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Brexit update

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Summary

The UK joined the EEC on 1st January 1973 and on June 23rd we will see the electorate vote on a choice to exit the European Union. The latest polls and media suggest the race is a close call, with the “leavers” recently gaining ground. When we dissect the polls and turf accountants’ odds, we estimate the probability of an exit is currently running at around 35%. The significant numbers of undecided voters on this complex issue have a history of following the status quo, so in all probability those on-the-fence now will most likely vote “stay in”.

Can we learn anything from history? There have been six EU referendums in recent times (though only one was a simple in / out). In 2005 four countries gave their electorate the chance to decide on the adoption of the EU Constitution. Holland and France rejected adoption, whilst Spain and Luxembourg approved it. In response to the two rejections the ‘Lisbon Treaty’ was drafted and both the dissenters then voted in a positive manner. In 2008, the Irish having not voted on the EU Constitution, held a vote on the new Lisbon Treaty and the electorate rejected this but on a second vote a year later finally accepted it. In 1975 the UK had an in / out vote which the “in” won by two thirds. Older readers will remember 1975 was a bleak time and we think fear helped the “in” lobby.

The underlying issues are multiple and complex and whilst most voters will struggle to grasp any rational analysis of the issues at stake, the wisdom of crowds might see such EU votes as simply an “in / out” issue. There is an established pattern of politicians using threats of such an exit to squeeze incentives from other member states and win reluctant swing voters to support the European federal project.

The uncertainty of an exit, and the huge amount of re-negotiating that would be required would arguably be damaging to UK economic growth prospects and the price of riskier assets may be vulnerable in the short term. Over the longer term, we have no confidence in the economic forecasts which usually reflect dogma far more than analysis.

Background

The EEC was established to build bridges between France and Germany and central to the “Club” was that German industrial wealth was used to subsidise French agricultural support policies.
In 1963 and 1967, the UK’s first two applications were rejected because France argued the UK did not have the “political will” to be a Club member. Britain’s Commonwealth trade club was an obvious poor cousin to the EEC and to avoid exclusion the UK needed membership.

The UK economy currently accounts for some 15% of EU GDP. Circa 45% of UK exports and 52% of imports flow to and from other EU countries. Combined this suggests the UK runs a deficit with EU members equal to over 3% of UK GDP. From the EU point of view 10% of exports go to the UK and over 60% of the EU trade surplus is due to trade with the UK.

Historically, non EU foreign direct investment (FDI) into the UK has been significantly above 1% of UK GDP p.a. and we might expect this to slow if Brexit created uncertainty over an EU passport. EU FDI into the UK since the 2007-09 financial crisis has not been material but previously this accounted for sums of 3%+ of UK GDP per annum, post Brexit, recovery to this level would seem doubtful.

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Swing issues to watch

- Immigration - Control of the border is probably the biggest voter issue and is linked to eligibility for benefits and the cost of public services for immigrants. Rational analysis indicates immigration is good for the economy and the flow from non-EU states is more of a problem. However, those hurt by wage pressure in low skilled jobs in sectors such as hospitality and retail know that the winners and losers have very different experiences. The UK minimum wage increase partly addresses this issue and a large number of "self-employed" (contract cleaners, etc.) are unlikely to be registered to vote.

- Terrorism - Looking at polls, every time there is a Paris or Brussels type atrocity the "exit" prospects jump. The impact doesn't last long but any shock event in the days leading up to June 23rd might prove to be critical to the eventual outcome.

- Club membership costs the UK £4bn p.a. (or £61.92 per UK capita per year). But this estimate is net of a lot of material transfers from losers to winners within the UK. Gross costs are roughly £16.5bn p.a. and the UK gets £12.5bn back in EU payments.

Consensus estimates - So what if the UK left the EU?

1. Sterling is likely to weaken compared to the Euro and USD. With significant funding deficits the Bank of England might be pressed to raise interest rates with negative impact on domestic consumption. Gilt yields might rise in response to tighter monetary policy and an increased risk premium.

2. Consumers might curtail spending as fears over job cuts gets significant media attention and GBP weakness increases inflation, reducing real disposable income.

3. Uncertainty about the terms of EU market access would slow FDI specifically and suppress business investment generally. Lower investment would slow productivity growth

4. A likely change in the Conservative Party leadership and a cabinet reshuffle.

5. Other EU members would consider following the UK, or threaten to, further weakening the Union.

Conclusions

ARC consider most investors and advisers will be best served by taking no immediate Brexit related action at this time. We believe the consensus on Brexit noted above is mostly discounted in current market prices. However, the longer term pros and cons of exit are far from clear and thus we would advise to review your current investment strategy to ensure you and your clients are comfortable with the positions they have should they face any short term shocks.

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