



## CIO Preview Flash

### Brexit: the clock is ticking – 100 days to go

March 16, 2016

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#### Timeline and details

- With David Cameron returning from the EU Summit on February 19<sup>th</sup> with a renegotiated deal that fell short of convincing the critics, the Brexit debate gained momentum - it now occupies U.K. headlines on a daily basis.
- We currently see the risk of a Brexit at “only” 35 percent, but this number could very well change. Boris Johnson, mayor of London, and Michael Gove, Secretary of State for Justice, are only two of several prominent politicians that joined the “leave” camp post the EU Council. Any kind of violent incident that the electorate could associate with the current European migration issue could also strengthen this camp. On the other hand, businesses from the U.K. as well as international ones are stepping up their “remain” campaign.
- Financial markets have already expressed their worries concerning a Brexit with the British pound (GBP) for example having lost 5.2%\* this year against the euro (EUR) and 2.9%\* against the U.S. dollar (USD). We believe the uncertainty is set to stay until polling day on June 23<sup>rd</sup>, no matter how clearly one party is in the lead, as voting intention surveys have proved unreliable in the past. Should the British vote to leave, uncertainty will continue, as an untested process of divorcing from the EU is to follow and that could take anywhere from 2 to 10 years to establish clarity on the new regime.

#### How bad could it be for the U.K. and for Europe

- We believe a Brexit would hurt the U.K. economy and U.K.-related assets – possibly more so in the short rather than in the mid term. Mainly through lower consumer spending, we estimate that 2016 U.K. gross-domestic-product (GDP) growth could drop by 0.5 percentage points (pp) to 1.5%.
- Europe wouldn't profit from a Brexit either. It needs to evaluate, however, whether it would lose more from a Brexit or from having offered too many concessions to the U.K. and that could set a precedent for other less enthusiastic EU members. This could derail further integration, a necessity in a common-currency regime. Whether a Brexit would encourage continental anti-EU movements is uncertain and would depend on the immediate repercussions for the U.K.
- Politically, the damage will likely be mutual. Both U.K. and Europe will lose international negotiating power. The jury is still out as to whether Europe would suffer more in the medium term from losing a proponent of free markets and necessary EU reforms or whether reasonable parts of EU integration would be accelerated without U.K.'s constant resistance.
- Assets worth some 46% of U.K.'s GDP are held by banks, companies, governments and households from the EU ex U.K. Any slowdown and asset depreciation in the U.K. resulting from a Brexit would therefore also spill over to the EU.

#### Asset-class views – Brexit would increase risk premia

We believe a “leave” would trigger a risk-off mode, weighing on most European risk assets. Immediate U.K.-related uncertainty will be aggravated by further EU disintegration fears. As a Brexit scenario is partially priced in, volatility is all but certain on June 23<sup>rd</sup>: a “remain” would trigger a relief rally in assets under pressure so far, a “leave” would prolong current negative momentum.

- **Equities:** A Brexit would hurt both EU and U.K. equities as the uncertainty triggers volatility and higher risk premia. Furthermore, a Brexit might trigger detrimental new trade barriers or tariffs between the U.K. and the EU. The weaker GBP that we expect in case of a Brexit has many potential implications. U.K. companies with a high export share of sales – FTSE 100 Index firms have an export ratio of 80% - are set to benefit. Stoxx Europe 600 Index firms, in total exporting 10% of their sales to the U.K., would slightly suffer – auto makers for example we think could see their earnings per share (EPS) decline by 5-14%. Given higher exposure to the domestic economy, FTSE 250 Index firms would suffer more than multinationals from a weakening U.K. economy. Year to date the FTSE 100 has lost only 0.6%\*, but the FTSE 250 4.8%\* and the Euro Stoxx 50 Index 5.9%\*.
- **Fixed Income:** We expect Gilts, periphery and other spread bonds to suffer short term from a Brexit-related risk-off mode.
- **Currencies:** We expect that a Brexit takes up to 10% off the value of the GBP and the EUR against the USD. A minor part of this downside is already priced in.

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# Glossary

## Explanation of terms

**Boris Johnson** is a conservative Member of Parliament and serving Mayor of London since 2008.

**Brexit** is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom of the European Union.

The **Conservative party** is a centre-right political party in the United Kingdom.

**Earnings per share (EPS)** is calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.

The **euro (EUR)** is the common currency of states participating in the Economic and Monetary Union and is the second most important reserve currency in the world after the U.S. dollar.

The **European Union (EU)** is a political and economic union of 28 member states located primarily in Europe.

The **FTSE 100 Index** tracks the performance of the 100 major companies trading on the London Stock Exchange.

The **FTSE 250 Index** is a weighted index of the 101st to the 350th largest companies (by capitalization) listed on the London Stock Exchange.

**Gilts** are bonds that are issued by the British Government.

**Michael Gove** is a conservative Member of Parliament, Lord Chancellor and the Secretary of State for Justice.

The **gross-domestic-product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

**Periphery countries** are less developed than the core countries of a specific region. In the Eurozone, the euro periphery consists of the economically weaker countries such as Greece, Portugal, Italy, Spain and Ireland.

The **risk premium** is the expected return on an investment minus the return that would be earned on a risk-free investment.

The **sterling**, also known as the pound sterling, is the official currency of the United Kingdom.

The **Euro Stoxx 50 Index** tracks the performance of blue-chip stocks in the Eurozone.

The **STOXX Europe 600 Index** is an index representing the performance of 600 listed companies across 18 European countries.

The **United States dollar (USD)** is the official currency of the United States and its overseas territories.

**Volatility** is the degree of variation of a trading-price series over time.



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