A Closer Look

A Briefing on Brexit: Evaluating the Risks of the U.K. Leaving the EU

BESSEMER TRUST

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In Brief

- **The potential for the U.K. to exit from the European Union (EU), termed "Brexit," is a risk factor we have highlighted for this year. With a referendum scheduled for June 23, we take a closer look at the issue.**
- **Our base case remains for the U.K. to remain in the EU, but recent developments and close polls suggest uncertainty will stay high until the vote, weighing on U.K. and potentially European markets.**
- **Bessemer portfolios are underweight U.K. assets and now neutral Europe versus the Balanced Growth benchmark, but the investment team is monitoring the situation carefully and is prepared to act as opportunities arise.**

We have described 2016 as a year peppered by diverse risk factors. While China, oil, and the Middle East have dominated in the first quarter, another 2016 issue we have highlighted is the risk of a U.K. exit from the EU (or "Brexit," as this is commonly described). We consider the probability of an actual Brexit occurring as relatively low: there are many economic benefits of being part of the union, especially with London serving as its de facto financial center, and UK citizens also prioritize the travel and labor mobility that membership provides.

However, the run-up to the June 23 referendum is likely to keep uncertainty elevated. Academic studies suggest a meaningfully negative economic impact from the U.K. leaving the EU, with uncertainty itself constituting an additional drag on productivity and growth. The market's anticipation of such an event is, consequently, likely to be negative for U.K. assets, with outflows to weigh on the equity markets and the local currency, the pound sterling (GBP), if the probability of Brexit increases.

To a lesser extent, such a development would also be negative for European equities at large as the U.K. currently serves as the effective financial center of the broader region for many companies, and as Brexit would put the credibility of the European integration into question. Within a 70/30 Balanced Growth portfolio at Bessemer, positioning is currently underweight U.K. equities and neutral European equities; the investment team is prepared to adjust portfolios as the situation develops.

Following a round of negotiations with the EU in late February, U.K. Prime Minister David Cameron set the June 23 date for the referendum for U.K. citizens to vote on whether the U.K. will remain part of the EU. The U.K.'s relationship with Europe has long been a contentious subject, especially within the ruling Conservative Party. Please see the sidebar on page 2 for a description of the EU. One of the commitments made in the Conservative manifesto before the general election last year was, in the event of a Conservative majority (which was not expected at the time), that there would be a referendum on EU membership by the end of 2017. A combination of factors has led to discontent with the U.K./European relationship and a call for renegotiation of terms and potential exit, but the broad areas of sovereignty and immigration seem to be the most pressing.

With regards to sovereignty, at a philosophical level, there is disagreement within the U.K. as to the EU member states' commitment to an "ever closer union among the peoples

What is the EU?

- The European Union (EU) is an economic and political partnership of 28 European countries with a total population of 500 million.
- A union was first established after World War II to foster economic cooperation, with the idea that countries that trade together are more likely to avoid going to war with each other. Initially, a deal was signed in 1950 by six countries (including France and Germany) to pool their coal and steel resources. Since then, it has developed into a single market, allowing goods and labor to freely move around as if the member states were one country.
- In 1957, the Treaty of Rome established the European Economic Community (EEC), the foundation of today's EU. The U.K. was one of three new members to join the first wave of expansion in 1973. Further expansions in each decade occurred thereafter.
- The EU has its own currency (the euro, used by 19 member states called the European Monetary Union, or EMU) and its own parliament that makes laws in a wide range of areas, including labor laws, consumer rights, transportation, and the environment.
- Financially, the EU operates with a budget of 145 billion euros (2015) with each country contributing and receiving according to pre-agreed negotiations/formulas. In general, the more prosperous countries contribute more than they receive — for example, the U.K.'s net contribution in 2014/2015 was £8.8 billion.
- **Key institutions within the EU:**
  - European Commission – EU civil service which manages the day-to-day business of the EU; 28 commissioners (1 from each country); President Jean-Claude Juncker; administers finances; proposes new laws; based in Brussels
  - European Parliament – split between Brussels & Strasbourg; 751 members (elected every 5 years) from all European countries; President Martin Schulz; votes on laws proposed by the European Commission
  - Council of the European Union – represents governments of the EU member states; rotating Presidency; based in Brussels
  - European Court of Justice – interprets and applies EU law; one judge per member state; based in Luxembourg

of Europe." As part of his negotiations, Cameron secured a "special status" excluding the U.K. from this provision. While many immigration issues are decided at the bilateral level, for example, between France and the U.K. generally, there has been discontent regarding EU mandates for immigrant benefits. Cameron negotiated an "emergency brake" for phasing in benefits for migrants if the demands on social services are too great. These consolations did not go far enough for a portion of the electorate and key politicians. Popular London Mayor Boris Johnson came out in favor of an "out" vote shortly after the referendum was called. Given the fact that many would call Johnson the second most influential leader in the U.K. after Cameron, his support for Brexit is significant and one of the reasons investors refocused on this issue in the recent weeks.

