Lazard Insights

Brexit Basics for Investors

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Summary

- The referendum on Brexit is a binary question, but the outcome is not. If the United Kingdom leaves the EU, there is a range of possibilities which depend on the terms of the new relationship.
- Key areas to consider for a better understanding of both sides of the argument include: trade, foreign investment, and EU contributions (in addition to the more sensitive issues of immigration and sovereignty).
- An exit from the EU is likely to have repercussions in economic growth, currency markets, and equity markets in general.
- For equities, the ramifications of Brexit span the criteria around earnings source (with sterling fluctuations playing a key role), large versus small cap, and stock- and sector-specific considerations.
- The financial services sector is a major contributor to the UK economy in terms of trade surplus and employment, and could be significantly influenced by regulatory changes and loss of access to the European Single Market.
- As fundamental investors we remain focused on companies that can thrive in varying economic environments.

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Introduction: A Binary Question but a Range of Outcomes

(This content is discussed in added detail in our Market Update: Brexit's Implications for Financial Markets and Beyond.)

The referendum question which will be posed to British voters on 23 June seems like a simple, binary choice—remain part of the European Union (EU), or leave? But in reality, there is a wide range of possible outcomes. A vote to remain would maintain the status quo and may even strengthen the EU as an institution. But a vote to leave would open up a wide range of possibilities, with varying degrees of impact on the economy and financial markets.

The nature of the new relationship between the United Kingdom and its most important trading partner would only be decided after a two-year period of negotiations, following a process laid out in the Treaty of Lisbon (2007). This negotiation period might seem like a relatively short time frame to unravel decades of economic and political entwinement, and while it could be extended, this would require the unanimous agreement of all countries. Moreover, no country has left the EU, which means Brexit would be unprecedented.

So what might the United Kingdom look like after leaving the EU? This is a key question, and one without a clear answer. There are some existing models which the United Kingdom could follow, such as membership of the European Economic Area (EEA), like Norway's, bilateral trade agreements like Switzerland's, or a customs union. The most extreme outcome would be if no agreements were reached, in which case World Trade Organization rules would apply at the end of the two-year period.

If the United Kingdom votes to leave the EU, there is little incentive for Europe to act generously in the two-year negotiation period. This would risk encouraging Eurosceptic movements in other countries to make a similar move, which could be destabilizing for the whole union.

The economic debate has focused on a few key issues, including trade, investment, and contributions to the EU budget, which we discuss next. For many voters, however, there are more emotive factors influencing their decision, such as immigration and sovereignty.

Key Considerations

Trade

From an economic standpoint, the most important question is probably whether the United Kingdom can retain access to the European Single Market. This provides tariff-free trade with a vast economy and close to 500 million additional customers for UK businesses.

Trade between the United Kingdom and the rest of the EU is important to both sides, but it's not a relationship of equals. The United Kingdom's exports to Europe are worth over £220 billion, and imports total around £290 billion (Exhibit 1, top chart). Campaigners in favor of leaving the EU argue that the value of Europe's exports to the United Kingdom puts the United Kingdom in a strong negotiating position.

But while these are large figures in absolute terms, the relative numbers do more to emphasize the importance of Europe as a trade partner for the United Kingdom (Exhibit 1, bottom chart). Over 40% of the United Kingdom's exports are absorbed by Europe, compared to around 15% traveling the other direction. Relative to GDP, the United Kingdom's exports to Europe are worth roughly 12% of its GDP, compared to around 3% for Europe in terms of the region's GDP.

Norway and Switzerland are often cited as models of a potential trade relationship the United Kingdom could follow if it chooses to part ways with the EU. But their special relationship comes with conditions attached: both must allow free movement of people, comply with EU product laws in order to trade, and contribute to the EU budget. A vote to leave the EU would be a rejection of these conditions, which could make them difficult points to concede in negotiations.

