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EU Referendum result: what next for the UK and our finances?

Guy Foster, Brewin Dolphin's Head of Research, offers his thoughts on the UK's options after the EU referendum, and how events are likely to unfold over the coming weeks and months.

Following the historic vote to leave the EU, the government is acting like a rabbit in the headlights but markets are on steroids and it is currently difficult to see what the direction of travel for the UK actually is.

In this briefing I will ignore much of the hysteria we are seeing in the news and will focus on what I think are the most likely ways forward for the UK, and the implications of those possibilities. I will also cover the potential impacts on the pound, interest rates, investments and property.

This is of course an initial response based on information available today, and we will be issuing further briefings as new developments unfold.

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1. What might our new relationship with the EU look like?

There are broadly three options for the UK to follow when it does eventually leave the EU. Here I will explain what each of them means in practical terms and what their implications may be.

Option 1: Membership of the European Economic Area

The option that would give the markets the most comfort would be membership of the European Economic Area (EEA). The EEA refers to an agreement among member states of either the European Union or the European Free Trade Association, and enables states outside of the EU to retain access to the single market. This is the relationship that Norway, Lichtenstein and Iceland have with the EU. It seems to be what pro-leave campaigner Boris Johnson is hinting towards when he says things like this:

"British people will still be able to go and work in the EU; to live; to travel; to study; to buy homes and to settle down. As the German equivalent of the CBI – the BDI – has very sensibly reminded us, there will continue to be free trade, and access to the single market."

The EEA offers relatively full access to the single market. There would be very modest differences from full EU membership, perhaps the most tangible of which would be that the contribution to European projects should be smaller than the current EU membership contribution, although that would need to be negotiated. As was argued by the Remain campaign before the vote, EEA membership would mean no say over rules which UK business would still be bound by, and would offer virtually no change from the current rules over free movement of labour[1].

1 EFTA *EEA Agreement*

This clearly satisfies the wording of the referendum question, "in or out of the EU", but we know that immigration was one of the biggest issues determining people's reasons for voting Leave, and that would not be addressed by EEA membership in its current form. Worse still the UK would not now have a veto over new countries joining the EU, including Turkey. As such the EEA route is likely to be a significant disappointment to many Leave voters and it would presumably have political ramifications.

Option 2: Operating under World Trade Organisation rules

The fall back option is that the UK relies upon the protections afforded to it by membership of the World Trade Organisation (WTO). Without a specific trading arrangement with the European Union the UK would be outside the EU's customs union. That means it would suffer from the common external tariff. The tariffs vary across different sectors. Cars, for example, would attract a tariff of 10% whereas various categories of machinery can see tariffs as low as 1.7%. The average is believed to be somewhere between 3% and 4%. Tariffs would make our own goods more expensive when they are exported to the EU. Assuming those costs could not easily be subsumed within profit margins (or wages) they would be likely to result in the UK losing market share to producers within the EU, EEA or those with a trading arrangement with the EU which covers that sector. Importantly, this could result in job losses, wage cuts - or both. We assume that the government would retaliate by placing its own tariff on imports from the EU which would limit the damage.

Option 3: A bespoke UK trade deal

Finally there is the potential to negotiate a bespoke agreement. It has been said many times that Europe would be keen to do this because they sell us more than we sell to them and therefore they want to keep trade flowing as smoothly as possible. The truth is that while trade benefits everybody, a deal is more important to the UK than it is for the EU. European Union trade accounts for around 20% of our GDP, yet UK trade only accounts for about 4% of the EU economy. The balance of power in future negotiations therefore lies substantially with the EU, and the UK will have its work cut out to persuade the EU to give it any special treatment.

Which option is most likely?

There are pros and cons to each, but I refer again to Boris Johnson because he has been most vocal on the topic recently. He seemed to hint at an EEA relationship. In the same article as mentioned above, he said:

"…the Government will be able to take back democratic control of immigration policy, with a balanced and humane points-based system to suit the needs of business and industry."

