GADD

Market Insight

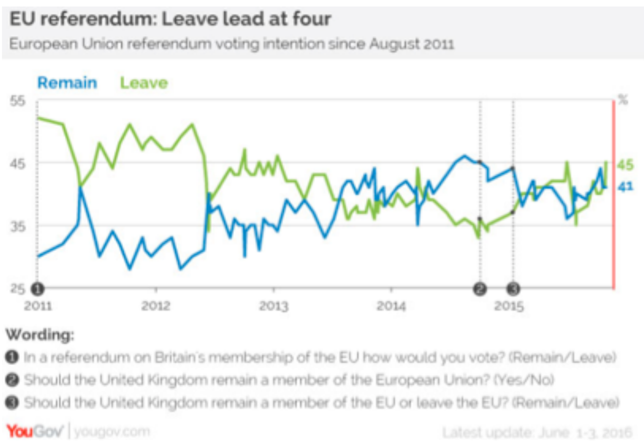
BREXIT

UK referendum on EU: Should I stay or should I go?

The "Brexiters" have jumped ahead of the "Remainers" in the latest polls over the much heated referendum on June 23 over UK remaining or leaving the European Union. Brexit fears show already on economic growth in the UK and on financial markets, with sterling as the first victim. A correcting, relief rally in both sterling and the FTSE would most likely follow from a "Remain" outcome, whilst a "Brexit" would probably trigger sharp losses on financial markets, first and foremostly on sterling.

Brexiters jump ahead

In a surprise move, the Britons in favour of exiting the European Union have jumped ahead of the advocates of the "Remain" camp. The jump came only days after the UK Prime Minister David Cameron came under crossfire in a TV show over the implications for the UK of the Migrant crisis in Europe.



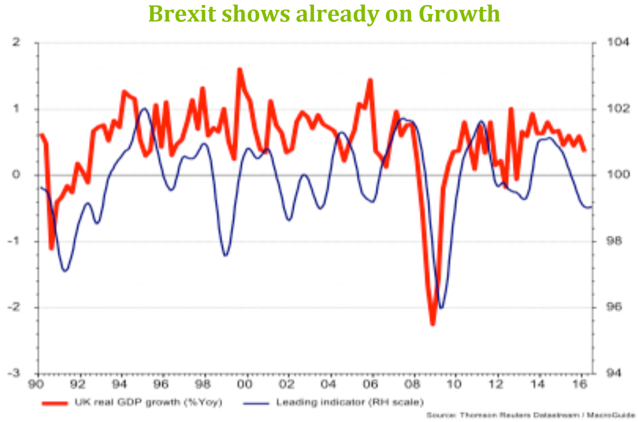
The chart shows that the "Leave" were already ahead of the "Remain" in 2012, when the European Union had to deal with yet another "exit" fear, that of Greece. Interestingly, the change of wording of the fundamental question of the referendum also seemed to have some impact on the polls. As point 3 in the chart goes to show, moving to the question of "Should the UK remain a member of the EU or leave the EU?" (Remain/Leave) seemed to give more courage to opt for Brexit for those many Britons who are unclear as to what to do. Clearly, the previous format of the question which required to say "No" to the question "Should the UK remain a member of the European Union? (Yes/No)" would have probably tilted the "undecided" camp towards the Yes, rather than opting for a "No" which highlights uncertainty.

The debate over Brexit appears to be flawed: those in favour of "Remain" point to the huge economic costs of leaving, whilst the "Brexiters" argue that the "Remain" scenario entails huge socio-economical costs over the Migrant crisis. So it's "Economics" vs "Migration" issues which explains why many voters are still undecided.

Brexit : what economic impact ?

Industrial surveys show that 50% of firms are already cutting spending in the UK or postponing them to after June 23rd. This has prompted the OECD to downgrade its growth forecast for the UK this year to a mere 1.7%, sharply down from the 2.1% the Organization was predicting only in February. To the Brexiters who questioned the OECD main reason for this sharp downward revision, the Paris-based organization has made no bones about the UK's possible exit from the European Union as being the main reason for the downgrade.

