The UK Referendum on Membership of the European Union - How It Might Affect Your Investments

For the third time in as many years we are faced with a vote that portends disruptive change to the UK political and economic landscape. Following the Scottish referendum and the general election, both of which reached outcomes that were deemed to be market-friendly, the UK population now has to decide whether or not to remain in the European Union. As on the previous occasions, opinions polls suggest that the result hangs in the balance, promising a period of uncertainty ahead. However, the ramifications of leaving the EU appear to be a lot greater than any of the potential outcomes in the last two polls, meaning that volatility could be far greater this time, especially as the result will be binary.

One of the few things that we know with any certainty is the date, Thursday 23rd June. That leaves plenty of time for the opposing sides to lay out their arguments but, with many column inches and screen hours to fill, it also increases the risk that the media's attention will be focused as much on the political pantomime as on the issues involved. For example, once the vote was announced, the opening of divisions within the government, especially in the case of Boris Johnson, garnered the majority of headlines. As investors we must be careful not to be distracted from the main event.

It is not our intention to take sides. Political affiliations tend to sit badly with investment decisions as judgement can become clouded by emotion. On the basis that a vote to remain within the EU would leave things looking much as they are, our principal aim is to assess the effect that Brexit would have and how we could position portfolios for that eventuality. In the interests of allowing as much space as possible for the investment discussion, we must assume that interested readers will already be well informed on the agreement that the Prime Minister has reached with his European counterparts on reforms.

By its very nature the debate will be emotional and contentious. Unlike in the case of a general election there will not be a chance to try again in five years' time. This means that both sides will exaggerate the pitfalls and benefits in an effort to win the day. Understandable as this is, it risks confusing the electorate. A study undertaken by Capital Economics of various surveys into the effects of Brexit on the economy showed, over an unspecified forecast horizon, that there was a gap of 22% of Gross Domestic Product (GDP) between the most extreme views. Bearing in mind such uncertainty and the difficulty that even professional investors will have making sense of such information, it seems only natural that market participants will demand a higher risk premium until the outcome becomes clearer. That would suggest some underperformance of UK assets relative to overseas assets, although this would be limited by valuations being "anchored" to some degree to international averages.

One further thing to make clear is that a vote to leave will only be the start of a period of negotiation on the terms of exit which could take a minimum of two years to complete. This would particularly involve new trade agreements, not only with the EU, but also with other trading partners, the latter of which could take several years to complete. We also have to be mindful of the risk that Britain's departure from the EU will encourage other separatist movements, for example in Scotland and Catalonia, which would have the potential to create further disruption. It might also give support to more isolationist parties in France and Germany, which both face national elections in 2017. The uncertainty will only end if voters choose to stay.

Asset Class Effects

Currency: The main victim in the run up to both the Scottish referendum and the general election was the pound, and this is happening again. There are good reasons for this to be the case. First of all it is a transparent and liquid vehicle to trade in with relatively low costs, therefore a favourite with speculators. More fundamentally, any material disruption to the UK economy and international trade would be distinctly negative for sterling. The UK continues to run a current account deficit of around 4% of GDP, and the money that flows out of the country to buy foreign goods and services needs to be replaced. If, as now, there are insufficient trade flows, the shortfall can be made up by Foreign Direct Investment (in corporate or infrastructure assets, for example) or capital flows (into investment assets, ranging from bonds and shares to property). These investment flows rely on a combination of perceived good value and confidence. If external investors are unsure on both counts owing to limited visibility on, for example, trade agreements, then they are likely to sit on their hands. It is also distinctly possible that UK-based investors look to hedge their risks by taking money out of the country, adding to the pressure.

We do not make currency forecasts, nor do we normally take strong views on currencies in our asset allocation process, believing that they tend to revert to the mean over our preferred longer term investment horizon. However, several high-profile investment banks have suggested that the pound could lose between 10 and 15% of its value in the event of Brexit based on experience during the financial crisis of 2008. That seems too high a risk to ignore. However a full blown crisis is unlikely to be on the cards. The fiscal position is improving and the country is solvent. There is also a self-correcting mechanism built into a falling pound in that the trade balance will improve and income from overseas assets will also be boosted in sterling terms. On balance, though, the pound will continue to trade weaker in our opinion.

