Economic Research

WEEKLY ANALYSIS

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Should I stay or should I go? Emotions vs. practicality

Brexit is ahead of Bremain at the polls. The pound sterling has taken a hit, but the bond market is soaring. The real estate sector is at risk. Will central banks take concerted action?

Key points

- The British referendum is polarised between emotions and practicality
- GDP up +0.4% for the first quarter
- Limited political options in case of Brexit
- British exceptionalism is already a reality
- Should I stay or should I go? Brexit leads!
- Brexit's impact on the economy
- Concerted action by the central banks
- Real estate market at risk
- Bond market immune to Brexit?
- The rating agencies are poised to downgrade the UK government's AAA rating
- The pound sterling has taken a hit
- FTSE 100 large caps could benefit from a depreciating pound sterling

The British referendum is polarised between emotions and practicality

The British, like most Europeans, are having increasing misgivings with regard to the European project. In this sense, the referendum on June 23 constitutes a threat and a major political event that transcends British borders.

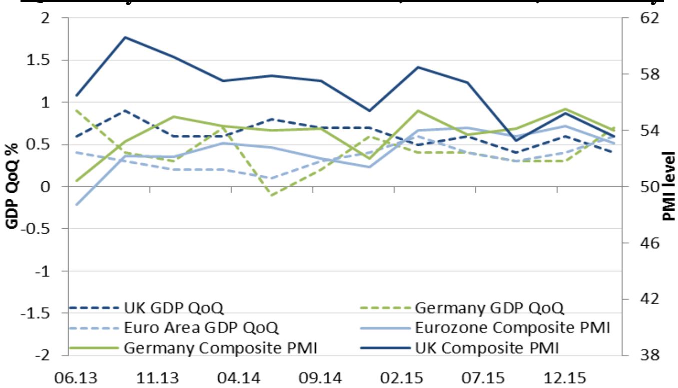
The rewards of European integration are no longer so evident to EU populations, who for over a decade have been contending with the most severe economic crisis since the 1920's.

Europeans believe their circumstances have rather deteriorated over the past decade. Naturally it is tempting to impute this deterioration in living standards to the political and economic model in place, and therefore to the European project and to the European Union itself.

No matter that the UK's GDP has posted stronger economic results than the Eurozone's over the past years, in particular thanks to a decrease in unemployment and an increase in consumption.

Observers should be heartened by this strong relative performance, which demonstrates that the status quo is advantageous to the UK, but instead, the sentiment that the country would be better off going it alone seems increasingly prevalent.

Quarterly GDP and PMI – UK, Eurozone, Germany



Sources: Bloomberg, BBGI Group SA

Bremain supporters are focusing their arguments on the economic situation and in particular on the risks of leaving the EU, noting various elements benefitting the British economy.

Brexit advocates are playing the sovereignty or even the nationalist card and raising the immigration issue.

This polarisation is not uniquely British and can be observed in several EU countries. In fact it will likely constitute one of the key issues in upcoming elections, particularly in France and in Germany in 2017.

A vote to leave the EU will de facto have significant consequences for the UK's political establishment and institutions. The leaders of the campaign against the EU will immediately demand more power and representation in government and will want to have a large say in the negotiations with the EU to determine the conditions of the UK's exit. Indeed, the negotiators' job will be neither easy nor quick, as they will have to find common ground with partners fiercely opposed to the EU.

Limited political options in case of Brexit

On the political front Brexit will likely give rise to a period of uncertainty, which could be mitigated by reassurances from UK and EU authorities and by joint action on the part of the central banks.

However, it should be noted that Article 50 of the Treaty on European Union states that a Member State must first give notice of its intention to withdraw. This stage constitutes the starting point of the negotiations phase between States to establish the conditions of withdrawal. EU member majority is required to ratify this agreement, which must occur within two years of the notification of the intention to withdraw. An extension can be granted if agreed to by both parties. The UK will likely not immediately give formal notice in order to buy time and bargaining power. In case of Brexit, the political options are fairly limited for the British negotiators. Existing models are probably not optimal. In the Norwegian model, EFTA members contribute to the EU budget and are bound by the directives governing the free movement of persons. In the Swiss model, bilateral agreements exclude the financial sector. A distinctive and likely complex path will thus have to be thrashed out, while the Brexit camp aims to dispense with budgetary contributions and free movement.

From the EU's standpoint, the aim will thus be not to set too favourable a precedent to avoid eliciting new inclinations toward independence among other Member States.

British exceptionalism is already a reality

Beyond political issues and potential threats of retaliation by the EU if Brexit wins, it is important to note that British exceptionalism is already well established in numerous respects.

