Market Snapshot – May 2016

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BREXIT: The End of an Era?

By Joe Zawawi

What is the "Brexit"

If you are reading this, you likely are well aware that "Brexit" is something more than simply the combined name of some celebrity couple (like Brangelina or Bennifer). Brexit (short for, "British exit"), of course, refers to the United Kingdom's potential withdrawal from the 28-nation European Union (EU). A referendum is set to take place on June 23rd, when all eligible residents may take part in voting to decide whether or not to remain a member of the EU. As we near that date, there's no doubt that headlines will be filled with the term Brexit with greater frequency. Consider this piece your primer.

The history of the UK-EU relationship spans over four decades. Although the early roots of the modern day EU began in 1957, Britain joined what was then called the European Economic Community (EEC) in 1973 under the leadership of Tory Prime Minister Edward Heath.

Given this lengthy and seemingly prosperous history, one wonders how the prospect of a Brexit has arisen. Evidently, leaving behind the free trade relationship that has been in place for decades raises much concern and uncertainty over not only the UK's future, but for its economy and investors as well. In this article we dig into the factors that brought us here and analyze the potential ramifications for the U.K. economy and investors.

Who wants to leave and why?

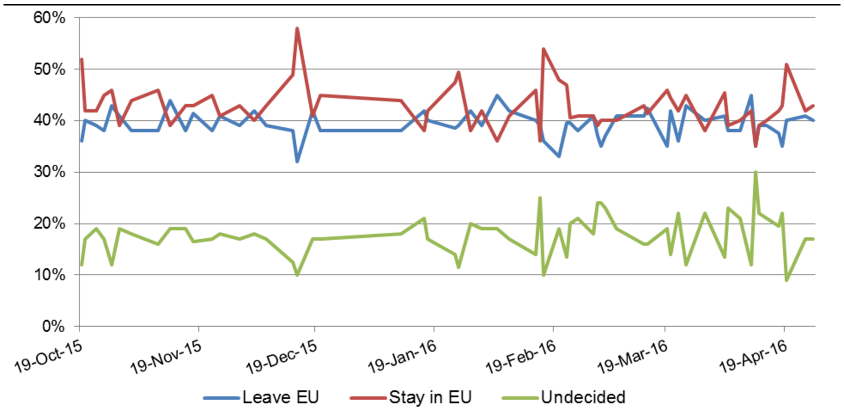
The number of Britons in support of the idea of a Brexit has been on the rise as a result of perceived immigration and economic challenges related to EU membership. Reflecting this trend, nationalist ideologies and parties such as the UK Independence Party (UKIP) gained some traction during the 2015 UK general election. About half of Conservative MPs are also in favour of leaving. In response to these growing calls during the election campaign, current Prime Minister David Cameron had promised to hold a referendum vote if he won, in order to "settle this European question in British politics".

Supporters of a Brexit cite numerous reasons as to why they believe that EU membership puts the UK at large economic and political disadvantages. From a cost perspective, membership fees amount to billions of pounds per year, of which they say the UK receives little in return. They also argue that the EU imposes too many rules on British lawmakers and businesses. In addition, there is a growing desire for Britain to take back control of its borders in order to reduce the number of migrant workers given that EU membership dictates a free movement policy; meaning that visas are not required to move between EU countries.

Remain-campaigners underline the value of the free trade agreement with the EU and point out that attempting to match similar benefits via new trade deals as a singular nation would be very difficult, and would likely leave the UK worse-off. They argue that the benefits of free trade far outweigh the membership costs, most of which is returned to the country via subsidies anyways. In addition, they believe that the UK has great influence in the EU policy setting process already.

Advanced surveys show that the race is quite close on average. Although the remain-camp has maintained a lead in the majority of the survey data taken since October, the voters in favour of leaving have remained firm. As of April 26th, a Bloomberg Composite Index that compiles data from seven different online and phone polls showed that, on average, 43% of those surveyed want to remain in the EU, and 40% are in favour of Brexit. 17% of those surveyed were undecided.

