Brexit - An Exit Story

Treasury Research & Strategy

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Key Highlights

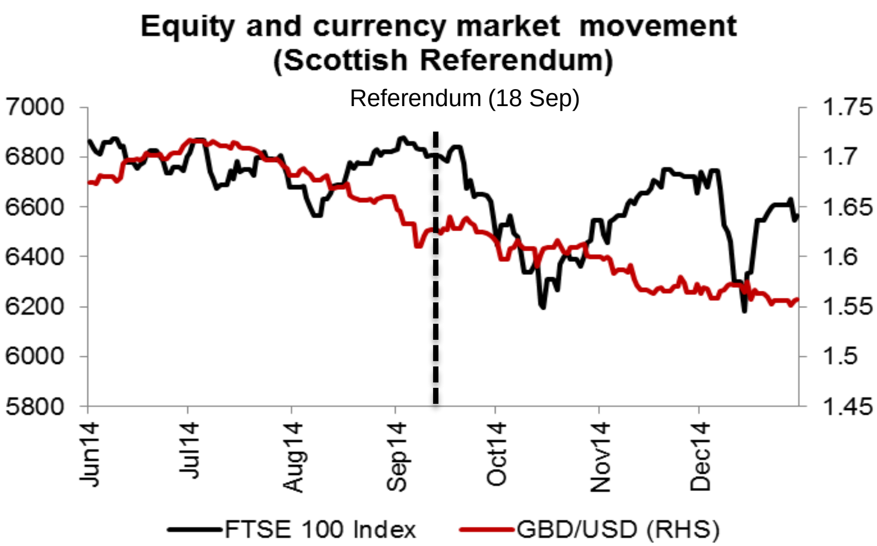
- UK's exit from the European Union will be decided in a referendum that may be held as early as June 2016, should David Cameron fail to renegotiate favourable terms for UK's continual participation in the EU.
- Growing uncertainty may drive potential market risk-aversion approaching the referendum. Tariff implications are likely to weigh down the British economy due to its large dependence on the European export market. In the unlikely scenario of a Brexit, UK's long term outlook will then depend on its ability to recover their free trade access with the EU and re-establish their label as an entry point into Europe.
- According to a poll by YouGov, involving a sample of 1675 participants, 45% were in favour of a Brexit while 36% are against it. 17% are undecided. Betting odds currently stand at 33% in favour of leaving and 71% in favour of staying.

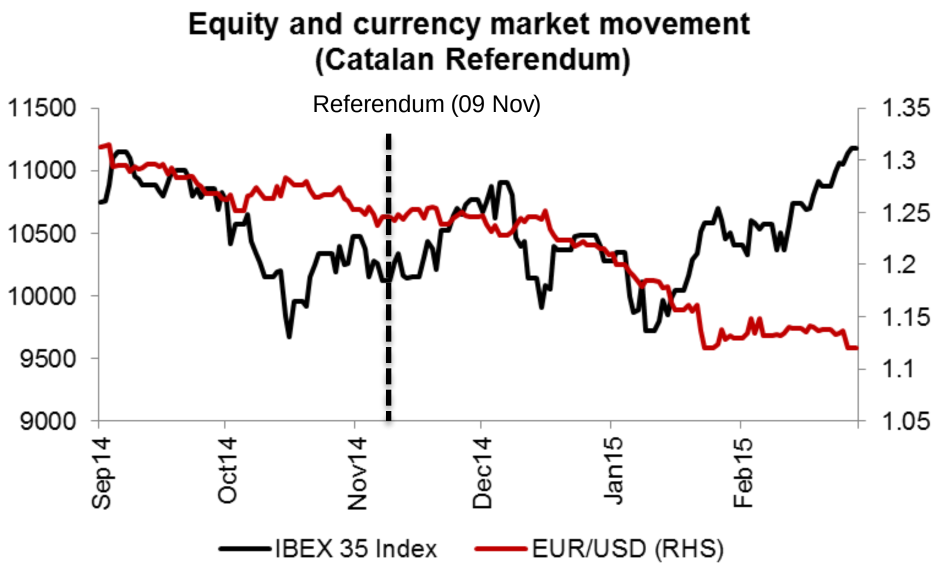
Markets	In the event of Brexit
Equity	Equity decline in export-dependent sectors in light of rising tariff costs.
FX	Sterling may depreciate due to loss of fresh capital inflows and policy divergence with FOMC.
Bonds	Usually more reactive to perceived event risks but highly dependent on BOE's reaction function outcome. Long term gilts may be less impacted.

