WEEKLY ANALYSIS

Alain Freymond – Partner - CIO

25th February 2016

Would a Brexit significantly change the UK's situation?

+0.5% increase in GDP in Q4. Spending still resolutely on the up at +0.7%. Investment on the decline. Uncertainty creeps in and the GB pound plunges ahead of the referendum.

Key Points

- +0.5% GDP growth in Q4, +2.2% in 2015
- Solid household spending (+0.7%)
- Services PMI remains on the right track
- Drop in investment and exports
- Increase in real estate prices and demand for buy-to-rent properties up +71% (new 3% tax)
- Unemployment rate at 5.1%, close to full employment
- The Bank of England buys time
- New record decrease in long rates
- The pound sterling hounded by the risks of Brexit
- 4.7% dividend yield, PE 13x 2017 profits
- Weighing up the advantages of bonds and equities

+0.5 % increase in UK GDP in the 4th quarter

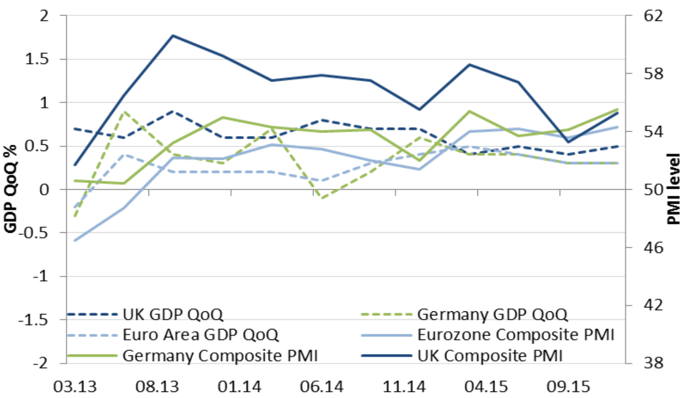
Real GDP growth in the United Kingdom stabilised at a more modest growth rate of +0.5% in the 4th quarter, giving an annual growth rate of +2.2%. This increase is a little lower than forecasts made in the 2nd quarter. The slowdown year-on-year is stark, as growth for 2014 stood at +3.4%, and the acceleration expected for the end of the year did not materialise.

The United Kingdom did nevertheless post its twelfth consecutive quarterly increase in GDP, thanks to excellent form in consumer spending. The country's economy is therefore in better health than Germany's and France's, both of whom recorded a downturn in growth at the end of the year.

The UK economy can therefore count on particularly robust household spending (+0.7%). The context over the next few months will be of renewed uncertainty. It is therefore not entirely certain that household sentiment will be sufficiently optimistic to prop up strong demand. As for services, which are far from the most important sector of the economy, growth remains at good levels (+0.7%) and risks of it weakening seem small. The services PMI was still on the right track at the end of January (55.6), but does not point to a boost in the current trend. Investment dropped -2.1%, and exports did not add anything (-0.1%). The British pound's -11% correction against the euro since 30th November has however increased the competitiveness of the UK's exports to the Eurozone. The same can be said of the -13% correction against the US dollar over the last six months. This increase in competitiveness could give the UK a pleasant surprise should spending weaken in the 1st quarter 2016.

The UK's year-on-year economic performance (+2.2%) is therefore clearly better than that of the Netherlands (+1.6%), Germany (+2.1%), France (+1.3%) and Italy (+1.1%), for example.

Quarterly GDP and PMI UK – Eurozone - Germany

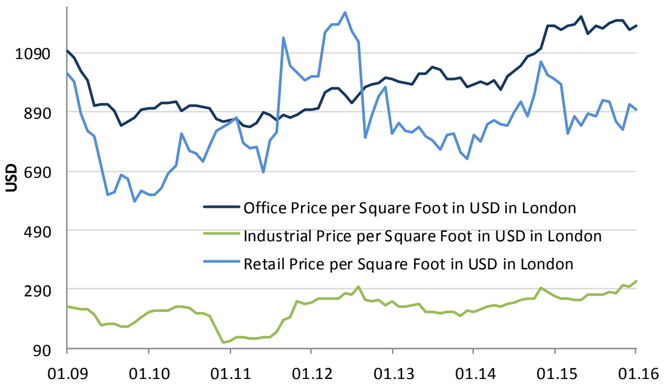


Sources: Bloomberg, BBGI Group SA

Real estate prices increase

Real estate loans have remained robust over the past few months, even increasing +38% year-on-year in January. This was probably in anticipation of a new +3% tax to be introduced in April 2016, affecting second homes and buy-to-rent properties. Indeed, the number of houses acquired by investor-landlords increased by +71%. Real estate owners were also particularly quick to take advantage of low interest rates, as indicated by the +42% increase in refinancing. The construction PMI indicator did nevertheless decrease from 60 to 55.