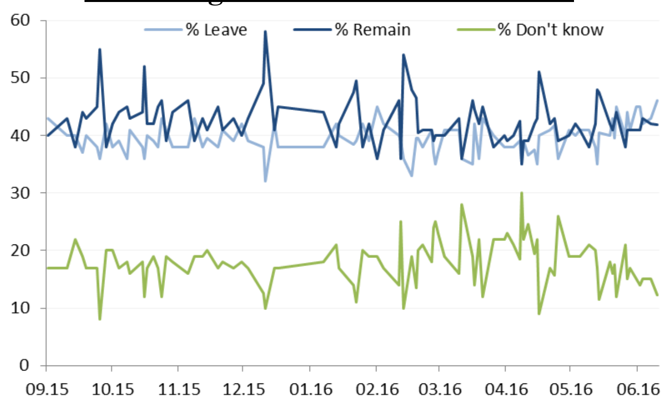
A withdrawal by the UK would thus not have the same impact as that of any other Member State.

The UK still possesses its own currency, which can fluctuate and allow adjustments required to boost the economy. Its monetary policy is already completely independent. Low rates were thus instituted much more rapidly than in the Eurozone, with a far swifter and more effective impact on the economy. Budgetary rules applicable to countries having adopted the euro do not apply to the UK, whose public deficit is managed differently. The latter can thus occasionally contribute to economic growth by acting counter-cyclically. From a structural standpoint, the UK thus already has room to manoeuver, which could potentially expand in case of Brexit.

Should I stay or should I go? Brexit leads!

Just a few days away from the referendum, fears related to the impact of a vote against remaining in the EU are intensifying, as the polls are increasingly showing the Brexit camp in the lead. A Bloomberg poll shows a score of 46% in favour of Brexit against 41.8% for Bremain, with the 12% of undecided voters still holding the key to the final result. It is entirely conceivable that at the last minute a large number of those voters will in doubt choose the status quo.

Bloomberg EU Brexit Referendum Poll



Sources: BBGI Group SA

In 1975 the British had already been consulted on the question and with two thirds of the vote had overwhelmingly elected to remain in the EEC. Will history repeat itself in 2016?

The impact of a potential Brexit on the economy

On the economic front, the most significant risks relate to capital flows and foreign trade. The UK is dependent upon foreign investors to finance both its current and fiscal deficits. The UK's current deficit is the highest among the G7 countries, and its fiscal deficit is also among the largest. Capital inflows have been significant in the past years, allowing the UK to finance its deficits. Negative prospects for the pound sterling should be offset by higher yields justifying the risk. However, it is far from certain that Brexit will give rise to conditions favourable to maintaining a high level of foreign investment in the UK, thus making it more difficult to finance these deficits. On the trade front, the UK has a deficit with many EU countries. According to Brexit supporters, leaving the EU will boost exports of British goods and services. However, most value added sectors are already well positioned and are unlikely to see their competitive advantage increase after Brexit. It should thus likely be easier to hinder the competitiveness of European firms than to improve British access to one of the largest markets in the world.

It is hard to imagine that the British economy will be better off taking the path of independence.

Concerted action by the central banks

The US Federal Reserve mentioned that the British referendum issue influenced its decision not to change its key rates at the most recent FOMC meeting this week. Janet Yellen revealed concern, shared by forecasters, regarding the economic and financial risks arising from the referendum's results. In case of Brexit, the ECB can be expected to react swiftly. It will likely push even further the unconventional policies already implemented. New measures to buttress the financial sector and exchange rate interventions would aim at limiting volatility risks in the financial markets.

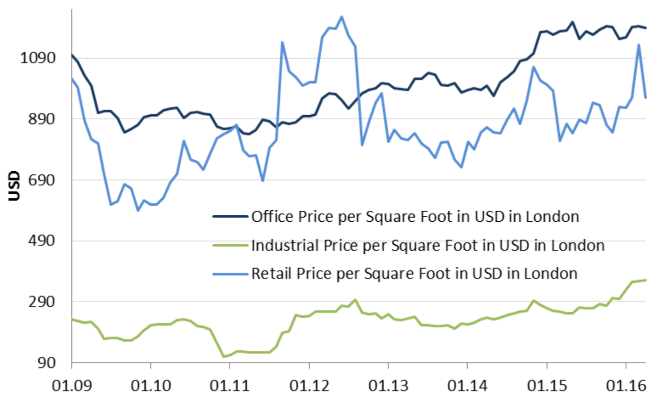
The BOE will likely announce an immediate rate decrease to attempt to limit a potential increase in volatility in the financial markets.

Real estate market at risk

Until the referendum was announced, the BOE's Financial Policy Committee (FPC) always paid close attention to overly strong performance in the real estate market. Indeed, it deemed that too large an increase in real estate prices and household debt could threaten financial stability. This trend has constituted a pillar of the country's economic recovery, as the wealth effect stemming from rising real estate values bolstered households' confidence and their propensity to consume or invest. The real estate sector thus has a lot to lose from the uncertainty that would follow Brexit. International investors have also favoured the British real estate market, and London in particular. The city is estimated to account for close to 60% of total investment by Asian investors and 25% of European investment for instance. Equally significantly, the European headquarters of 40% of the largest international firms are based in London.