However, as things stand, that would not be permitted to an EEA member. It is an issue in which the EU is currently in dispute with Switzerland. Indeed it is not permitted to anyone who has full access to the single market. That suggests that he might instead be hoping to negotiate a special deal for the UK, unlike anything our peers receive.

This could well be modelled upon the deal currently awaiting implementation between Canada and the EU. The Comprehensive Economic & Trade Agreement (CETA) is one of the most ambitious free trade agreements the EU has embarked upon – particularly because it does cover services to some extent. However, there is plenty of argument over whether the services provision is sufficient for the UK (and our large financial services sector).

The final point to note about the chances of achieving a bespoke free trade deal, even one modelled on the CETA, is that these negotiations take a long time, and that means a protracted period of uncertainty.

It is also worth remembering, as some commentators have speculated, that there may be some "need" to ensure the UK does not get the unique deal that an exiting UK government is hoping for, as to do so might fuel the fire of discontent in other European countries where a referendum is being called for. That would explain the urgency and frustration on the part of some European states to see a rapid resolution of this issue.

No UK exit?

A final possibility is that the UK does not leave the EU at all, but rather uses the mandate presented by the people to a new government to seek yet more reform – most obviously an emergency break on immigration. Nobody can pretend that such an agreement would be easily reached. Nevertheless it remains a possibility.

With all these potential eventualities considered we believe it is most likely that the UK will attempt to join the EEA. An important advantage of this is that the rules are largely established and therefore there is limited scope for retaliation and punishment by the remaining members of the EU. The UK would be able to claim to have abided by the terms of the referendum (which literally was only about membership of the EU).

The remaining EU, meanwhile, would be able to demonstrate that the UK has not won anything special, and that as a result each remaining country would now have a louder voice in EU negotiations with the UK's population-weighted voting block having left. By way of compensation the UK would then be able to proceed to try and strike its own free trade deals with other nations.

2. How will this affect the pound?

As we expected, the pound has taken the greatest share of the adjustment burden, falling against the dollar to levels not seen since the 1980s. Perhaps of greater relevance to both our trade and holiday plans is that the pound can no longer buy 1.3 euros. Now it buys just 1.2 euros. By our reckoning this adjustment is enough to place the euro and sterling on similar valuations – they now both seem slightly cheap relative to their trading partners. Both are now plagued by political risk however and the consequences for the euro are different from those of the pound in two important ways:

- First, the eurozone runs a substantial trading surplus and as such its currency is always in demand. The UK, on the other hand, runs a substantial trading deficit and as such needs to attract capital from overseas (we need foreigners to buy our assets or lend us money, on an ongoing basis to avoid the pound falling further).
- Second, the pound has been able to sustain that trading deficit because it offers foreign investors higher returns, or interest rates, than they may get in their own economies. The eurozone now has limited scope to cut interest rates because they are so close to zero. That means limited scope to disappoint holders of euro currency.

The pound, on the other hand, could see an interest rate cut. Anticipation of a rate cut is weighing on the pound, and if that possibility grows we can expect the pound to fall further.

The counter argument to both of these points is that investors may shun the euro now that Brexit stands to return the region to existential crisis.

Overall then it seems likely that the UK will enjoy a more competitive currency relative to most of the world following the significant devaluation. That will make it more expensive when holidaying abroad and will raise import costs but overall should be beneficial for exporters.