Chart I: Survey data of stay versus leave voters



Source: Bloomberg

What could an EU exit mean for the economy and investors?

Economic Growth

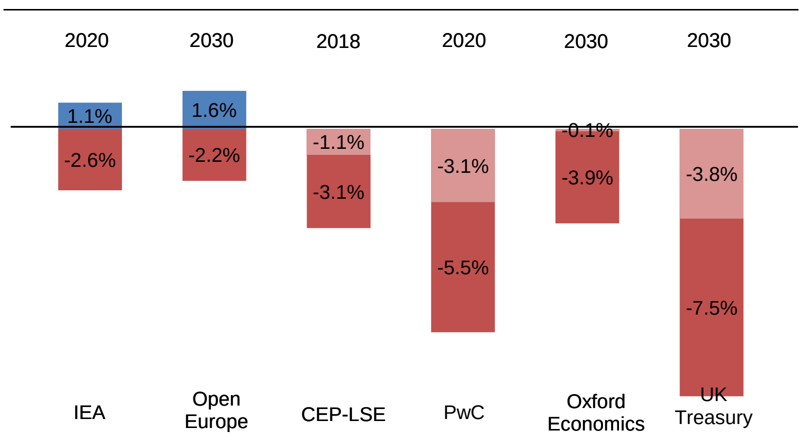
Those in favour of EU membership highlight the fact that a Brexit would result in the UK losing its beneficial trade tariff agreement with other European nations, and argue that it would discourage inward investment flows from other EU businesses looking to expand into the UK. In addition, preventing EU citizens from coming to work is also seen as a restraint on growth. These factors have all positively contributed to the UK's economy in the past.

The leave-campaigners make the case that trade with countries outside of the EU could increase, and under more favourable terms than negotiated through current EU relations. Furthermore, removal of costly membership fees and EU regulations imposed on the UK that are viewed as restrictive would further bolster growth.

There have been numerous studies conducted by economists from various points on the political spectrum that hypothesize a range of estimates on the potential post-Brexit impact on GDP. Although some of the predictions do call for positive outcomes under the right conditions, by and large, the studies suggest that a Brexit is more likely to lead to economic contraction for the UK.

Considerations of new trade deals that the UK would have to establish with the EU and the rest of the world play a large part in post-EU growth projections. Think tank Open Europe has suggested that if the UK was able to achieve highly favourable trade deals, it could be better off by up to 1.6% of total GDP by 2030, however, the potential loss is much greater than that – up to a 2.2% loss. The treasury analysis carried out in the UK implies a loss in the range of 3.8% and 7.5%, as illustrated in Chart II.

Chart II: Best-case vs. worst-case projections of impact on GDP



Source: UK Telegraph

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Trade

Under the current single market model, imports and exports among member states are not subject to tariffs. If Britain left, it would need to negotiate new trading deals with not only the EU, but also non-EU countries it traded with previously under EU trade relationships.

Given that over 50% of the UK's exports go to EU countries (total exports to the EU amounted to about £135B in 2015), remain-campaigners point to this as evidence that the economic stakes are high. If the UK did leave the EU, businesses hoping to export to the EU would still have to meet its production standards in addition to the new tariffs their products would be subject to. Brexit could, for example, severely impact the UK's automotive industry whereby automotive exports would be facing a 15% tariff. Furthermore, approximately a third of financial and insurance services from the UK are exported to EU countries. The stay-camp also doubt that the UK economy standing alone would have enough influence in striking favourable trade deals where global trade has become increasingly led by the EU, China and the U.S.

Advocates of a Brexit recognize that new trade deals would need to be established but argue that stronger trading links could be created. Similar to Norway, Britain could join the European Economic Area which would free it from EU rules that are currently enforced on certain industries, and provide access to the EU market except for some financial services. Under the Swiss model, Britain could negotiate trade deals sector-by-sector. Ideally, a completely free trade agreement would work best. The Comprehensive Economic and Trade Agreement which was recently signed between Canada and the EU is an example of this, under which Canada isn't subject it to any membership fees and will still eliminate some trade barriers.

