Breaking up is hard to do

Exploring the economic and financial consequences of the UK’s upcoming EU membership referendum, and the implications for investment strategy.
Since joining the European Economic Community in January 1973, which later became the European Union (EU), the UK has had an uneasy relationship with the project.

Its commitment has been tested several times over the years. More recently, the marriage has hit the rocks and may be about to break down completely.
While some believe the UK’s financial contribution to the EU’s budget is a waste of money, others warn that an emerging European superstate, which is both unaccountable and unelected, poses a threat to national sovereignty. To stop the country’s never-ending debate about EU membership, Prime Minister David Cameron has promised to hold a referendum on 23 June 2016.

The conversation surrounding the possibility of the UK leaving the EU is so popular today that it even has its own name – Brexit. If the Scottish independence referendum in September 2014 is any guide, then it is likely to be a closely run contest and forecasts of the result could fall wide of the mark. In the short term, uncertainty surrounding the decision now presents one of the key risks for the UK economy and financial markets.

As investors, we want to be able to make informed decisions as the situation evolves. To shape our long-term thinking and guide our investment decisions, we have analysed the potential impact of Brexit on the UK economy through a framework of five key myths – wages and employment, trade and industry, financial services, public finances and foreign investment.

If you would like to receive a copy of the full report, _If you leave me now_, please contact your investment manager or email info@rathbones.com.

**Wages and employment**

Although there are manifold socio-political contentions, it is difficult to conclude that the UK economy has not benefited from the increase in immigrant labour from Europe (immigration from outside the EU is another matter). Most immigrants are working age and relatively well-educated, offsetting the negative effects of the country’s own ageing population. However, public services may come under pressure if migrant workers stop returning to their native countries upon retirement.

The academic literature confutes the idea that immigration from the eurozone has taken away jobs from UK nationals and depressed overall wages. There appears to be no correlation between immigration and rates of unemployment for UK natives when one looks at county-level data, for example. Although immigration may have put downward pressure on wages for the very lowest-skilled workers, some studies suggest it has actually increased those across the rest of the market. Therefore, we would not expect wages to increase (pushing up inflation) or the unemployment rate to fall significantly if the UK votes to leave the EU.
**Trade and industry**

The UK runs a deficit in goods and a surplus in services with the EU. We believe the idea that the UK’s trade balance would collapse if the country leaves the EU is an exaggeration. The country may even be able to retain access to the single market, which takes almost half its exports. Yet it might then have to accept most EU rules and even pay money to Brussels in return, like Norway and Switzerland.

Even without an agreement, the UK would remain protected from any unfavourable treatment by global trade rules. However, EU trade tariffs do present some risk. There are nearly 20,000 of them and a vote to leave would threaten some economic activities and industries more than others, notably motor vehicles, chemicals and clothing. Yet the business models of most UK exporters are not based on providing the lowest-cost goods. Quality assurance, ease of doing business and transparent supply chains are among the many reasons why overseas companies choose to import products from the UK.

The longer-term impact of a Brexit on trade depends on how well Europe progresses by reducing the remaining trading barriers between its members. Further European harmonisation without the UK would increase the risk that EU imports from the UK could be replaced by internal trade.

**Financial services**

Some Eurosceptics look towards the Swiss financial services industry, which has thrived outside the EU, and believe this model could work for the UK. However, Switzerland’s relationship with the EU is complex and could not be replicated easily. Evolving legislation could push financial services activity back towards the Continent if the UK were to exit the EU, resulting in a gradual loss of business and investment. Indeed, we are already seeing new legislation that makes it increasingly difficult to do business in Europe from a non-European platform. Notably, some foreign banks that use the UK as a base for operating in Europe have suggested they would move to the Continent if the UK leaves.
However, we believe this is highly unlikely to result in a rapid loss of business. Additionally, given London’s history of financial innovation, supportive government policy and well-established role as a centre of global finance, there is scope to ameliorate the long-term consequences.

**Public finances**

Meanwhile, a simple calculation suggests the UK would save £9 billion a year if it did not have to contribute to the EU’s budget (figure 1). Yet at least two-thirds of this saving would probably be eroded by the UK government compensating businesses and organisations that benefit from EU subsidies; continuing contributions into the European Economic Area (EEA) if the UK were to retain access to the single market; or losses from the positive contribution made by eurozone migrant workers.

Although we do not expect the UK economy to collapse if voters choose Brexit, the process of leaving would create uncertainty, which could reduce growth and, in turn, government tax receipts. As such, we do not believe the government’s fiscal position would change enough to cause a substantial reaction from gilt markets.

**Figure 1. For better or worse**

UK contributions to and receipts from EU budget in 2014/15 (£ billions).

<table>
<thead>
<tr>
<th>Contribution based on GNI</th>
<th>Contribution from customs receipts</th>
<th>Contribution from VAT receipts</th>
<th>UK rebate</th>
<th>EU budget disbursements</th>
<th>Fee for collecting duties UK rebate</th>
</tr>
</thead>
<tbody>
<tr>
<td>£13.7</td>
<td>£3.0</td>
<td>£2.3</td>
<td>-£4.8</td>
<td>-£4.4</td>
<td>-£0.8</td>
</tr>
</tbody>
</table>

*Source: OBR, Datastream and Rathbones*
Foreign investment

There are concerns that foreign investors will withdraw from the UK if the country leaves the EU. So far it is difficult to conclude that even the prospect of Brexit is slowing the flow of inward investment — across a number of measures, 2014 was a record year. Surveys indicate that research and development will be the focus of investment projects over the coming years — an area for which the UK is very attractive.