Real Estate Prices



Sources: Bloomberg, BBGI Group SA

In this context, it is no surprise that we continue to see tensions on real estate prices (+10.4% year-on-year) and a rise in mortgages. Homeowner buyers are in fiercer competition with those buying to rent, thus maintaining strong demand, despite an increase in supply.

The Bank of England's Financial Policy Committee is still keeping a very close eye on the real estate sector, which is behaving "too well". It believes that too high a rise in real estate prices and household debt could threaten financial stability. Nevertheless, the BOE is undoubtedly not prepared to cast doubt over or put the brakes on this trend, just as long as it remains one of the pillars of the current economic recovery. The wealth effect caused by the increase in real estate prices is indeed not unrelated to consumer confidence, and households' inclination to spend or invest.

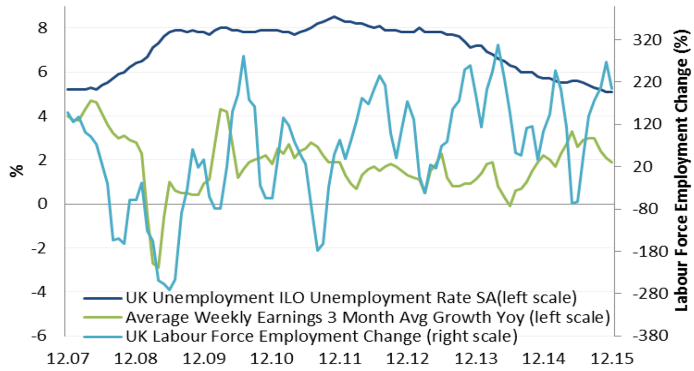
Employment and salaries increase

The UK employment market has followed in the footsteps of the US employment market over the last seven years, and unemployment currently stands at 5.1%, so once again similar to the levels seen when the financial crisis struck in 2008. After having leapt from 5.5% to 8.5% at the height of the crisis in 2011, current unemployment rates stand at close to full employment, going hand in hand with the inflation recovery.

The job market therefore remains firmly on the right track, and is particularly dynamic, although job creation in December (205,000) was a little below November's levels. Salary increases were impressive up until August, but have somewhat trodden water since then, nonetheless recording a +2% year-on-year increase. The trend reversed in June 2014, and then stabilised in the 4^{th} quarter.

There have been slightly fewer tensions on the job market over the last few weeks, but a further boost to salary increases over the next few months is not impossible. However, this change is clearly linked to a recovery of the current economic trend. If this trend continues, tensions on salaries in the United Kingdom should quickly step up, affecting spending and inflation.

Job Creation and Salary Increases



Sources: Bloomberg, BBGI Group SA

Spending remains an important growth catalyst

Retail sales increased +2.3% in terms of volume in January, posting their greatest increase for two years. Most analysts were caught totally unawares as January's sales completely cancelled out the drops seen in December. Retail sales increased +5.2% year-on-year. January's excellent figures will certainly have a considerable impact on changes to GDP in the 1^{st} quarter. Lower unemployment rates, falling crude oil prices, increases in disposable income and high consumer confidence levels will prop up demand in 2016.

Spending remains an important growth catalyst

Retail sales increased +2.3% in terms of volume in January, thus posting their greatest increase for two years. Most analysts were caught completely unawares, as sales in January fully cancelled out the drops seen in December. Retail sales increased +5.2% year-on-year. These excellent figures for January will certainly have a considerable impact on changes to GDP in the 1^{st} quarter. Unemployment rates at their lowest, falling crude oil prices, an increase in disposable income and high levels of consumer confidence will prop up demand in 2016.