Financial Markets

The uncertainty related to a Brexit is likely to add to market volatility leading up to the referendum. Market moves that can be attributed to this have already been seen; with the pound sterling dropping 1.3% against the USD the day after the referendum date was set; and subsequently hitting seven year lows back in February. If the Brexit were to occur, the UK's current account deficits and budgets would be put under pressure and the pound could be expected to decline further.

10 year UK government bond yields rose following the referendum date announcement as well; and it stands to reason that yields could rise further if the Brexit occurred as foreign investors would likely be less willing to lend to the UK.

Industries sensitive to interest rates or the pound such as financials, real estate and exporters are likely to be the most impacted.

If voters do choose to remain, sterling and sterling-denominated assets may be considered to be attractively priced as short term moves that were based on fears related to the prospect of Brexit begin to reverse.

Regardless of the longer term ramifications of a Bexit, a vote to leave the UK would undoubtedly lead to massive short term uncertainty. And financial markets despise uncertainty.

Stay or Go?

Although the consensus view of economists is decidedly negative on average for economic growth post-Brexit, the ramifications for the economy and for investors are difficult to forecast. There are too many unknowns associated with the prospects for a post-EU Britain to say with certainty which path is best. The same can be said for a post-UK European Union, which is a different beast altogether.

Anti-Brexit supporters hold faith in the EU system and that the UK has a bright future within it, whereas leave-campaigners believe that Britain has the potential to be stronger on its own, and that leaving poses little risk to the UK's future trade prospects and ultimately growth.

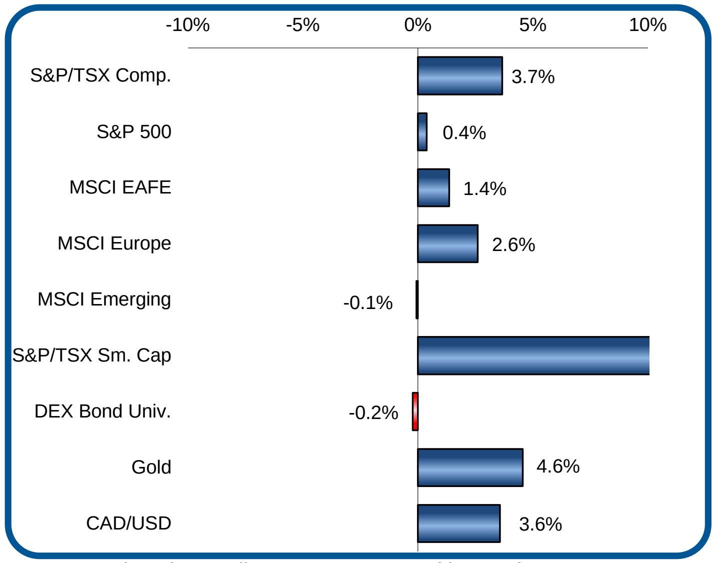
Perhaps the most practical path would be if the UK chooses to stay and avert the potential risks that arise from exiting, while the British government simultaneously works in re-negotiating terms surrounding the certain immigration and regulation policies that are of the highest concern to Britons. The threat of a British exit itself should provide leverage as Prime Minister David Cameron's government embarks on policy negotiations in the coming weeks.

For investors, the reality is that the British economy is doing quite well relative to its European counterparts. With inflation on the rise, improving sentiment and an IMF 2016 economic growth target of 2.2%, the case can be made for strength in equities and the pound if the UK decides to stay, as well as the possibility that rising interest rates could very well be on the table.