Brexit would diminish the attractiveness of London as an operational base for these firms. The risk of a downturn in the real estate market is high.

Real estate prices

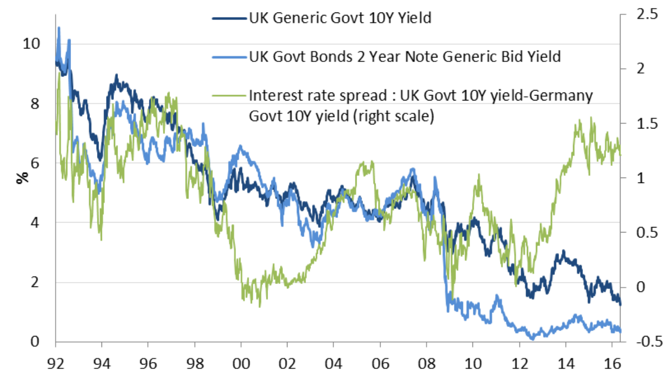


Sources: Bloomberg, BBGI Group SA

Bond market immune to Brexit?

The CPI remains slightly positive (+0.3%), despite the decline of the pound over the past months, the price of imports has not risen, and inflationary expectations are at a standstill. Nevertheless, a lasting depreciation of the pound should have an impact on imported inflation, which is not yet visible probably due to the drop in commodity prices at the start of the year. The increasing likelihood of a negative vote on June 23 has for now absolutely not penalised UK government debt. On the contrary, UK government 10-year bond yields have broadly benefited from the trend over the past weeks and from capital flows toward 'risk-free' assets. Ten-year yields are at record lows, falling below their January 2015 floor to only 1.1%, and the yield spreads between gilts and Bunds have decreased. This situation is utterly extraordinary, as it does not seem to be taking into account the significant risks of higher rates and risk premiums logically associated with Brexit. The rating agencies have already indicated that UK government debt would very likely lose its AAA rating.

UK government yields – 10-year and 2-year

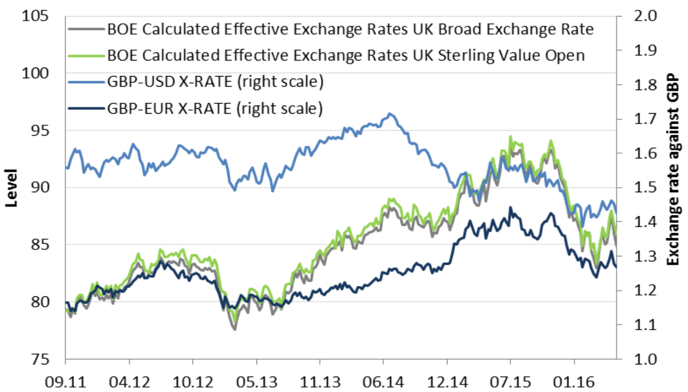


Sources: Bloomberg, BBGI Group SA

The pound sterling has taken a hit

The British currency should have benefited from relatively positive fundamentals, but the decrease in interest rates and the referendum have caused a decline in yields and a fall of the pound, the most liquid British asset. Capital flows to the UK could diminish and make it more difficult to finance the UK's double deficit. A negative vote would likely further penalise the pound despite its fall over the past months, but it will be the first to rally if Bremain wins.

GBP Effective exchange rate

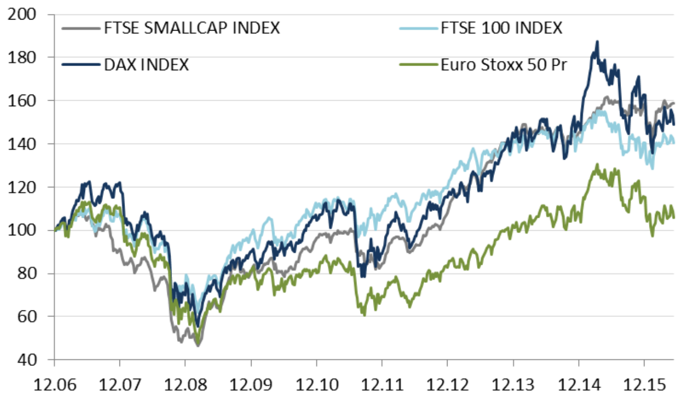


Sources: Bloomberg, BBGI Group SA

FTSE 100 large cap profits could benefit from a depreciating pound sterling

Just several days away from the referendum, UK equities are not showing any more signs of nervousness than European shares. Their performance in local currency (-2.2%) is in fact superior to that of continental equities (-10.6% in euro). The fact that over 70% of revenues of listed large caps are generated abroad in the context of a falling pound will help profits. Circumstances are different for small and medium caps, which generally have greater domestic exposure and could thus underperform over the next few months.

UK (large – small), Eurozone and German equities



Sources: Bloomberg, BBGI Group SA

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