Brexit shows already on Growth



The 200-odd pages long HM Treasury analysis over the long-term economic impact of EU membership and the alternatives is steadfastly clear in its conclusions: the UK would experience a severe recession if the country were to opt for the Brexit, with a total output cut of 3.6% in 2016-17 accompanied by some 500'000 job losses and a sharp fall in sterling by more than 15%. And that is the central case. When devising a "worse case" scenario, the numbers grow to 6% loss in GDP and more than 800'000 job destructions over the next 2 years.

After 15 years following the leaving of United Kingdom from the EU, the annual output loss would be 6.2% from a central, "remain" growth path, if the UK were to chose the Swiss way of Negotiated bilateral agreements. In this case, each household in the UK would incur an annual loss – actually, an earning shortfall – ranging from £ 3'200 to £5'400 relative to the "remain" GDP per household.

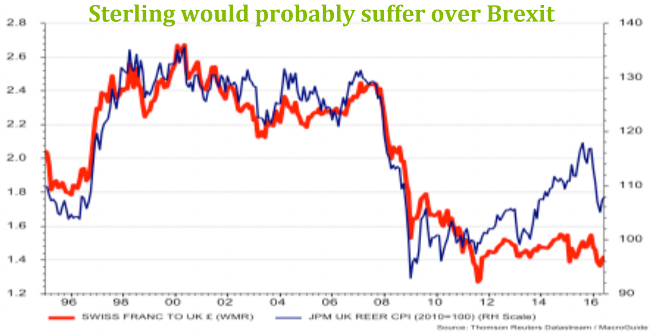
These numbers are pretty scary. Probably too much. Duncan Smith, one of Brexit leaders, makes an easy call when he says that if analysis of the Treasury was right, the world would come to an end over a Brexit. Such scaremongering would be laughable if the issue was not so serious, Brexiters rightly argue.

Sterling as the first victim ?

Economists differ over the magnitude of output and job losses if the UK was to leave EU. But, aside from a partisan organisation called "Economists for Brexit" which unsurprisingly estimates that GDP would actually rise following a Brexit, all other Economic Think tanks forecasts lower GDP and higher unemployment over Brexit. Where both the partisan organisation and the other agree is over the currency, which would be hit by a Brexit.

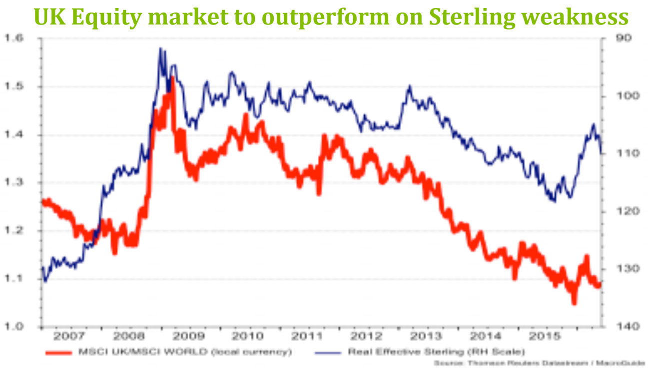
Indeed, the pound has been falling steadily vis-à-vis the Swiss franc, but this trend pre-dates Brexit fears. Recent losses against the Euro have resulted in a sharp reversal of the Sterling in real effective terms, namely against a basket of the UK trading partners' currencies, adjusted for inflation differentials. This is the best measure available for measuring the competitiveness of UK exports. Deviations from the mean of the real effective exchange rate also provide a perfect estimation of the degree to which a currency is over or undervalued in Purchasing Power Parity (PPP) terms.

Looking at the currency chart suggests that sterling would probably be hit by a "Brexit", for at current levels, the real effective exchange rate is close to fair value.



The Equity market may be the (Union) Jack of all trades…

When comparing the real effective sterling rate to the ratio of the UK Equity market index to the World Equity market index, we note that there is a pretty good correlation pertaining to the UK equity market outperforming when Sterling weakens (like in 2008) and conversely. The reason is straightforward: only 23% of the FTSE 100 market cap is domestic demand driven, against a share of 56% for the Eurostoxx index and 70% for the S&P 500.
In conclusion, Brexit would be bad news for the currency but would probably represent less of a hit



for the Equity market, as at current levels, it is both attractive in valuation terms (the UK offers the one of the highest Dividend yields amongst Developed markets) and it fails to reflect the recent weakening of the real effective Sterling. We cannot but hope that the UK will opt for the "Remain" option, and that should trigger a relief rally in both Sterling and the Equity market.

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