MONTHLY OVERVIEW

Global equities were mostly in the green during April. The S&P/TSX Composite finished the month up 3.7% overall. Materials were the largest gainers, jumping 20%, as commodities rebounded. Nine of the top ten gainers within the index during the month were precious metals producers. Canadian health care stocks also added over 15% on average after having their value cut in half in the prior month; this gain was due mainly to a rebound in Valeant Pharmaceuticals after an announcement that a new chairman and CEO would be joining the company. In the U.S., the S&P 500 traded up 0.4%, keeping the year-to-date performance in the green at 1.7%. Although modest, this positive performance is refreshing after the market turbulence that was experienced earlier this year. Gains were also chalked up overseas; in Europe, the Stoxx Europe 600 Index rose 1.9%, while in Asia the MSCI Asia Pacific Index added 1.8%. (All returns in local currency terms)

1 MONTH RETURNS



Source: Bloomberg, All Returns are TR and in Local Currency

Looking at Canadian economic data that was released in April, the country's economic growth slowed for the first time in five months during February. Month-over-month GDP fell 0.1%, following the 0.6% rise in January; however, this was less than the average estimate by economists which called for a decline to the tune of 0.2%. The slowdown was due to a drop in output of 0.8% in both the manufacturing and mining sectors. The performance of the mining component, which includes oil and gas extraction in the StatsCan data, is consistent with the depressed natural resource prices at the start of the year. Oil prices have since rebounded, with WTI prices closing April at US$46/b, up materially from the February low of US$26.05/b. The small setback in monthly growth has not swayed economists' projections for overall Q1 growth, which currently stands at 2.8% on average according to Bloomberg.

As widely expected, the Bank of Canada kept the overnight rate on hold at 0.50% at its policy meeting in early April. The Bank raised its 2016 growth forecast to 1.7% citing the weak handoff from last year (2015 Q4 real GDP growth of 0.8%), the benefits of the weak loonie and supressed energy prices on non-resource sectors, and the positive effects of the fiscal stimulus package.

U.S. growth in the first quarter rose at its slowest pace in two years as business investment, exports and consumer spending all slowed. After rising 1.4% in the last quarter of 2015, GDP grew at a 0.5% pace in the first three months of 2016. Consumer spending in March was flat in real terms which led to core personal consumption expenditures, a measure of pricing pressure ex energy and food, to edge slightly downward to an annualized rate of 1.6%. Continued job growth, low energy prices and consistent rises in personal income growth, however, support the prospect of stronger growth moving forward.

In Asia, most investors were surprised that the Bank of Japan didn't expand their ¥80 trillion asset purchase program and left interest rates unchanged at -0.10% after its last meeting in April. Most economists expected some sort of action from the central bank as the strengthening yen has continued to pose a risk to growth prospects. Governor Kuroda has said that the Bank would like to allow more time to assess the impact of the current negative interest rate policy. Given the inaction from the BoJ, attention was turned to the federal government to see if it will provide any sort of stimulus. Prime Minister Abe is mulling over the possibility of postponing a sales-tax increase that is scheduled for April 2017. It has been suggested that consumers have been opting to save now, and thus holding back on spending, in anticipation of the future tax increase, and so pushing the date back further may work in complementing the current stimulus package from the central bank.

MARKET OUTLOOK

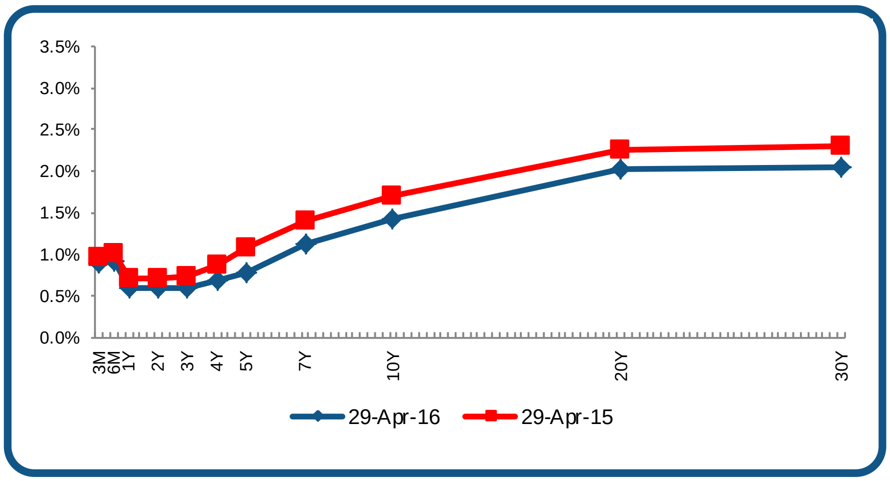
On June 23rd, Britain holds its referendum vote to decide whether or not to remain with the European Union. Per our main article this month, prepare for the likelihood of increased market volatility as the date draws nearer. (You may follow advanced surveys here). Although the Federal Reserve is not holding a meeting in May, the implied probably that the Fed will pull the trigger on another rate hike in June before the Brexit vote is at just 10%, based on futures data. Although the Fed recently adjusted its outlook from four rate hikes this year to two, the better half of the market is not pricing in a potential rate hike until December.