Economy	In the event of Brexit
Trade	Rise in tariff costs and the exploration of supplementary markets to make up for the loss of EU trade.
Finance Sector	Possible restructuring as firms seek alternative entry into EU markets
Businesses	Less red tape for SMEs, allowing for greater innovation and entrepreneurship

Brexit: Equity Market Implications

- After the Scottish and Catalan referendums in late 2015, their respective equity markets saw some short term decline and increased volatility mainly due to political risk and uncertainty. Given the much larger scale of a Brexit and its far reaching impacts on both the European and English economies, UK's manufacturing, pharmaceuticals and financial equities are expected to be in the spotlight given their heavy contributions to UK's trade balance. **Even in the event where a Brexit does not occur, the political uncertainty resulting from the referendum would probably weigh on the domestic sentiments in the short run, causing potential short term volatility in the equity space**, albeit the effects tend to be short-lived.





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Brexit: Forex Implications

- As market players contemplate the prospect of a potential Brexit, we have already seen the GBP come under some pressure, albeit how much of its decline is due to tapering of BOE rate hike prospects and softening economic momentum vis-à-vis Brexit risks is unclear at this juncture. Nevertheless, increased FX volatility in the near-term is likely should the Brexit referendum materialise earlier than expected. This is because foreign investors look to the UK as a single point of access into the EU, and the loss of that title as a result of a Brexit may dissuade capital inflow into the UK and decrease demand for the GBP. In a pessimistic scenario, capital outflows could worsen the pressure on GBP.

- Even if Britain manages to re-establish free trade access with Europe to mitigate potential downside economic risks, the short term uncertainty during the transition phase would likely still place stress on the GBP.

- **All-in-all, the short-term economic and sentiment-driven drags from a Brexit scenario would likely keep the Bank of England (BOE) on its accommodative stance.** BOE is likely to stay on hold at 0.5% for longer or even initiate a rate cut(s) to further support economic growth. Further unwinding of BOE rate hike expectations could inject further pressure on the GBP.

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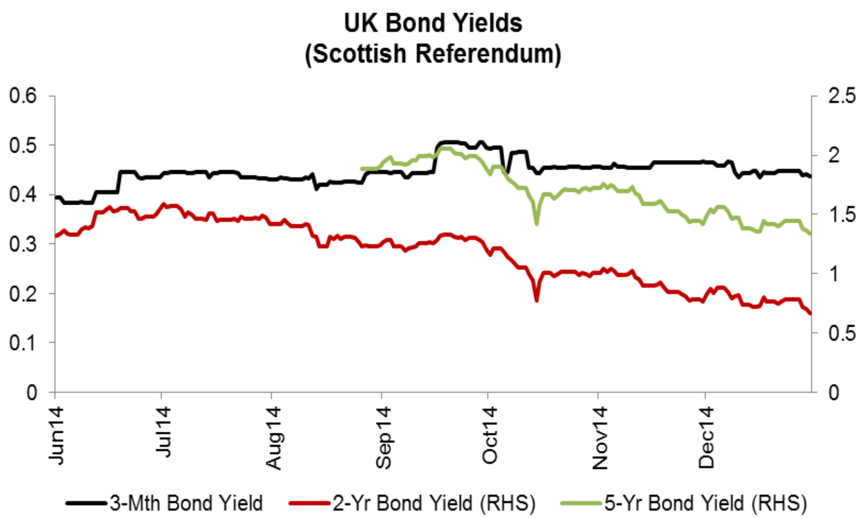
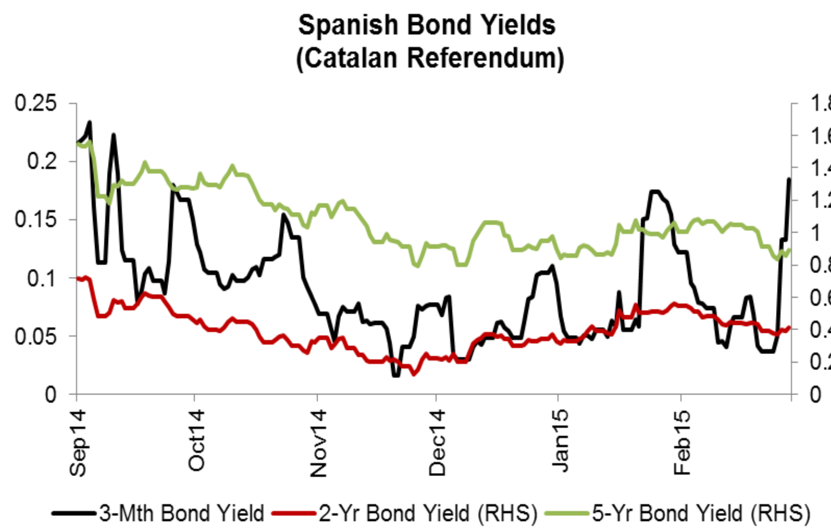
Brexit: Bond Implications