Leave campaigners would argue that trade with Europe is becoming less important over time and other trading partners more relevant; they believe that leaving the EU will free the United Kingdom to make its own trade agreements with other countries. As a member of the EU, the United Kingdom is already party to 53 trade agreements with more in progress. Leaving the EU means new agreements would have to be negotiated, which may not be straightforward. For example, the EU's agreement with Canada took seven years to complete.

Exhibit 1

Europe Is a Major Trade Partner for the United Kingdom

As of 11 March 2016

Data include exports of goods and services. Seasonally adjusted data. EU to UK exports are approximated through the import data in GBP (from ONS) converted to EUR, and then the ratios for GDP and total exports are computed with EU data (from Eurostat).

Source: ECB, Eurostat, Haver Analytics, Office for National Statistics

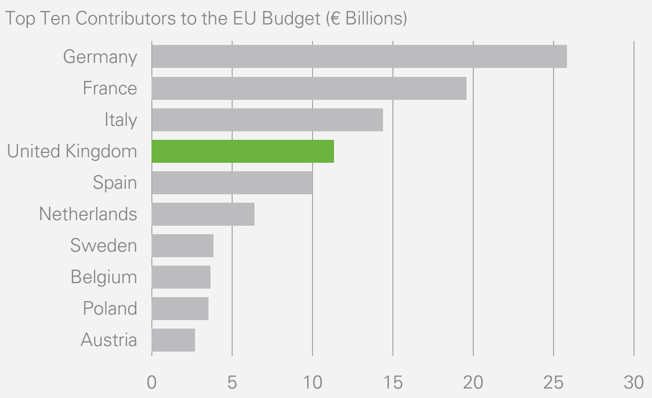
Foreign Investment and the EU Budget

Outside investment into the United Kingdom is another key aspect to evaluate. Foreign direct investment into the United Kingdom has increased significantly since 1993, and about half of this comes from the EU. A vote to leave the EU would create uncertainty during the negotiation period, and could diminish capital flows into the United Kingdom. It remains an open question with regards to how much of the United Kingdom's attractiveness comes down to its role as a gateway to the European market. Corporate relocations could therefore be a risk in any sector where exports to the EU's single market are important.

Capital flows are also important for financing the United Kingdom's large current account deficit, which currently exceeds 5% of GDP.[1] If the United Kingdom chooses to leave the EU and the pound sterling weakens, this deficit would become more expensive to finance.

One of the potential benefits of Brexit could be saving on EU budget contributions. The United Kingdom is one of the countries that contribute more than they receive back, although it is not the largest contributor (Exhibit 2). While the sums involved appear large, at over £8 billion (or €11 billion) for the 2014 UK contribution, this is only around 0.5% of national income. The Office for Budget Responsibility, which provides independent analysis of the United Kingdom's public finances, says that the weaker economic performance caused by Brexit would more than outweigh these savings.

Exhibit 2
The United Kingdom Is Not the Largest Contributor to the EU Budget



As of 2014
Source: European Commission

Additionally, leaving the EU would not necessarily mean an end to the United Kingdom's payments towards the EU budget. Despite not being a member, Norway's contribution is 90% of the amount paid by the UK on a per capita basis,[2] and Switzerland also contributes to the EU budget.