Monthly Market Statistics: April 2016

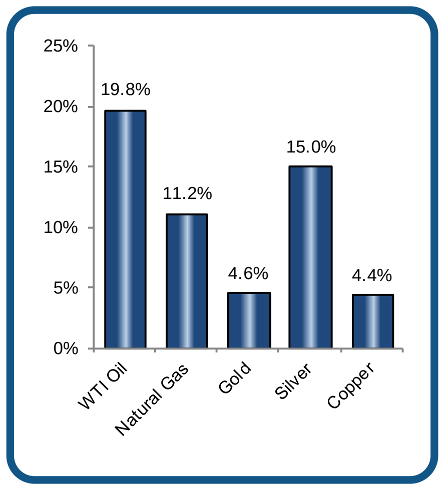
Total Return Index Returns (Annualized After One Year)

	Local Currency Returns							Canadian Dollar Returns						
	1M	3M	6M	YTD	1YR	3YR	5YR	1M	3M	6M	YTD	1YR	3YR	5YR
TSX Composite	3.7%	9.7%	4.8%	8.4%	-5.4%	7.0%	3.0%	3.7%	9.7%	4.8%	8.4%	-5.4%	7.0%	3.0%
S&P 500	0.4%	7.1%	0.4%	17%	12%	113%	110%	-2.9%	-4.2%	-3.6%	-7.6%	5.1%	19.7%	17.4%
MSCI EAFE	14%	0.7%	-6.5%	-5.1%	-10.7%	5.8%	6.6%	-0.3%	-3.5%	-6.7%	-9.2%	-5.4%	9.7%	8.1%
MSCI World	0.9%	4.7%	-2.3%	-0.9%	-4.2%	8.8%	8.7%	-16%	-3.5%	-4.7%	-7.9%	0.1%	15.0%	12.7%
MSCI Pacific	0.6%	-13%	-9.2%	-8.6%	-13.7%	4.8%	8.5%	0.4%	-2.4%	-4.1%	-9.3%	-4.1%	8.2%	9.3%
MSCI Emerging	-0.1%	8.4%	-1.1%	2.7%	-12.4%	2.3%	15%	-2.7%	18%	-4.0%	-3.4%	-14.4%	3.1%	12%
TSX Small Cap	12.4%	27.1%	18.0%	21.9%	12%	5.0%	-2.6%	12.4%	27.1%	18.0%	21.9%	12%	5.0%	-2.6%
Global Small Cap	15%	8.3%	-0.2%	0.5%	-3.1%	9.6%	8.5%	-0.9%	0.1%	-2.2%	-6.3%	17%	16.1%	12.7%
CDA Bond Uni.	-0.1%	13%	2.6%	13%	2.1%	3.4%	5.0%	-0.1%	13%	2.6%	13%	2.1%	3.4%	5.0%
CDA 1-5 Yr Bond	-0.1%	0.3%	0.8%	0.3%	14%	2.2%	2.7%	-0.1%	0.3%	0.8%	0.3%	14%	2.2%	2.7%

