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UK referendum on Brexit

The UK's vote on Brexit will be held on June 23rd. Polls suggest a very tight contest.
The UK referendum on whether to remain a member of the EU takes place on June 23rd. Opinion polls suggest the result is hard to call. An average of the last 6 polls compiled on May 16th by the Daily Telegraph newspaper puts both sides on 50%. But opinion polls have sometimes been a poor guide to UK voting results, as they were for last year's general election. Given this, some view the odds quoted by bookmakers as a more reliable indicator. These have consistently suggested that the "remain" camp will win by a small margin.

Most studies show Brexit would be bad news for Europe and especially for the UK.
With Brexit therefore a real possibility, investors need to consider what the main implications might be. To us, and to most analysts, they are likely to be negative, most especially for the UK, but also for the rest of Europe. The April 2016 study of the OECD suggests that the UK economy will be more than 3% smaller than otherwise by 2020 if the UK opts to leave the EU and that the economy of the rest of the EU will be nearly 1% smaller than otherwise. The main factors for the reduction in UK GDP would be (i) less robust trade, (ii) reduced immigration, (iii) higher risk premia and (iv) lower confidence or increased uncertainty. London's current advantages in the financial sphere would also be eroded – especially in euro-related business. The rest of Europe stands to be negatively impacted partly because it is a big net exporter to the UK (which accounts for around 16% of all goods exports from the rest of the EU) and will therefore suffer if the UK is weak. But Europe may also be impacted by higher risk premia and increased uncertainty.

A Brexit vote could trigger sharp movements in markets.
For the near term, IMF President Mme. Lagarde has suggested the consequences of a Brexit vote range from "pretty bad to very, very bad" and has warned of a market panic, a sharp fall in UK stock and house prices and recession. Meanwhile Bank of England Governor Carney has also suggested that a sharp drop in sterling, falling house prices and higher inflation risks could all combine to induce a UK recession. Thus, the immediate negative consequences of a Brexit vote, not only for the UK but perhaps also for the rest of the EU, would stem in large part from market adjustments to higher risk premia and increased uncertainty. In other words, currencies and asset prices, especially in the UK, could move quite sharply after the Brexit vote.

Brexit would severely jolt the EU political process.
Two of the most basic trends for the EU since its establishment are, first, that over time countries join it and, second, that member countries vote from time to time to become more tightly linked. Brexit would represent a big reversal on both counts and thus take investors into new territory. Regarding the EU political process, a UK departure would remove the hitherto loudest voice within the EU in favor of liberalization. The UK currently has 13% of votes on the European Council. If she departed Germany

would be more politically exposed and might find it harder to muster a 35% blocking minority to prevent restrictive measures being passed. Also, net recipients of EU Budgets would gain influence at the expense of net contributors. Then again, a UK departure could encourage separatism elsewhere and a reduced willingness to support EU projects, including country bailouts.

Instabilities from the UK would spill over into the rest of Europe.

For the UK, the uncertainties would be even greater – not least because the UK is where the major impacts would fall. A Brexit vote could well spell the end of Mr. Cameron's term as Prime Minister, and the ruling Conservatives do not in any case command a strong majority in the House of Commons. Perhaps more importantly, as Scotland is strongly pro-EU, a Brexit vote would increase the chances of a second Scottish referendum on independence resulting in a vote to leave the UK. That would reopen potentially troublesome questions including how much Scotland – as opposed to the rest of the UK – would be liable for the outstanding public debt of the UK (roughly $2.3 trillion). Then, there is the uncertainty about the future relation between the UK and the EU. Theoretically, the Treaty on European Union allows a 2 year window for negotiation but few believe that new arrangements can be agreed in this time. A liberal trading arrangement might be impossible to negotiate if the EU price is the free movement of labor. After all, EU immigration into the UK is cited as the biggest objection to the EU among those in the UK wishing to leave it. In the absence of a satisfactory agreement, the UK might become highly disruptive so far as its trade relations with the EU are concerned. For example, it might seek to protect its present FDI advantage by the combination of a weak currency, special tax deals and more liberal labor laws.

Probably the markets are positioned for the UK to remain. There may be trouble if they are wrong.

Predicting market movements in the near term is almost impossible as one never knows what current market prices discount. But we think there is a good chance that as June 23rd nears European assets, and especially UK assets, will sell off if the vote still looks close or if a decision in favor of Brexit looks a significant possibility. This is because a Brexit vote is generally viewed as very bad for the UK and bad also for Europe. We also suspect that, on balance, markets are still assuming the UK will in the end vote to remain. As this is our main scenario, we do not hedge our equity exposure. If we are wrong on this and the markets tank, we would view substantially lower equity prices as buying opportunities.