Perspectives

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European Union Referendum

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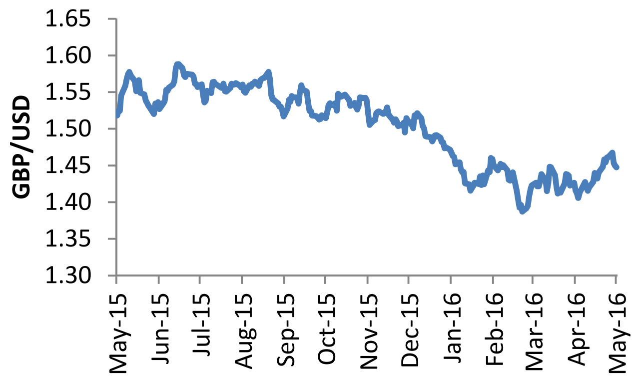
Since the beginning of 2016, UK economic data has underperformed relative to expectations, ranging from weaker inflation to slowing manufacturing and GDP. The economic data, combined with global market developments, has given the Bank of England (BoE) cover to hold off on rate hikes for the rest of the year. In fact, markets are now pricing in a 40% chance of a rate cut in 2016! At the beginning of the year markets were pricing the possibility of a rate cut around zero. Market expectations of a rate hike have now been pushed to the second half of 2018. It is noteworthy what a vast change in expectations this is from a couple years ago when some forecasters expected the BoE might raise interest rates before the Fed. This shift is only driving a greater divergence between US and UK monetary policy, which in turn should weaken the GBP versus the USD.

Despite the weakening fundamental backdrop of the UK economy, the main driver of GBP in 2016 will be the risk of voters deciding to the leave the EU during the referendum on June 23rd, otherwise known as "Brexit." It will not simply be the date of June 23rd when GBP will experience significant volatility, but the entire time period from today until the election – perhaps even in the weeks after the election (especially if the "Leave" vote passes). There are several dates that can be viewed as crucial points or "look through" driving the GBP one way or another. For instance, the official campaigning period begins April 15th; the mayoral, local and regional UK elections on May 5th; the BoE meeting minutes release May 12th etc. The positions of prominent political figures in the UK can also drive polling and therefore the GBP. When Boris Johnson, the former mayor of London announced he would advocate leaving the EU, it sent the GBP plummeting and gave the "Leave" vote an enhanced sense of legitimacy. Currently, the polling is about even for both the "Leave" and "Remain" camps – although the betting markets (often quite accurate) are only pricing in a 30% likelihood of Brexit. Political pundits believe between 15-20% of voters are still undecided, so the coming weeks could see significant swings in sentiment.

Exhibit 1: GBP has weakened versus USD over the last 12 months



Source: Bloomberg, Opus

Sentiment towards the GBP is extremely negative. According to derivatives markets, protecting against GBP weakness has become significantly more expensive. A driver of these market conditions is the UK's significant current account deficit, constituting 5% of GDP. This means that the value of the goods and services the UK imports exceeds the value of goods and services that it exports. Therefore the UK is highly dependent on foreign countries to fuel its economy, particularly Europe. Because the UK economy is highly leveraged to the global economy and financed with foreign capital, Brexit risk increases the risk of capital flight. Capital flight translates to a weakening GBP, making the UK's imports more expensive. The cycle can reverberate negatively throughout the economy.

If the vote to leave the EU succeeds, the "Leave" camp has stated the UK would be able to achieve trade deals with the EU outside of full EU membership similar to deals that Norway and Switzerland have. They believe that unhinged from the burden of Europe, the UK economy would soar on its own. Brexit means freedom from European bureaucrats who interfere in a variety of ways including restrictions on labor laws and banking compensation. The Euroskeptics are passionate about regaining control over immigration. Immigration is an especially sensitive issue given how Europe has struggled with terrorism over the past year as a tide of refugees pours in from Syria and other war-torn areas.

But why would the EU be open to a favorable free trade deal with a nation that just voted to leave? Furthermore, the EU must consider what the implications mean when member states like Spain, Portugal, and especially Greece see an ex-member state still enjoying the privileges of being part of the European club under a favorable trade deal. Undoubtedly, the EU would hold significantly more leverage in negotiations with the UK than vice versa – the EU takes around 50% of UK exports, while the UK takes in a mere 10% of EU exports. While freedom from European bureaucrats may please Euroskeptics, the British must consider the costs of leaving such a large free market, as well as the loss of influence in large multinational institutions. Big multinational companies like HSBC that are domiciled in the UK have already discussed the possibility of relocation (which could be a blow to government tax coffers). A reduction in UK immigrants from within the EU also means hurting the business sector whose bankers, doctors, and builders come from a variety of foreign countries.

Finally, if the UK can leave the EU, why can't Scotland leave the UK? A vote to "leave" can produce a negative political cycle leading to more uncertainty and adverse developments in financial markets.

Even if the UK votes to stay, the EU is still an economy with multiple and serious tail risks that can weigh on growth and inflation. Growth, albeit still at extremely low absolute levels, has ticked up over the past year – on the back of low energy prices, quantitative easing, and a weakened euro. However the long-term structural headwinds all remain. How will the EU deal with their rapidly deteriorating demographics, increasingly polarized and dangerous politics, terrorism, never ending Greek bailout negotiations, restrictive labor laws, and general lack of competitiveness across industries? At a time when the need for cooperation and further integration has never been more needed, the desire of Europeans to break apart and gain sovereignty has never been greater. Regardless of the vote, prospects for a strong UK economy that is linked to the fortunes of Europe is bleak. **It is likely a vote to remain in the EU will create a relief rally for GBP in the short run but all the above mentioned factors should translate to a weaker GBP in the long run.**