Impact on bond markets

- Short-term bills typically tend to be more reactive to perceived event risks. Given greater uncertainty about the UK's prospects as the referendum approaches, bill rates may even rise in the interim. Much will depend on the BOE's reaction function outcome (eg. do they keep/cut rates to accommodate downside growth risks or be forced to hike rates to stem capital outflows?) and which part of the yield curve the ensuing flight to safety bid will settle on.

- **Longer-tenor gilts may be less impacted if the experience from the Scottish and Catalan Referendums are to be used**.





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Brexit: Financial Sector Implications

- **Risk of undermining its financial hub status?** In the event of a Brexit, the separation could potentially undermine UK's position as Europe's Financial Hub. Over the years, ties to the EU have acted as a catalyst, allowing for capital inflows and the development of UK's financial sector, and accounting for almost 10% of the UK's GDP and 11% of its tax receipts. If the UK separates itself from the EU, foreign firms may begin to reconsider their position and potentially relocate to EU states such as France or Germany in an attempt to maintain their market share and avoid higher costs of operations should the Euro zone insist that euro-denominated transactions be moved from London.

- **Follow the money?** The potential shift of capital flows and investments from the UK to other parts of Europe may also tempt some companies, possibly including financial institutions, to relocate out of the UK so as to seek other opportunities in Europe.

- **No financial deregulation upside?** A Brexit would free the financial sector from EU's complicated regulatory legislations. However, this may not translate to financial deregulation as it will be unlikely that the UK government will stray far from its European counterparts in order to preserve financial competitiveness and stability. In addition, the Brexit would nullify many contracts between EU and UK, adding on to business costs for firms to return to the status quo.

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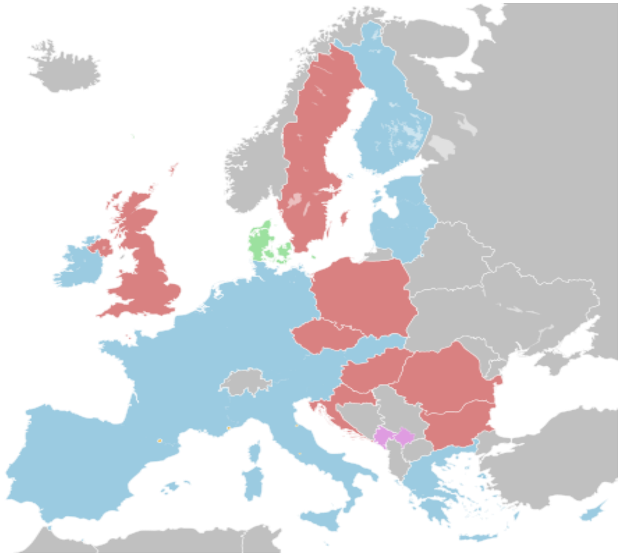
Brexit: A Detailed Look