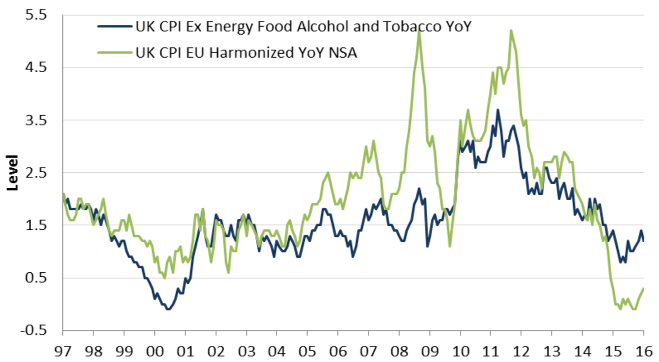
The BOE buys time

The BOE is keeping a close eye on developments in the real estate and jobs markets, and for now can push back interest rate normalisation. Indeed, in the short term, the slight economic slump is allowing the bank to attenuate its assessment of the risk of tensions on salaries. The risk of an interest rate rise currently seems to be shrinking for domestic reasons, and unless the GB pound remains weak and crude oil prices rise rapidly, external tensions will remain insufficient to prod the BOE into action. It should leave its monetary policy unchanged on 17th March and keep its historically low 0.5% discount rate for some time to come. For the time being, members of the Monetary Policy Committee are still largely in agreement about maintaining the status quo, providing that inflation and pressure on salaries do not become stronger. Given the still very low levels of inflation, monetary policy could be left unaltered in the 1st quarter of 2016.

A lack of inflationary pressure and the economic slowdown push rates to their lowest ever level

Underlying inflation is stabilising, with a +1.2% increase year-on-year, whilst the CPI (Consumer Price Index) has just tipped into the black (+0.3%). Despite the drop in the GB pound over the last few months, import prices have not risen and inflationary prospects seem to be at the tipping point. The British government's 10 year rates have significantly benefited from the gloomy climate on the stock market at the beginning of the year, sliding again from 2.0% to 1.25%. 10 year rates hit new record lows, dropping below their rate from January 2015.

CPI Inflation



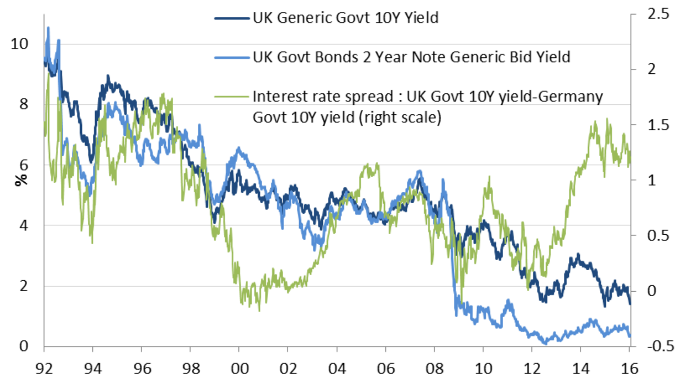
Sources: Bloomberg, BBGI Group SA

Providing there is no real surprise sparking a sharp increase in price indices, we believe that it is still likely that long rates will stabilise at between 1.5% and 2% over the coming months.

Brexit risks are affecting the pound

The British pound should have benefited from positive relative economics and fundamentals. In reality, the drop in interest rates over the last few weeks actually lead to an almost linear contraction of yields in GB pounds, euros, Swiss francs and US dollars. The long rates differential is therefore relatively stable, and has had no major effect on the British pound.

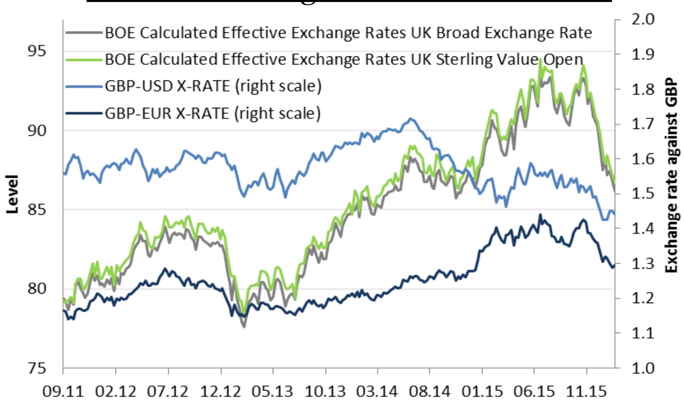
UK 10 Year and 2 Year Government Rates



Sources: Bloomberg, BBGI Group SA

The negotiations between the United Kingdom and their partners in the European Union have also undoubtedly already had a significant impact on the stability of the British pound. The prospect of a referendum on the 23rd June has already triggered a -11% drop against the euro, and a fall of -13% against the US dollar over the past few months.