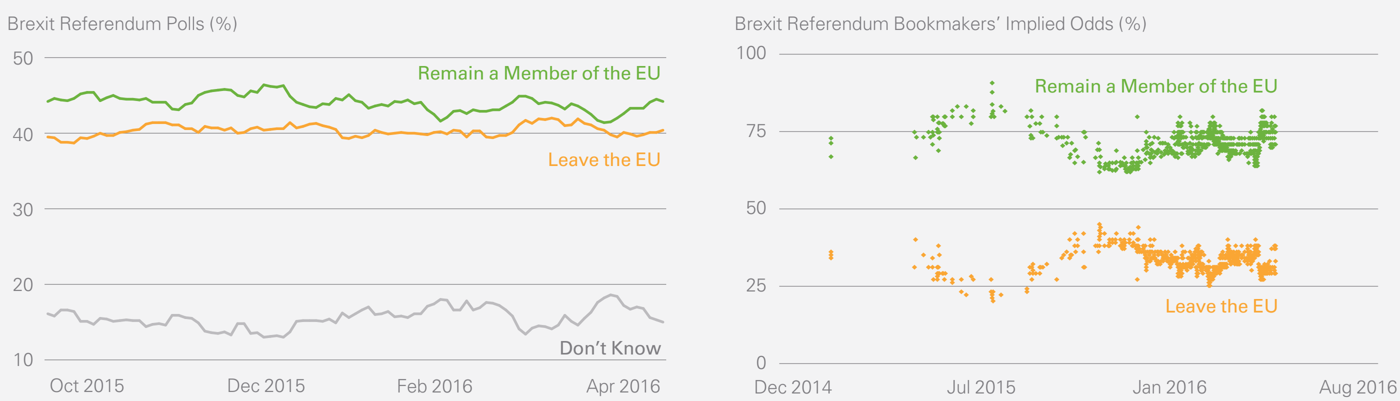
Public Opinion

Opinion polls suggest that the outcome is too close to call, and given the large proportion of voters who remain undecided, there is a significant swing factor (Exhibit 3, left chart).

However, opinion polls did a poor job of predicting the UK general election in 2015—when the Conservatives took a surprise majority—and in the 2014 Scottish referendum a rogue poll shortly before the vote surprised politicians and observers alike, and perhaps ultimately influenced the outcome. Bookmakers' implied odds have become an increasingly popular way of gauging political outcomes, and it is interesting to note that these have shown a much higher likelihood that UK voters will choose to stay in the EU (Exhibit 3, right chart). The latest figures suggest just a 25%–30% chance of leaving. However, a popular saying cautions that "a week is a long time in politics." In the months and weeks leading up to the 23 June vote, unexpected events could sway the vote in either direction.

This referendum will be decided by a simple majority, and there is no minimum turnout required. The Leave camp appears to be more motivated and vocal, and voter lethargy might mean the actual result is quite different from the polls. Whether undecided voters make their minds up before 23 June, feel confident in their views, and sufficiently motivated to actually go out and vote, remains to be seen.

Exhibit 3
What Do the Polls Say?

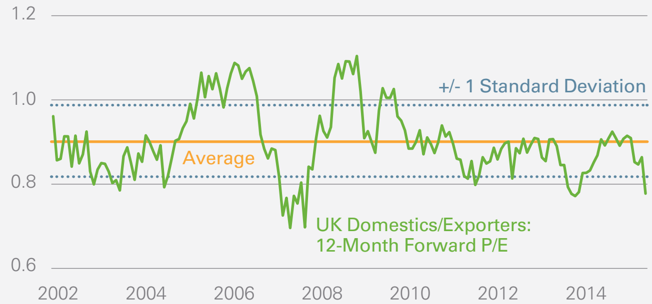


Poll data as of 26 April 2016; bookmakers' data as of 12 May 2016. Polls are shown as the rolling average of the last 13 polls, as that is the average number of polls per month on our data set. Data include 16 different polling organizations and 108 polls taken since 4 September 2015.
Source: oddschecker.com, Societe Generale, whatukthinks.org

Exhibit 4
The Sterling Has Weakened

As of 22 April 2016
Source: Federal Reserve Bank of New York, Haver Analytics

Exhibit 5
The Valuation Discount of UK Domestic Stocks Relative to Exporters Has Widened



As of 10 April 2016
Estimated or forecasted data are not a promise or guarantee of future results and are subject to change.
Source: Barclays Research, Datastream, IBES

Implications

Economic Growth and FX

For financial markets, the uncertainty around Brexit is a major issue. The two-year period of negotiations could leave businesses and investors with less clarity to make informed decisions.