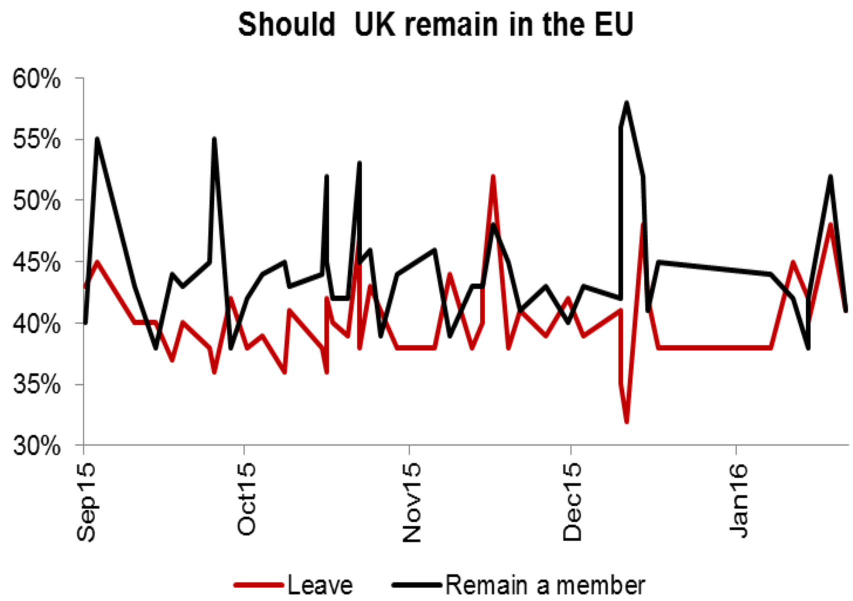
What is the Brexit?

Back in early 2015, Europe faced the possibility of a Grexit, Greece's exit from the Euro Zone. Currently, pressure has been mounting on UK's Prime Minister David Cameron to successfully renegotiate favourable terms for his country's continual participation in the EU. If no agreement can be reached by the referendum, there may be a chance that Britain leaves the union and the Brexit would be official. As of January 2016, polls show the UK public tied in the decision to leave, showing growing discontent and the increased need for David Cameron to step up negotiations.

