March 2016 Investment Publications Highlights

Should We Stay or Should We Go? The Economic Consequences of Leaving the EU

Swati Dhingra, Gianmarco Ottaviano, and Thomas Sampson, Centre for Economic Performance, the London School of Economics and Political Science, March 2015

The upcoming UK referendum on European Union (EU) membership, which some refer to as the "Brexit" vote, will have profound implications on the country's economy. According to the authors, even under the most optimistic assumptions, the United Kingdom has far more to lose than to gain from a decision to exit the union; they identify economic growth, trade, and foreign direct investment as some of the areas that will be vulnerable.

As an EU member, the United Kingdom currently faces low barriers to trade within the union, which has helped it to specialize in core industries. With almost 15% of UK GDP tied to trade with the EU partners, British businesses and consumers have benefited from low barriers to trade. The United Kingdom has also benefited from high levels of foreign direct investment, ease of economic migration, and access to trade agreements negotiated by the EU with non-EU countries.

The authors argue that even in an optimistic scenario, in which the United Kingdom continues to have a free trade agreement with the EU like Switzerland and Norway, UK GDP would be reduced by 1.1%. In a pessimistic scenario, where non-tariff trade barriers are more meaningful, UK GDP would fall by 3.1%. While the reductions to GDP in both scenarios do incorporate a savings of 0.5% of GDP linked to the income that is usually transferred to the EU, it does not account for long-term losses linked to protectionism.

One area that may be impacted in the long term is productivity growth. The authors suggest that a slower productivity growth rate could double or triple the losses identified in their optimistic and pessimistic scenarios. GDP declines of that size would be comparable to the declines during the global financial crisis of 2008–09. While the impact of an exit vote is not known exactly, even in a benign environment, the UK economy appears set to lose.

Brexit: What If?

UBS Asset Management, March 2016

The current market consensus is that the United Kingdom will vote to stay in the EU. While UBS agrees with that, fears of a UK exit vote are increasing. According to the authors, the considerable amount of uncertainty linked to the referendum is likely to impact the UK economy negatively in the months leading up to the vote.

The authors expect economic growth to begin to wane ahead of the vote due to short-term delays in business activity. UK growth is heavily reliant on overseas investment and trade, and a possible exit vote would likely result in fresh investment decision delays by foreign corporations as managers wait for clarity on trade terms. The United Kingdom's renegotiation of its trade relationship with the EU will be particularly important, since UK exports to the EU make up roughly 45% of total UK exports.

The services sector, a major contributor to the UK economy, is particularly vulnerable to an exit vote. With many banks and institutions using London as a base of operations, revenues could be materially lower if they are no longer permitted to freely conduct business activities across the EU.

The headwinds to the services sector would only be partially offset by a boost to export growth from a weak pound sterling, which still has room to depreciate. While it is unlikely there will be much pressure on short-term bond yields, credit rating agencies have indicated that an exit vote will be viewed negatively. Although the impact of a rating downgrade on gilts is unclear, a steepening of the long end of the curve is possible.

The impact on UK large-capitalization equities from the referendum is likely to be minimal, as large shares of earnings are generated outside of the United Kingdom. At the sector level, properties could suffer the most in the short term, as a more restrictive immigration policy reduces housing demand and the pool of cheap labor. But even if the United Kingdom votes to leave, a lengthy legal procedure is likely to delay its approval, complicating any long-term outlook. Given that Greenland needed about three years to negotiate its separation following its 1982 referendum, a UK separation could be a multi-year affair.

Brexit and EU: Assessing the Impact of Brexit on Credit Markets

Matthew Bailey, *Europe Credit Research*, J.P. Morgan, February 2016

Many proponents and skeptics of UK membership in the European Union (EU) are seeking to convince voters their position will be the least destabilizing. Proponents suggest an exit vote would force the United Kingdom to renegotiate over 60 trade agreements, while skeptics argue that voting to stay would further challenge UK values through new EU integration efforts. While it is still too early to know the consequences of the vote, the authors lay out potential weaknesses following an exit vote and recommend reducing exposure to peripheral EU countries.

The authors assert the transitional cost of a UK exit in the short run could include negative GDP growth and a period of uncertainty as the country renegotiates trade terms with its trading partners. In the months ahead of the referendum vote, the British pound may continue to weaken against the dollar, particularly as the United Kingdom has the highest current account deficit in the Group of Ten. In all, the authors believe the chance of a UK exit vote is at least a one-third probability, noting that credit markets imply chances are higher, near one-half.

Relative to credit markets, UK equity markets are pricing in only a small premium to account for the risks associated with an exit vote, judging by relative levels of equity market volatility in the United Kingdom and the Eurozone. In both credit and equity markets, the authors see financials, property, airlines, and retail as the sectors most vulnerable to an exit vote, as higher labor costs and a weaker currency may weigh on these sectors' profits. In an exit vote scenario, aerospace, chemicals, and pharmaceuticals may be best positioned for potential gains.

Although the authors acknowledge that judging the referendum vote's long-term impact is difficult, they suggest an exit vote could encourage other EU countries to reconsider their membership. Among the countries they identify, France and Greece are two that could follow the United Kingdom, given the strength of both countries' national movements. The authors even suggest Germany could question the benefits of staying in the EU. As investors could look for a potential weak link after a UK exit vote, they should consider cutting periphery exposure, particularly in financials. ■

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