Effective Exchange Rate US Dollar - Euro



Sources: Bloomberg, BBGI Group SA

Whilst it is true that it is still difficult to tell whether the United Kingdom will stay in the European Union following on from this referendum, we nonetheless believe that the exchange rate could appreciate to between 1.30 and 1.35 against the euro and head back towards an average rate of 1.45 and 1.50 against the US dollar. The recent strength of the Swiss franc should leave room for the pound to bounce back to between 1.45 and 1.50.

The limited effects of a potential Brexit

Beyond political issues and potential risks of revenge on the part of the European Union should the electorate vote in favour of Brexit, we believe it important to highlight the fact that the UK is already clearly rather unique in many ways. Should the UK leave the European

Union, it would therefore not have the same effect as if it were another member, who is also part of the Eurozone.

Indeed, we should point out first of all that the United Kingdom still has its own currency, which fluctuates, and enables the country to make the adjustments that are vital for the economy to recover. It also has, of course, its own fully independent and autonomous monetary policy. The policy of low interest rates was thus put in place much quicker in the UK than in the Eurozone, meaning that it was much more effective, and its effects felt sooner. Brexit would have no particular impact on the BOE's ability to react.

Next comes budgetary austerity. Austerity was applied with perhaps necessary zeal by members of the Eurozone, but was not applied in the same way in the United Kingdom, as it is not subject to the same budgetary regulations as countries that use the euro. The British public deficit can be managed differently, and can thus sometimes help to stabilise economic growth via counter-cyclical action. Brexit would have no real impact on the country's ability to take such action; it could even be increased thanks to greater policy independence. The structure of the United Kingdom's economy is also less industrial, and more dependent on its services, and particularly its financial, sectors. The size of the manufacturing sector as compared to GDP (8.5%) is relatively low compared to the Eurozone (14.5%). Leaving the European Union should not massively affect the financial sector, which is a great exporter of services to the European Union, thanks to its specialisation and competitiveness. The British financial/banking sector seems to us in particular to be quicker to react to systemic risks and will not lose this ability should Brexit become a reality. Surprisingly, the jobs market is one of the country's most important distinguishing features due to the fact that it is more flexible than most markets in the EU.

There is thus some wiggle room to take advantage of from a structural point of view; this room to manoeuvre could be broadened should Brexit happen. However, it is not given that this ability to react would have any major effect on the British economy.

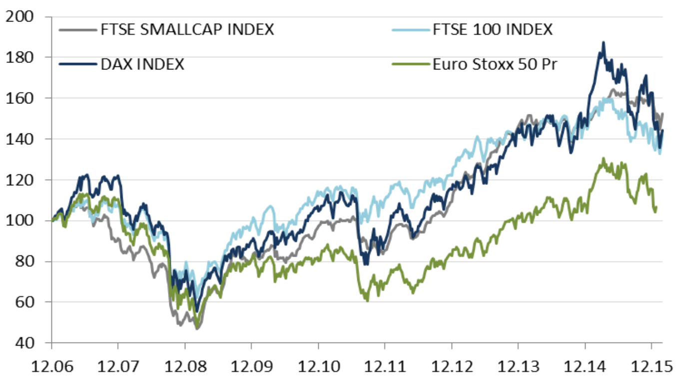
The concerns of many investors regarding the damaging consequences of Brexit on the British economy are undoubtedly very overblown.

The United Kingdom already has significant independence on many levels and well-established unique points. Brexit would therefore undoubtedly not trigger the feared ramifications for British exports to the Eurozone.

Weighing up bonds and equities

The British market is once again trading at 13x 2017 profits and has one of the best dividend yields of developed markets (4.7%). The recent increase in bonds brought long rates up to 1.3%, but we believe that the United Kingdom's economic prospects will not be significantly affected by the uncertainty regarding Brexit.

UK (large – small) Eurozone – Germany Equities



Sources: Bloomberg, BBGI Group SA

Conclusion

The British economy retains some sort of leadership in Europe, and should maintain a growth rate higher than +2.2% in 2016. Perhaps the risks of Brexit have already partly been anticipated.

BBGI Group is regulated by the Swiss Financial Market Supervisory Authority and offers the following services to Swiss and International clients:

- Institutional Asset Management
- Private Banking
- Fund Management
- Advisory Services for Institutional and Private Investors
- Currency Risk Management
- Real Estate

BBGI Group SA
Rue Sigismond Thalberg no 2
1201 Geneva -Switzerland
T: +41225959611 F: +41225959612
info@bbgi.ch - www.bbgi.ch