Eurozone and EU countries



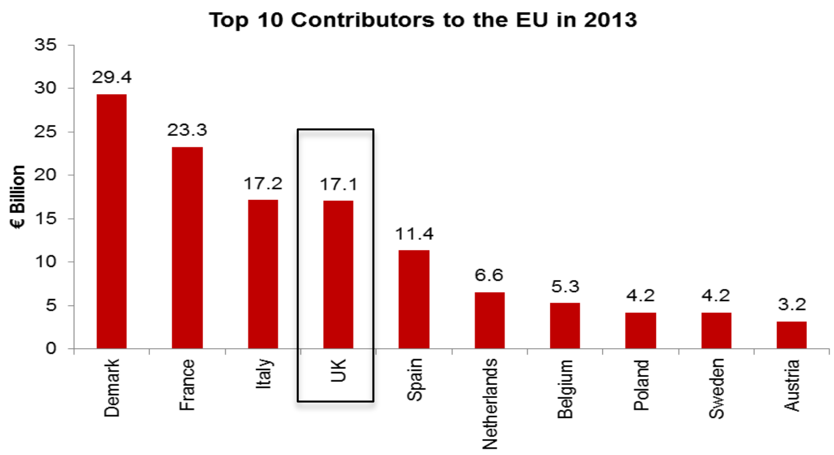
Eurozone Other EU members

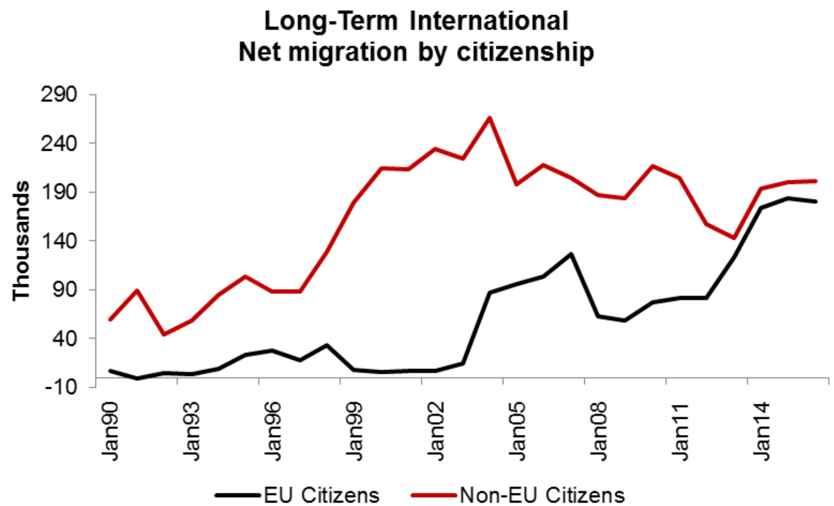


Source: Google images, whatUKthinks.org

The British Frustration: Why leave?

- **Being held back:** Pro-Brexit supporters believe that membership within the EU has been holding the UK back from further economic growth. These supporters argue that the regulations set by the EU have created unnecessary restrictions and red tape that weigh down British businesses.
- **Over-Migration:** With free movement of labour being one of the principles of the EU, the UK has seen a sharp increase in migration in the past 5 years. This large inflow of citizens include high and low skilled workers alike, creating a more productive economy but at the cost of a more competitive labour market and downward pressure on domestic wages.
- **High membership cost:** Being the 4th largest contributor to EU's budget, arguments against EU membership suggest that Britain would be able to save £933 per household every year, capital which could be better used for education, housing and healthcare.





Source: ONS, European commission, leave.eu

The 4 Es of England's Demands

• **English Sovereignty** In the event where EU is drawn to form a "European Super-state", the UK wants exemption from such a union, protecting themselves from complete political integration. This also allows the UK to maintain sovereignty as a separate member of the EU, ensuring economic and political independence on a global scale while bringing more autonomy to its parliament in relation to the EU's influence on UK's domestic affairs.	• **Euro Independence** With a declaration of a "multi-currency" EU, the UK would be protected from any potential pressures to form a financial union with the Euro. Furthermore, it guarantees protection for nations outside the EZ, ensuring that these nations are not disadvantaged and protecting non-EZ members from possibly high EZ bailouts.
• **Economic Governance** Under the EU, English businesses are said to face excessive regulations. Thus, targets have been set to reduce these regulations, allowing the UK to extend their free trade deals with other powers such as Asia and America and providing access to new markets.	• **Extensive Restructuring** In an effort to protect themselves being outvoted by the 19 member EZ, the UK seeks a restructuring of the EU to provide non-EZ nations with greater power to make decisions and defend themselves against EU directives.

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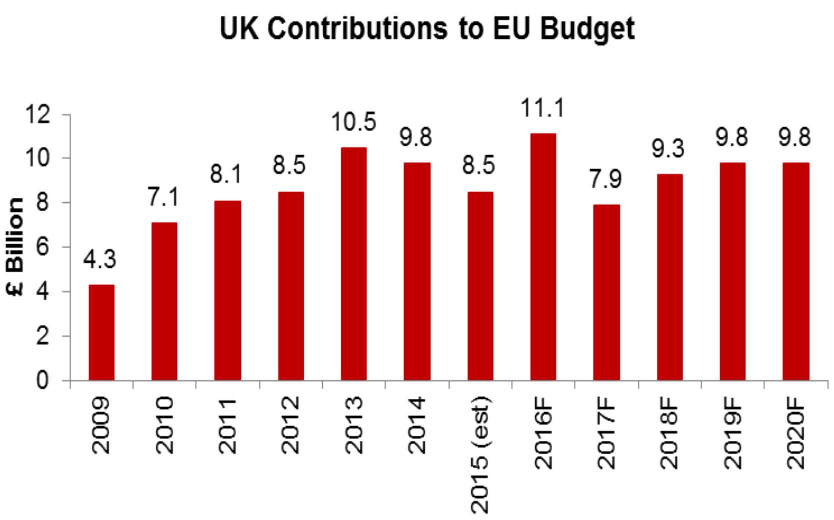
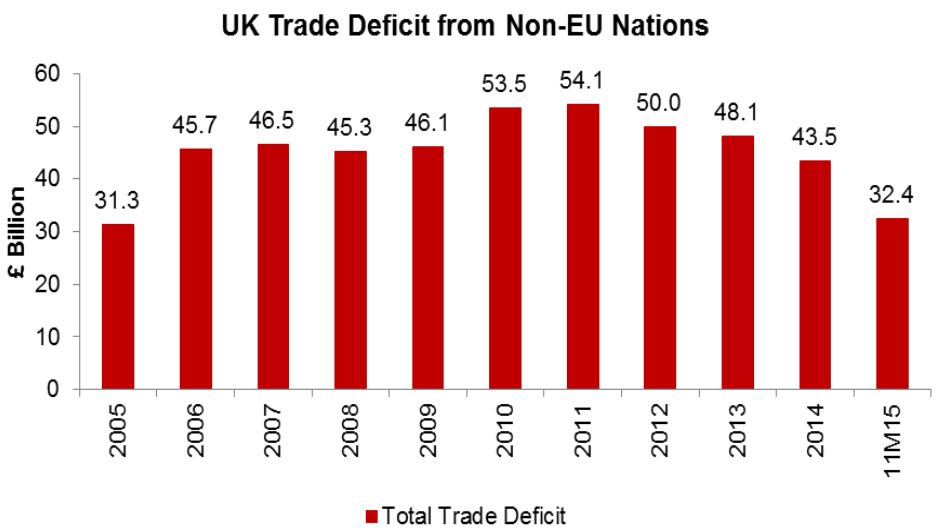
Impact on trade and economy: Pro-Brexit