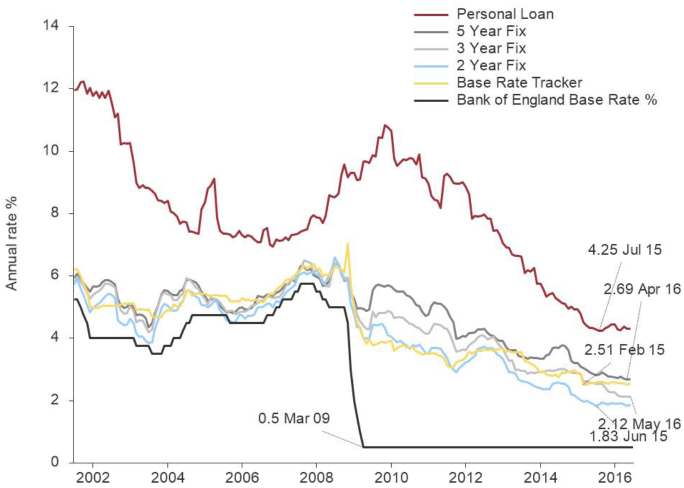
3. Interest rates and mortgages

A rise in import costs will contribute to an increase in inflation. Inflation is already likely to rise because of the recovery in petrol and energy prices. We believe the combination of these factors will push the rate of inflation above the UK's inflation target next year. Despite this, to the extent that the UK economy is weakened, and lingering uncertainty about the future remains, we would expect the Bank of England to actually be more inclined towards offering monetary support to the economy.

That means that a 0.25% interest rate cut (taking the base rate to 0.25%) seems a real possibility. Crucially, however, we would not expect this to be passed through to consumers in terms of lower borrowing rates. If anything the need to compensate for higher potential credit and lower overall bank profitability might mean that standard variable rates on mortgages creep higher.

Overall it is probably fair to expect borrowing rates to remain little-changed with the risk that they could rise slightly, particularly for fixed rate loans and new loans. Deposit rates for savers, on the other hand, will remain extremely challenging and those few accounts that offer a positive real rate of return are likely to come under renewed pressure.

How mortgage costs have fallen



Source: Thomson Reuters Datastream

4. House prices

A decline in house prices is another very real possibility, although the severity of it would depend upon how hard the UK economy is hit. The UK currently needs to build around 75,000 new homes per year before it can start offsetting a shortfall which we estimate may stretch to two million homes in total. These fundamentals will support the market against some strong headwinds. We expect the economy to come under pressure with lower growth, potentially higher unemployment, lower wages and falling confidence.

Under such circumstances a moderation of house price growth seems likely in areas where affordability is stretched. In London that may mean outright declines. But we suspect that would not be in all areas, and that London residential property will remain sought after by foreign buyers - especially now that the pound has fallen so sharply, making UK properties more affordable.

5. The stock market and equities

Markets seem bound to remain volatile and individual shares will reflect their own sensitivity to UK economic performance, as well as currency movements, in that companies with overseas revenues ought to be more valuable to UK investors because their overseas earnings will be worth more in sterling terms. So we see those stocks as being beneficiaries of the turbulence. Economically sensitive UK stocks are the ones that have seen the greatest selling, as well as UK mid and small-cap stocks.

The important thing to recognise here is that investors will try to flee en masse to those safer, defensive, international companies while shunning the more exposed UK-focused names. Both pools of companies are likely to offer opportunities for the investor who is focused on valuation.

It is important to note that beyond those UK-centric stocks, a diversified portfolio offers a degree of protection against many of the risks that the referendum result has prompted. We are actively managing portfolios every day, taking profits where necessary and investing in promising sectors offering good value.

The greatest risk to UK savers comes through an ongoing decline in the pound which would erode the real purchasing power of their hard-earned wealth. Having a diversified portfolio with plenty of overseas revenues offers a good way of hedging that risk and this is the theme of the portfolios we are constructing.

Guy Foster, Head of Research

Guy leads Brewin Dolphin's Research team ensuring that a rigorous and exhaustive investment process is employed. He also provides recommendations on tactical investment strategy to Brewin Dolphin's investment managers and strategic recommendations to the group's Asset Allocation Committee. Before joining Brewin Dolphin in 2006, Guy was an Investment Director at Hill Martin (Asset Management). Guy has a Masters in Finance from London Business School. He is also a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. Guy frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of Brewin Dolphin.