Bonds: The main factor in favour of UK government bonds is that whatever the result it will still be the same government in charge, meaning a perceived safe hand on the tiller and a commitment to balancing the budget. Assuming for now that bond investors will continue to have no issues with the UK's solvency despite the potential for lower tax receipts in the event of Brexit-driven economic weakness, it is the outlook for interest rates and inflation that will have the most profound effect on gilts. The UK is a very open economy and somewhat prone to bouts of inflation, especially in response to a weak pound, which, as we outline above, is a key risk. Long-dated bonds have been massive beneficiaries of the disinflationary global environment, but yields could rise in the face of higher inflation, exposing investors to capital losses with limited income to make up that loss. On the other hand, though, if the economy was undermined by a lack of confidence and lower incoming investment, would the Bank of England be forced to stay its hand on raising interest rates to boost growth? Given that deflation is currently perceived in economic circles to be the greater existential threat, it is possible that rates would remain relatively low with the yield curve steepening.

On balance there seems to be no strong argument to stray far from our current weightings. As we have reiterated on several occasions in the past, sovereign bonds constitute a key "insurance" element of client portfolios and will continue to protect us from unexpected negative developments, as they have done in early 2016. Any uncertainty about the economy may only serve to widen credit spreads in the sterling Investment Grade bond sector, potentially opening up better buying opportunities.

Equities: Large UK companies have recently been battered by influences well beyond these shores. Resource companies have been badly affected by collapsing commodity prices, exporters to emerging markets by the slowdown in China, for example. The fortunes of such large companies will not be materially affected by domestic events. Indeed, a weaker pound would bolster profits by making our exports more attractive and flattering the translation of earnings booked overseas. Dividends declared in dollars would enhance yields to sterling investors. With some three quarters of FTSE 100 revenues and earnings derived overseas, large cap equities provide something of a natural hedge against domestic uncertainty. Reflecting this opinion, we remain overweight in the defensive Healthcare and Tobacco sectors and also Media, although continue to believe that the commodity cycle makes Resource sectors less attractive despite their near 100% non-UK exposure.

More domestically exposed sectors and smaller companies will remain under greater pressure as concerns rise about weak demand, higher input costs as a result of the lower pound, and a wage-driven margin squeeze if access to cheaper labour from Europe is cut off. The biggest potential loser is the Banking sector, which is under pressure from several angles. Weaker activity in the UK would be poor for growth, but of greater concern is the threat of loss of access to European markets, something which is currently permitted via "passporting" rights. Although nothing is certain, it is probable that banks would have to apply for new licences to operate on the Continent, which would reduce the attraction for international banks to base their European operations in London. HSBC, for example, has said it might relocate 1,000 staff. Any reduction in banking activity would have severe knock-on effects for London – both the economy and the real estate market. We are currently Underweight Banks.

There are some smaller sub-sectors that might benefit from Brexit. Travel & Leisure companies with greater exposure to the UK would see more in-bound tourism with overseas travellers attracted by a cheaper pound. UK holidaymakers would also be more inclined to stay at home. Testing companies could prosper if the UK abandons the current EU accreditation system and reintroduces a separate British standard. Please contact your IW&I representative for more specific details.

Conclusions

It should be apparent from these comments that there are no easy conclusions to be reached, although we might feel more relaxed about the risks if the economy were booming and the world experiencing strong demand. Moreover, for all the arguments that might be made, voters will approach the referendum with their own peculiar biases. Some will focus on the economy, others on the judicial system. In current polls the most pressing concern of the majority of those interviewed is immigration. It seems probable that markets will be influenced by the polls in the run up to the vote, despite pollsters being discredited at the general election, although it's fair to say that it's much easier to call a two horse race. Having said that, there is already some bias emerging in the polls, with internet respondents – tending to be a self-selecting group – more in favour of leaving and telephone respondents – a more random selection – more in favour of staying. It has even been suggested that weather and exam timetables will play a part, as older voters with a greater propensity to vote to leave Europe might stay at home if it is raining, while students, who are more in favour of staying, might be distracted by academic requirements. On such vagaries could the UK's future depend. Our optimal stance now is to continue to focus on high quality investments in a sensibly diversified portfolio with some tilts to reflect stocks or sectors where we see asymmetric risks, and the inclusion of overseas assets to hedge currency risk. It is probable that more opportunities will arise as the campaign unfolds and nerves start to fray.