- **A catalyst to SMEs:** A Brexit would lift tight EU regulations on businesses, serving as a catalyst for SMEs to pursue opportunities in different markets and expand their productivity. Policies that limit weekly working hours and energy usage will be scraped, allowing for the economy to expand without excessive red tape. The UK would also save a forecasted £11.1billion in contributions to the EU in 2016 alone, according to official estimates. These savings could be used to stimulate the economy in fiscal policies that improve infrastructure and labour competitiveness.
- **Freedom to expand trade negotiations:** Without EU's restrictions, the UK is free to conduct independent trade negotiations with large export markets such as the US and China, thus potentially providing access to new markets for British goods. Being in trade deficit with non-EU countries, the potential reduction on import tariffs arising from these new trade agreements with non-EU nations would also in turn help to reduce import costs, therefore strengthening the UK's overall trade position as well.





Source: House of Commons Library, CEIC

Impact on trade and economy: Pro-EU

Despite long term potential in the separation, the short term impacts cannot be ignored as the separation could create immediate shocks to UK's trade position.

- **Increase in tariff barriers:** A rise in tariff barriers translates to raising export costs for all British goods entering the EU. Despite the possibility of said tariff to be lifted in an optimistic future, the immediate shock to the UK economy may see foreign owned businesses re-locating to lower cost EU nations till new FTAs are finalized.
- **Increase in non-tariff barriers**: With greater border controls and legal obstacles affecting UK exports, export costs and barriers to trade are increased hurdles for goods coming into the EU from the UK. Thus, further supporting the stand that foreign owned businesses may seek to re-locate to escape these disadvantages.
- **Exclusion from future trade agreements:** With the EU in the midst of major trade negotiations with US (Transatlantic Trade and Investment Partnership) and Japan (Economic Partnership Agreement), a Brexit may lead to the exclusion of the UK, essentially leaving the UK out of any economic benefits which could arise from these negotiations and agreements.
- **No longer a gateway into the EU:** By separating themselves from the EU, the UK would no longer serve as the doorway into the EU, reducing its attractiveness as a financial capital. Investment inflows are expected to decline as the financial sector relocates and/or restructures to respond to the change.