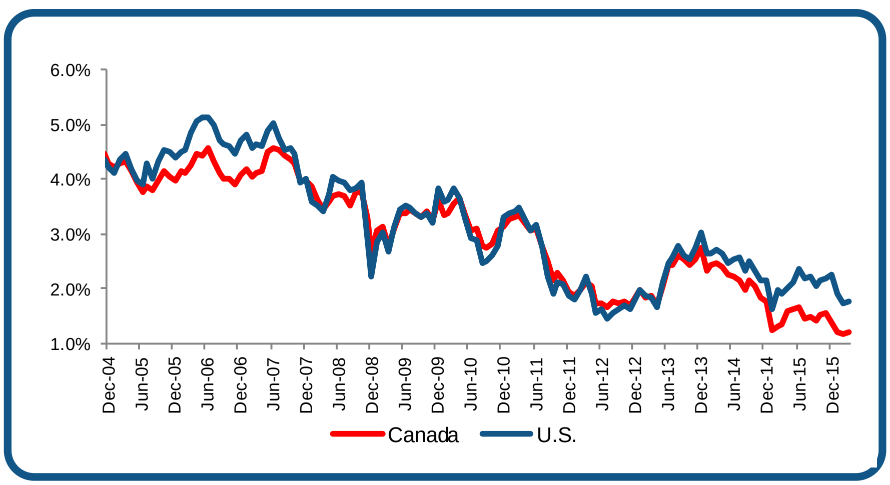
Canadian Yield Curve



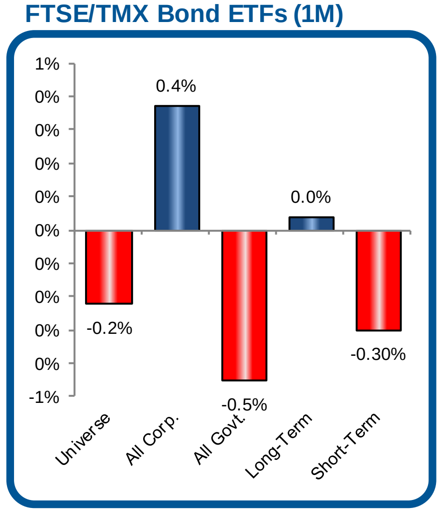
Commodities Performance (1M)



10YR Government Bond Yields



FTSE/TMX Bond ETFs (1M)



Source: Bloomberg, iShares.ca

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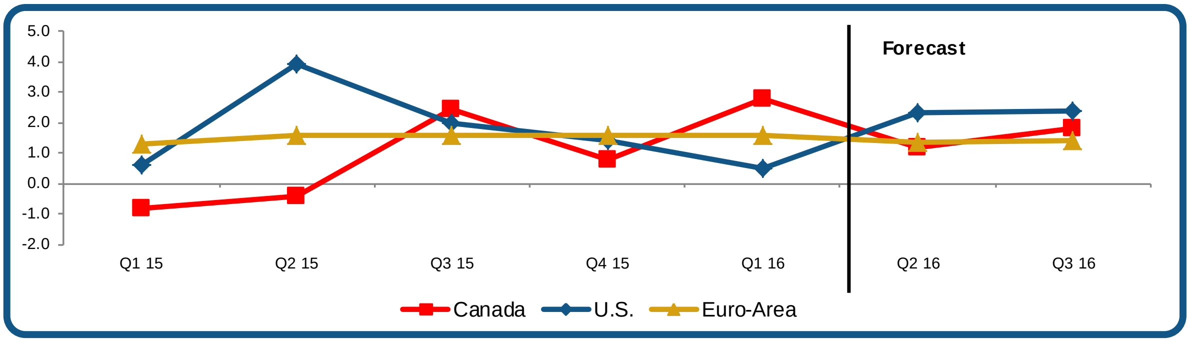
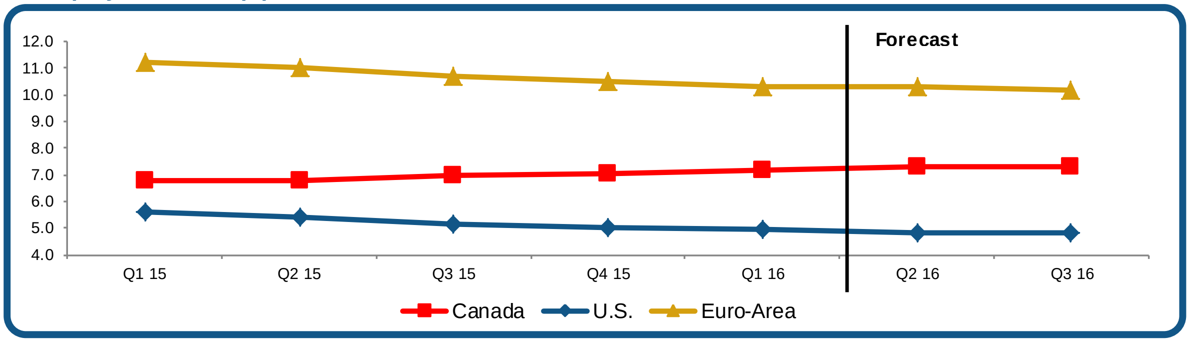
Economic Statistics