Yet there are some concerns. For example, in Ernst & Young’s 2015 UK attractiveness survey, 72% of investors highlighted that UK membership of the single market is at least ‘fairly’ important to the UK’s attraction as an investment destination. Although it is difficult to forecast the long-term implications of Brexit, we do not expect an outflow of foreign investment in the short to medium term. That said, uncertainty could postpone inflows, particularly in the financial sector, and sterling could suffer an increase in volatility as a result.
**The economy and bonds**

One of the key conclusions from our exploration of the issues surrounding Brexit is that the implications of the decision to leave or stay in the EU are more complex and finely balanced than newspaper headlines imply. Therefore, we urge investors to avoid any individual investment tips that rest on the result of the referendum alone.

Assessing the possible impact of Brexit on the pace of UK economic growth is difficult because there are so many moving parts and unanswered questions. Due to the finely balanced spread of potential outcomes we do not expect the direction of financial markets to be affected significantly in the run-up to the referendum or immediately after, even if the UK votes to leave the EU. However, a significant increase in volatility is likely in an environment of uncertainty.

In our report, *If you leave me now*, we assign some probabilities to a simple, illustrative schema to show that the likelihood of a sustained negative impact on the UK economy is perhaps at worst 1 in 6, and more likely 1 in 10 (EU completion pursuant to a full Brexit with no special terms). Although these odds should be taken with a large pinch of salt, it is important to think, like markets, in probabilistic terms.

In particular, general economic uncertainty could place upward pressure on gilt yields. Overseas investment in UK government debt is close to an all-time high, increasing the market’s vulnerability to any deterioration in sentiment. However, the Bank of England could shift monetary policy to offset any negative effects from economic uncertainty and loss of confidence.
The stock market

UK equities are likely to be affected in different ways according to the size of the underlying businesses. More than three-quarters of FTSE 100 revenues come from operations abroad so we do not expect a large amount of volatility. Only around one pound in every six is earned in Europe.

Companies in the FTSE 250 Index are more domestically oriented. Any increase in the likelihood of a full Brexit could depress their share prices (figure 2). However, we note that this index did not become more volatile relative to large-caps in either the run-up to 2014’s Scottish independence referendum or 2015’s UK general election.

The financial sector faces the greatest risks. At the start of 2015, the share prices of European banks plunged to near the lows of 2012, when the eurozone looked likely to disintegrate. Negative interest rates are squeezing banks’ profits, and investors are worried about the financial health of a number of institutions. Share prices could fall further if the industry becomes the focus of negotiations before the referendum.

Figure 2. UK equity risk premium and economic uncertainty

Domestically focused UK stocks are more sensitive to the EU debate.

Source: Datastream, I/B/E/S and Rathbones.
**Foreign exchange**

Sterling is susceptible to bouts of volatility from changes in investment flows into or out of the UK. Any slowdown in debt and equity investment would put downward pressure on sterling, just as it did after the UK was forced to leave the Exchange Rate Mechanism in 1992. Sterling volatility also increased sharply around 2014’s Scottish independence referendum and 2015’s general election (figure 3).

![Figure 3: One-month implied currency volatility](image)

Currency markets do not like the uncertainty of elections and referendums.

Source: Bloomberg and Rathbones.

Meanwhile, the timing and direction of central bank monetary policy is another source of uncertainty for sterling. The Bank of England’s looser stance on interest rates adds to the downside risks of sterling against the US dollar, while the even looser bias at the ECB makes near-term moves in the euro-sterling exchange rate more finely balanced.
If sterling depreciates, we do not expect UK companies to benefit meaningfully. Over the past 10 years, export volumes, prices and the trade balance have been insensitive to changes in the exchange rate due to a number of factors. They include more complex global supply chains, the increasing dominance of financial services exports, weak external demand and companies using currency weakness to boost profits rather than cutting prices. Manufacturers with more local supply chains stand to benefit the most.

In or out?

On 19 February, the European Council released decisions on a ‘new settlement’ for the UK with the EU. The Prime Minister has trumpeted the deal as a victory and one that he believes will pacify swing-voters currently threatening to vote to leave. However, we think the proposal for a mechanism to restrict social benefits to immigrants is unlikely to satisfy those for whom immigration is the driving force behind their anti-EU position. Remember that immigration consistently outranks broader EU issues in the polls of voter sentiment. As such, we do not believe the new settlement will materially alter the balance of likely outcomes.

Investors should note that there was no discernible impact on gilts or UK equities on the first trading day after the announcement (gilt yields were unchanged and the FTSE 100 Index rose). Sterling suffered sharp falls, confirming our view that this is where the effect on volatility is likely to be most acute. However, investors should note that the correction in sterling over the past few months is as much about an overbought starting point and a broad brushed ‘risk off’ environment as it is about fears of Brexit.
Key points

– To shape our thinking and guide our investment strategy, we have analysed the potential impact of Brexit on the UK economy through a framework of five key myths.

– One of our key conclusions is that the implications of the decision to leave or stay in the EU are more complex and finely balanced than the campaign rhetoric implies.

– We expect UK financial markets to become increasingly volatile as a result of economic and policy uncertainty. However, the finely balanced spread of potential outcomes makes the emergence of any pervasive directional trends one way or the other unlikely.

– If the UK does vote to leave, then some industry sectors are more vulnerable than others, particularly motor vehicles, clothing and chemicals.

For further information and updates on the Brexit debate, please visit rathbones.com/brexit
The value of investments and income arising from them may fall as well as rise and you might get back less than you originally invested.