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Market Insights
Brexit: risks and opportunities

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The referendum on whether the UK should remain part of the European Union (EU) will settle the matter of Britain's EU membership for the foreseeable future. Discussion of the arguments for and against British membership has already created a large amount of uncertainty ahead of the 23 June vote.

When asked about the potential for a UK decision to leave the EU, Christine Lagarde, Head of the International Monetary Fund (IMF), has said that "uncertainty is bad in and of itself" (FT.com, 25 February 2016). She went on to say that: "No economic player likes uncertainty. They don't invest, they don't hire, they don't make decisions in times of uncertainty."

The upcoming referendum has come to be seen as a cloud over potential investment activity in the UK until the question is resolved. While there is no historical precedent for a comparable member state ever having left the EU, I spoke with a number of Invesco Perpetual (based in Henley-on-Thames) fund managers – Mark Barnett (MB), Head of UK Equities; Jeff Taylor (JT), Head of European Equities; Mike Matthews (MM), Fund Manager, Fixed Interest; and Stephen Anness (SA) and Andrew Hall (AH), Fund Managers, Global Equities – to discuss the risks and opportunities of a vote in either direction.

How likely do you think the UK is to vote to leave the EU?

MB: The opinion polls are showing that it could be a close call, but the betting odds are indicating that a vote to leave is unlikely. Lessons from other referendums, including in Scotland, Scandinavia and Switzerland, indicate that voters tend to vote for the status quo.

JT: EU membership has long been a political issue in the UK and was a key campaign topic in the 2015 general election. Those who argue against membership focus on issues of immigration, the financial costs of EU membership, and limits on the UK's ability to forge trade agreements with non-EU nations independently of the EU.

Proponents of EU membership point to the ease of trade and travel within the EU – i.e. no tariffs nor immigration restrictions, economic benefits from a larger common market and having greater clout when dealing with global issues. Proponents argue that a British exit from the EU, a 'Brexit', could usher in significant political and economic uncertainty, potentially thwarting growth and threatening the status of the UK as a major financial centre. The vote is likely to be close. Opinion polls currently indicate a small majority for the 'Remain' campaign.

MM: That's right. The current evidence from opinion polls is that the UK will vote to remain in the EU, but of course there is a significant chance of a vote to leave too.

SA: Given the pollsters' success (or lack of it) in predicting the outcome of the UK general election of 2015 there is clearly an element of danger in trying to second guess the electorate, particularly when the polls for both the 'yes' and 'no' sides appear relatively close. However, on balance, we believe that the current relatively favourable economic conditions will lead to the electorate voting for the status quo and the UK remaining part of the EU. In addition, there is very little information available on the process of leaving the EU and what this might look like, which may deter 'leave' voters.

How comfortable do you think financial markets are currently with the prospect of Brexit?

MB: I am concerned with the impact the EU referendum will have on markets, simply because markets do not like the uncertainty surrounding a vote. Polls showing a close vote will create a large amount of uncertainty. I also worry about the impact the vote will have on levels of investment. During the run-up to the Scottish referendum we saw a material slowdown in the level of investment and job creation. There is also the uncertainty of further political ramifications in the aftermath of the vote.

JT: As Mark said, financial markets don't like uncertainty. But so far, the only significant expression of Brexit fears in the markets has been the increased volatility in the value of sterling.

AH: That's right, the biggest impact so far has been felt in currency markets, where sterling fell 13% from its 2015 high on 18 June to the 26 February 2016 low (source: Bloomberg).

It has since rallied from these lows but we would expect to see further volatility, dependent on polling data. Sterling weakness is an important factor for those companies which have significant exposure to the UK economy. From an equity perspective, there has been some weakness in UK small cap stocks, which tend to be more domestically orientated. However the FTSE 100 index has been one of the best performing markets in Europe year to date (22 March 2016).

MM: It doesn't look like Brexit is currently playing a major role in the pricing of fixed income markets. There has been some volatility in sterling, but it is difficult to disentangle what is Brexit uncertainty and what is related to central bank policy. For example, sterling has actually strengthened in recent weeks as the European Central Bank (ECB) and the US Federal Reserve (Fed) have become more dovish (as they look to keep interest rates low). The gilt market also seems relatively relaxed, with yields in the 10-year gilt only slightly higher on 21 March than on 20 February 2016. Clearly this is a dynamic situation and as we get closer to the referendum levels of volatility could increase.

What would Brexit mean for your market and your economy?

MB: The UK economy is robust enough, with a highly skilled workforce, to withstand the impact of a vote in favour of Brexit, notwithstanding some near-term disruption to investment. As Jeff, Andrew and Mike have observed, sterling is likely to take the majority of the pressure. The UK stock market is a heavily overseas market – over two thirds of the FTSE All-Share constituents' revenue comes from outside the UK (source: Lazarus Partnership, as at 8 March 2016) – and hence, near-term volatility apart, the impact there should largely be limited to the impact of weak sterling.

MM: It's very difficult to identify what effect a single factor will have on what is already a volatile market. That being said, irrespective of the long-term arguments for and against Brexit, the immediate aftermath of a vote to leave the EU would involve uncertainty and therefore volatility in bond prices. Non-domestic owners of gilts and sterling corporate bonds may disinvest to some extent. Domestic investors might not be as sensitive to Brexit risk but their broader appetite for risk may be affected.

Again, I would emphasise that we could see sterling come under further pressure. The pound has been sensitive to political uncertainty in the past, for example in the run-up to the Scottish independence referendum in 2014 and the UK general election in 2015.

Exit from the EU would be negative for UK exports, at least for a period before new trade agreements could be established. This would also be negative for the pound. Again, it might be countered to a certain extent by more dovish central bank policies elsewhere (as low interest rates are maintained).

SA: As global investors, the UK is a relatively small component of our overall market (circa 7% o f the MSCI AC World index, as at 29 February 2016). However, the impact of the UK exiting the EU would undoubtedly have a wider impact on Europe and may give rise to debate in other EU countries as to their own continued membership. The UK economy may suffer as investors defer investment decisions as the process and negotiation of withdrawal takes place; however it would be likely to benefit from a competitive perspective as sterling depreciates. Outside Europe and the UK, we wouldn't anticipate a significant impact on other markets or economies.

JT: The debate about Brexit has not led to any changes in the Invesco Perpetual European Equity team's valuation-focused fundamental investment strategy. In our view, European politics should not be confused with the concept of investing in European equities.

There may be knock-on effects for the rest of Europe from the issue of Brexit, but it is important to note that firstly, Brexit is far from certain to happen, as we've heard earlier; and secondly, what the settlement between the UK and the rest of the EU would look like is uncertain and so it is premature/inappropriate to speculate sensibly about what the true impact on the rest of Europe would logically be.

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