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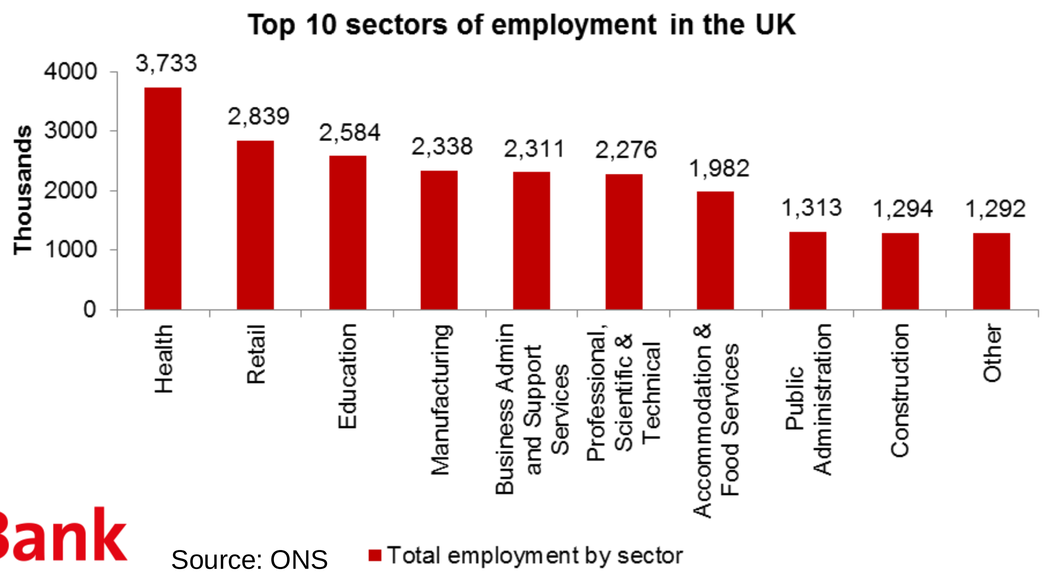
Impact on Labour, Migration & Politics: Pro-Brexit

- **SME driven employment:** With the lifting of EU regulations serving as a catalyst for business growth, employment would be boosted as SMEs expand and grow. With economic growth being supported by SMEs and entrepreneurs, the UK may attract a new generation of businesses into the economy, stimulating growth and employment.
- **Protection of labour force:** The UK will gain full control of their borders and will be able to control the flow of workers and migrants in and out of their country, thus serving as a form of protection for their local labour market. With greater control over migration, the UK will also have more control on the migrant screening process, ensuring that migration value-adds the British economy instead of coming at a cost, translating into increased productivity and economic growth.
- **Return of British power and sovereignty:** Pro-Brexit supporters argue that after the break-up, Britain will become a independent and powerful voice on the global front, serving as a bridge between the US and Europe. The separation will give control over domestic laws and policies back to the British Parliament, preventing domestic laws and policies from being overshadowed by restrictive EU legislations which were set with the intention to regulate EU nations in general.

Impact on Labour, Migration and Politics: Pro-EU

- **Greater unemployment:** Despite a possible boost on the SME front, UK's labour market would experience immediate shocks if global manufacturers decide to relocate to avoid tariff costs. With manufacturing being the 4th biggest employer in the UK economy, contributing to 8% of total employment, a relocation of foreign manufacturers would have a significant impact on UK's employment rate, potentially overshadowing any potential gains.
- **Losing its voice:** Without the EU, the UK faces the threat of being ignored by the major economies in global discussions. In areas such as environment, security and military, the effectiveness of the negotiations is ultimately dependent on the potential influence the nation has. Being independent from the EU, UK's influence may not be as large as before, thus increasing the chance of the UK being sidelined in global affairs.



Source: ONS

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Brexit: Leave or Stay?

- Many of the negative effects from the separation of the UK ultimately stem from the loss of the many benefits that the EU brings to its member states. Holding the status as the gateway to the EU, the UK has enjoyed being a financial and trade hub for foreign multinationals for many years. A Brexit would threaten this status and potentially create havoc if firms start to relocate and pull funds out of the UK.

- For the separation of the UK to ultimately be beneficial, the British parliament would have to put in place policies to ease the economy into the transition so as to prevent the immediate short term shocks from rocking trade and employment. Its ability to weather these shocks would also depend on the UK's capability to quickly re-establish free-trade rights with the EU, returning the UK to its previous title as the gateway into the Europe.

- On the global front, the value of the British voice in international politics may see the UK being sidelined in areas such as environment and international security. This assumption is taken from the fact that being an independent state, its influence would be smaller than the EU bloc. However, if successful in obtaining independent trade deals with US and China, the growth in the UK's economy may uplift the UK's overall importance in the global economy.

Disclaimer

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