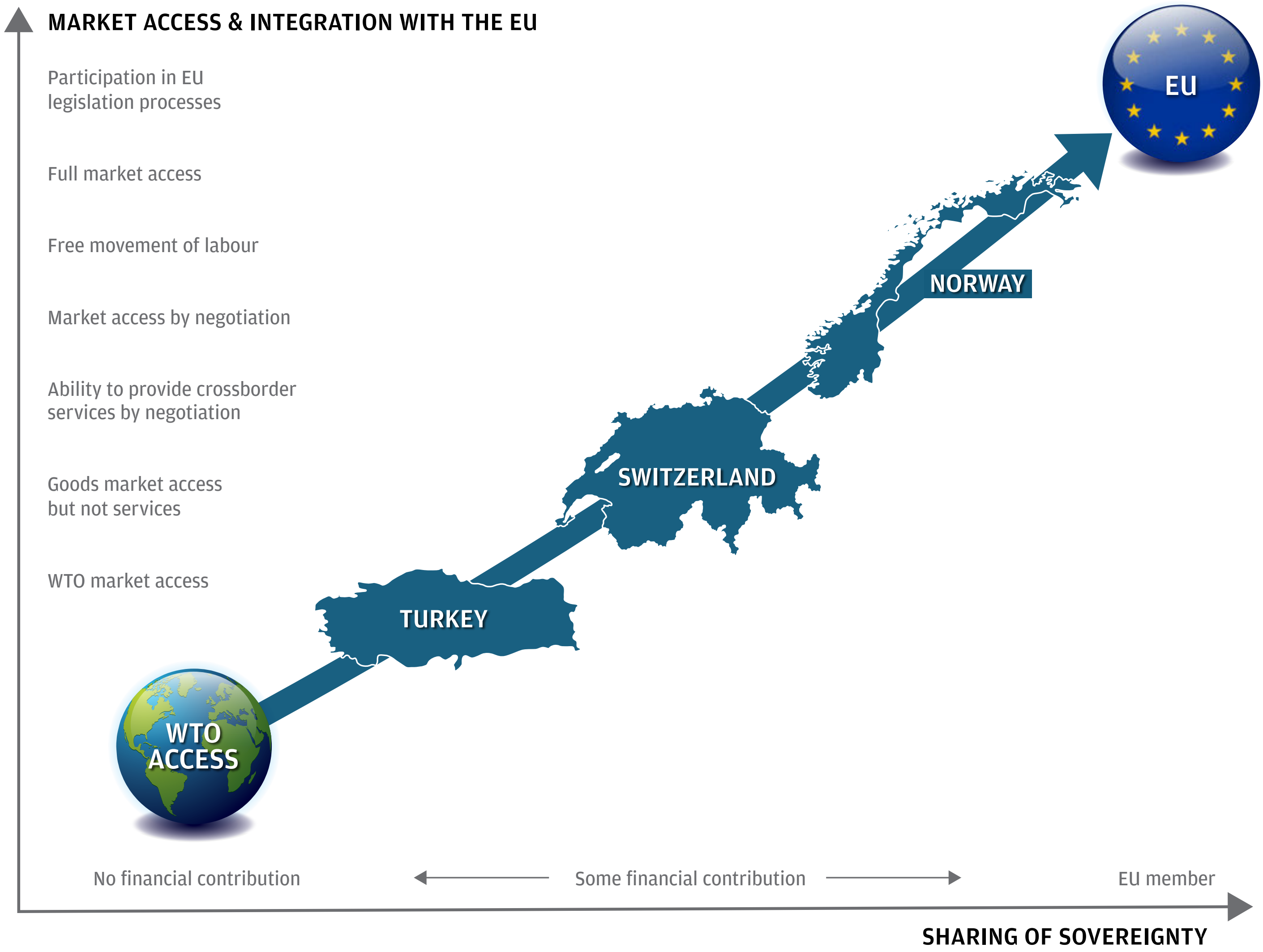


Source: FactSet, ONS, J.P. Morgan Asset Management; data as of 25 February 2016.

Supporters of Brexit say this guarantees a generous settlement for the UK, because the rest of the EU would not want to put that trade at risk. However, most of the deficit is with Germany and Spain, so it's not guaranteed that the rest of the EU would see it that way, and political rancour over the decision to leave could also infect the negotiations. But Britain also runs a significant surplus in services trade including a GBP 19 billion surplus in financial services trade in 2014. Whether the UK would get an equally generous deal on services seems more doubtful.

Much depends on whether EU leaders believe it is in their long-term interest to maintain London as Europe's preeminent financial centre. They might, and they might not. Switzerland is often cited as a model for Britain's relationship with Europe outside the EU. Switzerland has negotiated around 20 bilateral agreements with the EU and dozens of sectoral deals. But in return it has implicitly had to accept free movement of labour from the EU, and it has no deals on financial or any other kind of services.

EXHIBIT 4: SPECTRUM OF POST EXIT EU-UK TRADING ARRANGEMENTS



Source: J.P. Morgan Asset Management; data as of 25 February 2016.

IMPLICATIONS FOR INVESTORS

Recently the BoE summarised four decades of research on the net economic benefit of EU membership: the answer was that it was in the range of -5% to +20% of GDP.[5] The net benefit of Britain leaving the EU would be just as difficult to measure, even long after the fact. It is certainly impossible to predict in advance. But the analysis above does highlight some key takeaways for investors:

- Expect sterling to remain weak for the duration of the campaign. Britain's reasonably sound fiscal position suggests that Gilts would be much less affected, and short-term money market rates are likely to be held down by the BoE's no change stance on rates. But in past episodes of political uncertainty—notably, the Scottish referendum in 2014—we have seen the yield curve steepen slightly relative to the US, and we could see that happen again if the polls continue to be tight.
- Expect growth and investment to be modestly lower in the first half of 2016 due to the uncertainty created by the vote. But don't expect this to outweigh more important factors such as growth in Europe and the US and broader sentiment in global markets.
- Expect most of these effects to reverse themselves in the event of a Bremain vote. But do not be surprised if sterling ends the year materially weaker, on a trade-weighted basis, than at the end of 2015. And do not be surprised if there is talk of another referendum on EU membership if the June vote is reasonably close.
- In the event of a vote for Brexit, expect these macroeconomic factors to intensify, and UK growth to be materially slower than in the no-change scenario. The eurozone would also see a short-term hit. But even for the UK, the broader global outlook will be more important to medium-term growth and the broad direction of UK asset markets.
- Longer term, the microeconomic impact of Brexit will be much more important than the macro. Investors should be especially alert to the outcome for UK financial services firms, many of which could be negatively affected. Manufacturers should benefit, at the margin, from the weaker currency. But uncertainty about the post-Brexit trading relationship will loom large for them too, and skill shortages could be a negative for some companies if inward migration from the EU is curtailed.

[5] *EU membership and the Bank of England,* Bank of England, October 2015.

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