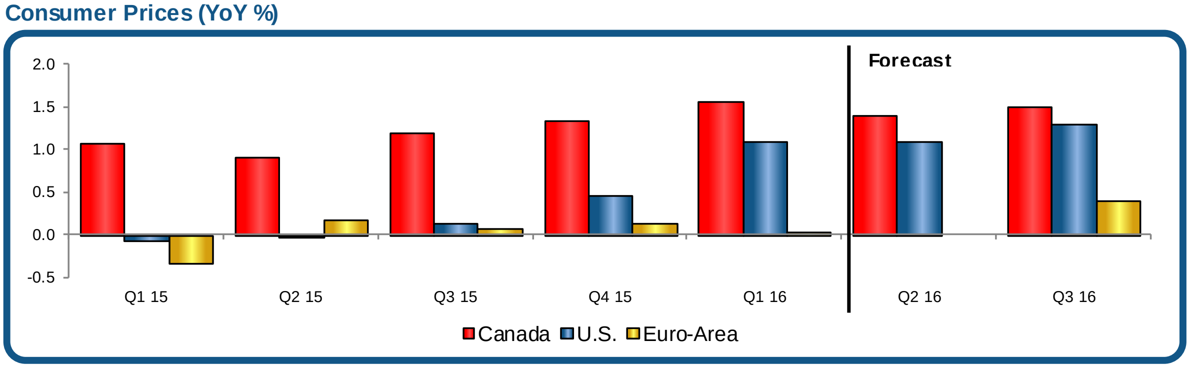
Real GDP (%)



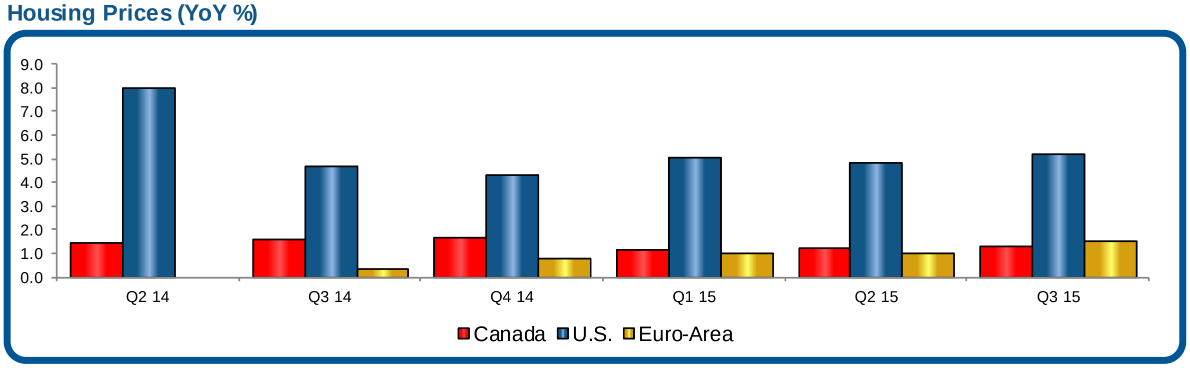
Unemployment Rate (%)



Consumer Prices (YoY %)



Housing Prices (YoY %)



Source: Bloomberg

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