We saw the first glimpse of the potential impact of uncertainty after February's announcement of the referendum date, with a sharp decline in the sterling versus the US dollar, to levels we have only seen twice in the past thirty years (Exhibit 4).

The uncertainty that would arise from the two-year negotiation period is perhaps the reason that a *Financial Times* survey of 100 economists found that 67% would reduce their 1-year GDP forecasts in a Brexit scenario, and 76% would cut them over the medium term.

A vote to remain is likely to bring strength to the sterling, along with some recovery in the relative underperformance of Brexit-sensitive stocks and sectors (more on this later).

A vote to leave, on the other hand, can be expected to lead to further sterling weakness, and this in turn could drive inflation higher. This would leave the Bank of England with a difficult decision, with rising inflation on one hand, but a weaker economy on the other. On balance, the consensus view seems to be that the Official Bank Rate would be cut to a new record low.

In terms of impact on economic growth, much depends on the outcome of negotiations with the EU. The majority of commentators, including the Treasury, expect a negative impact on growth as investment and hiring decisions are delayed in the face of uncertainty and consumers delay large purchases. There is already some evidence emerging of a pause in activity, with recent Purchasing Managers' Index data declining and service businesses stating that contracts had been delayed because of the upcoming referendum. Consumer confidence has also been weakening since January, and spending has been decelerating although weather effects mean it is difficult to quantify how much of this is due to referendum-related concerns.

Longer-term GDP impacts depend on many unknown variables. Normal patterns are likely to resume, but some of Brexit's potential consequences, such as lower population growth, decreased investment, and impediments to free trade, would have a negative impact. The question is whether the benefits of leaving the EU could be large enough to offset these.

Equity Markets

As equity investors, macro considerations are no doubt important but the impact on individual companies is more relevant from our perspective. Some stocks and sectors would clearly be more affected than others, and currency fluctuations will be an important factor. Companies which generate most of their revenues outside the United Kingdom are likely to benefit from sterling weakness. But importers, such as some retailers, will generally face higher costs. A weaker sterling will make outbound travel more expensive, but potentially make the United Kingdom a more appealing destination—so the effects are likely to be stock-specific in nature.

Businesses which are more exposed to the domestic economy are most likely to be hurt by lower growth, and this may explain some of the underperformance of UK mid- and small-cap stocks year to date. Mid and small caps tend to be more domestically focused than (large cap) FTSE 100 companies, which generate nearly 80% of their earnings abroad.[3]

There is also a risk that a Brexit scenario will increase the pressure for a re-run of the Scottish referendum, so companies with significant business in Scotland may underperform once again.

The weakness in domestically focused companies is already visible to a certain degree. The forward price-earnings ratio of UK domestic stocks relative to exporters has widened to roughly a one standard deviation discount (Exhibit 5). These data suggest there has already been a strong reaction, which could represent an attractive opportunity if voters choose to remain.

Financial Services

The financial services sector would be significantly impacted by Brexit. The United Kingdom has a major trade surplus in financial services (Exhibit 6, left chart), and roughly 40% of this is directly to the EU. Single market access through the "passporting" scheme has been a huge benefit to this sector. This scheme allows European firms to operate throughout the EU without the need to set up an office in each jurisdiction. There would be significant costs if these businesses were forced to relocate operations to, for example, Dublin, Frankfurt, or Paris, as well as increased regulatory costs and possibly additional higher capital requirements to operate in Europe.

This sector is also very important from an employment perspective, with well over a million jobs in finance and insurance, (Exhibit 6, right chart). The government recently stated that 285,000 financial services jobs are directly linked to business with Europe, and that job losses could be in the tens of thousands.

Impact on the Rest of Europe

The impact of a Brexit vote would not be confined to the United Kingdom, and there would be political and economic ramifications across the EU. In terms of trade, some countries are clearly more exposed than others. Belgium, Ireland, the Netherlands, and Germany are among those most affected in terms of the importance of exports to the United Kingdom relative to their overall economy.

