THOMAS MILLER INVESTMENT

A Brief Overview of the EU Referendum and Implications for Asset Allocation

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Introduction & summary of our position

■ In a referendum to be held on June 23rd 2016, British voters will be asked: “Should the United Kingdom remain a member of the European Union or leave the European Union?” The G20, IMF and various US officials have highlighted “Brexit” as a key risk facing the global economy. This note explores the implications of either outcome for financial markets and asset allocation decisions.

■ In line with the market consensus position, our base case scenario is that Britain will vote to remain in the EU. This is simply an assessment of probabilities and does not rule out the possibility of a “Leave” vote.

What happens after a “Leave” vote?

■ David Cameron has said he would trigger Article 50 of the Lisbon Treaty, the formal mechanism for leaving the EU. That would begin a process of complicated negotiations for ending membership which could go on for up to two years. All EU members will need to agree to an extension of this 2-year deadline if that were required.

■ It’s worth noting that during these two years both the French Presidential Election and German Federal Election will take place. Political posturing may thus be expected to complicate the negotiation process.

■ Proponents of Brexit have suggested an alternative in which Parliament could repeal the 1972 European Communities Act to achieve a de-facto exit.

■ A leave vote will herald a period of political upheaval in the UK. For instance, it could trigger a Conservative leadership challenge. It is also likely to lead to calls for a new Scottish Referendum.

What are the financial market implications of a “Remain” vote?

■ Investor positioning data currently shows historically high levels of GBP short positions. A vote for the status quo will restore investor confidence and likely trigger short covering which could result in a sharp rally in sterling. The combination of ongoing expectations for low interest rates and record current account deficit will keep a lid on sterling’s upside in this scenario.

What are the financial market implications of a “Leave” vote?

■ While the longer term implications of a Leave vote for the British economy are highly uncertain, there is little doubt that the shorter term implications are largely negative.

■ The UK currently runs it largest peace-time current account deficit on record. It is worth noting that much of this deficit derives from trade with EU partners.

Below, we note some plausible financial market implications of a leave vote:

Currency markets:

■ The negative current account balance leaves the UK heavily dependent on foreign capital to finance its deficit. This leaves the country vulnerable to changes in investor sentiment.

■ In the worst-case scenario, Brexit could trigger a sharp sell-off in the trade-weighted value of sterling and lead to a full-blown sterling crisis.

Bond markets:

■ Sterling corporate bonds may suffer as UK companies (and possibly the country) could face ratings downgrades.

■ Gilts could remain well supported through a combination of likely central bank buying and safe haven demand [other safe havens such as gold are also likely to rally].

■ All else equal, other developed market government bonds (particularly US Treasuries) will rally in this scenario.

■ A sharp decline in sterling will trigger inflation concerns further down the line [and potentially increase the attractiveness of index-linked gilts].

Equity markets:

■ The impact will vary by sector and market cap.

■ Due to higher diversification of sources of revenues, large cap stocks should outperform their small/mid cap counterparts.

■ Sectors with heavy UK exposure such as house-building and retail are likely to underperform the broader market. Defensive sectors such as utilities should hold up better.

■ Euro-zone equity markets will also suffer.

■ Overall, both UK and Euro-zone equities will lag the US markets but we’re likely to see broad-based risk aversion across financial markets.

Monetary policy:

■ The Bank of England may well have to intervene in the currency or government bond markets or in both markets.

■ The Bank of England may be inclined to leave interest rates on hold for longer in an attempt to contain the economic fallout but pressure from weak sterling could force market rates higher. The BOE will face a difficult choice.

■ In the worst case scenario, the Bank of England may be forced to raise interest rates in an attempt to stem the flight of foreign capital.

■ Other major central banks may be more inclined to maintain accommodative monetary policy settings in the immediate aftermath of a leave vote. The US Federal Reserve Bank in particular may point to this “international development” as an excuse to delay further policy tightening in June.

Investment strategy & portfolio positioning:

■ While it is tempting to try to pre-empt the outcome of the referendum and position portfolios for a particular expected outcome, the prudent course of action in the run up to the vote is to maintain positioning in line with long term asset allocation consistent with our clients’ investment objectives (i.e. “neutral”).

■ For UK investors, a key part of this long term strategy is to maintain broadly diversified portfolios with global exposures that mitigate the EU/UK—specific downside risks of the Referendum.

■ Non-sterling base currency clients with exposure to sterling assets (such as specialist insurers with sterling liabilities and assets) should maintain sterling hedges to mitigate the downside risks to sterling.

■ The situation remains very fluid and highly uncertain. Post referendum, we will tilt our strategy to reflect the financial market expectations outlined above, while responding to any new developments. Indeed, the initial market reaction may throw up unanticipated opportunities as markets could overshoot.

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