Perhaps more interesting are the political consequences, which would create a set of open questions and unknowns: Could the United Kingdom's departure unsettle the whole EU? Will other countries seek similar concessions to those negotiated by the United Kingdom in February 2016?

Conclusion

British voters face an important but difficult decision in June, made all the more challenging by the lack of clarity about exactly what the United Kingdom's relationship with Europe would look like.

When we think about trade and investment, it seems likely that there would be some short- to medium-term negative economic consequences if the United Kingdom leaves the EU. Over the longer term, it is less clear. The Leave campaigners argue that the United Kingdom would be more competitive outside the EU, and that any short-term pain will be worthwhile for the long-term benefits of Brexit.

But we should remember that the economy is not the only thing voters are mulling over as they make their decision. Sensitive subjects like immigration and sovereignty may prove to be more important factors, particularly for undecided voters. And certainly, at this point in time the polls suggest the outcome is too close to call.

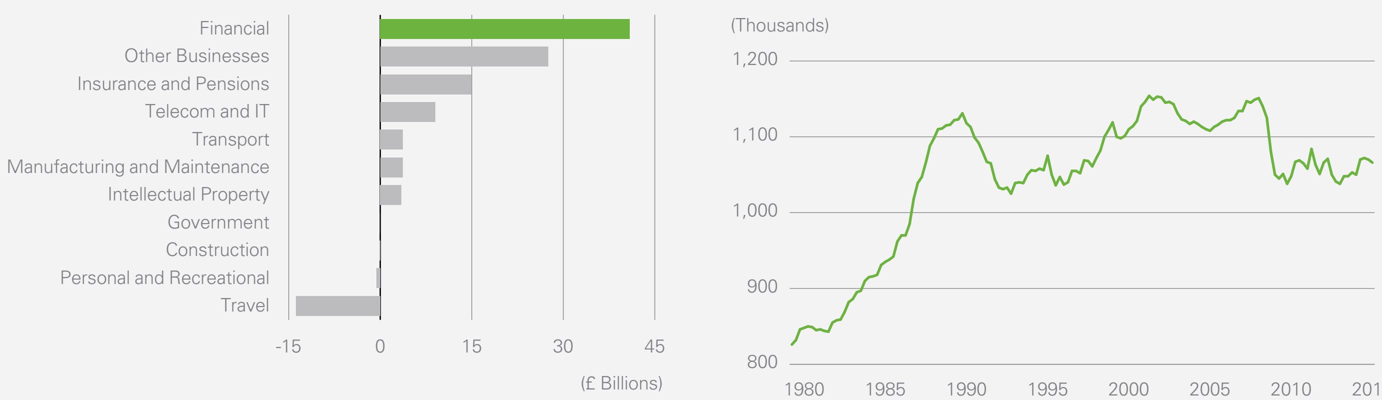
As investors, the key to this situation is the uncertainty that the possibility of Brexit creates, and uncertainty is something that is generally not enjoyed by financial markets. At least until the referendum, and possibly afterwards, we can expect to see financial market volatility and this could be exacerbated by shifts in the polls or other events. But volatility often means opportunity, and in the long run, politics often has far less influence than short-term market responses might suggest. This means that we can use our fundamental understanding of companies to identify opportunities to invest at attractive valuations and in businesses that we believe can continue to be financially productive regardless of the referendum outcome.

Exhibit 6

The Financial Services Sector May Be Significantly Impacted

Trade in Services Balance 2015

Employment in Finance and Insurance



As of 31 March 2016

Source: Haver Analytics, Office for National Statistics

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Notes

1 Source: Bloomberg, as of 31 December 2015.

2 The Economist. "The Brexit Delusion." 27 February 2016.

3 Credit Suisse. "Brexit: Breaking up is never easy, or cheap." 25 January 2016.

Important Information

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