Economic Implications of Brexit for the U.K. and the EU

The economic implications of Brexit for the U.K. would be significant, hence the importance of this topic for financial markets. Our assessment, shared by 75 of the 100 economists polled by the *Financial Times* at the beginning of the year, is that a vote to leave the EU would be negative for growth prospects. There are a range of estimates as to the exact impact on gross domestic product (GDP), but we think a low single-digit drag is a decent assumption. The Bank of England has suggested that the effect could be as high as -9.5% of GDP. There are secondary consequences of an "out" vote that should also be considered. For example, Scotland is largely in favor of remaining a part of the EU, but a U.K. vote to leave would potentially trigger another Scottish referendum for its own independence, bringing additional complications and volatility. Also, Britain would need to renegotiate the approximately 60 free trade agreements it currently has with other countries by proxy of its EU membership. This means that trade with other countries may also be affected, thereby further denting growth.

Whether or not the U.K. officially leaves the EU, we believe that uncertainty itself can be a drag on growth. The extent to which the current uncertainty continues or builds is the question. It is important to note that a vote for Brexit would really only be the first step in a long process of the U.K. leaving the EU. Experts estimate that Brexit could take at least two years, and that an "out" vote would kick off a series of complicated negotiations as to what the exit would actually entail.

We also think it is possible that in the event of a vote to leave, EU leaders would try to negotiate further in the hope of reversing the referendum. At some point during this complicated process, the citizens of the U.K. and Europe may be able to reach a common ground and avoid a full exit. In this scenario, the point that uncertainty is its own constraint on growth is relevant, and prolonged uncertainty over the course of a couple of years would still dent GDP. The Bank of England conducted a study on the role that uncertainty has played in the U.K. economy and found evidence to support that heightened uncertainty does depress growth (Exhibit 1). Households engage in precautionary savings while firms postpone production and investment and are hesitant to enter new markets in uncertain times.

Exhibit 1: The Bank of England finds evidence that uncertainty weighs on economic growth

Granger Causality Tests for Relationships Between Uncertainty, Confidence, and GDP Growth (1985 to 2012)

		To		
		Uncertainty	Confidence	GDP Growth
From	Uncertainty	–	***	**
	Confidence	–	–	***
	GDP Growth	**	***	–

Within the table, *** and ** denote statistical significance at the 1% and 5% levels, respectively; – denotes no statistical significance at the 1%, 5%, and 10% levels.

Source: "Macroeconomic uncertainty: what is it, how can we measure it and why does it matter?" Bank of England Quarterly Bulletin 2013 Q2

The longer a period of uncertainty continues, the deeper the impact on economic output. The current governor of the Bank of England, Mark Carney, furthered this sentiment on March 8 when he told the Treasury Committee that the U.K. leaving the EU is the "biggest domestic risk to financial stability, because, in part, of the issues around uncertainty."

The implications for the rest of the EU would likely be more moderate than those for the U.K., but still noteworthy. The U.K. makes up only 9% of EU imports and 6% of EU exports[1] but accounts for a disproportionate amount of financial intermediation. The U.K.'s financial sector made up 24% of the EU's total gross value from financial services in 2014, and 80 of the 358 banks operating in the U.K. were headquartered elsewhere in Europe in 2013.[2]

Given the core of finance to a country's economy, we foresee many drags and complications from separating U.K. and European companies and banks from this perspective. There are likely additional costs to consider as well, as other EU members may be required to foot the portion of the EU bill that the U.K. would otherwise cover. After Germany, the U.K. is the largest contributor to the EU budget. While the U.K. leaving the EU is quite different than a core country leaving the European Monetary Union (EMU), it could help set a precedent and provide momentum for anti-EMU parties from core countries. Both Germany and France have elections in 2017, so this debate may intensify as it pertains to core Europe. Another consideration is that the U.K. was often the most "market-friendly" voice on issues ranging from bank regulation to corporate taxation. The slant of European decisions on such topics may be more negative for markets going forward to the extent that the U.K. is no longer taking part.

U.K. Equities and Currency Most Vulnerable to a Brexit

In our view, markets are likely to react to opinion poll developments ahead of the actual June 23 vote. As things stand, an average of key polls shows an

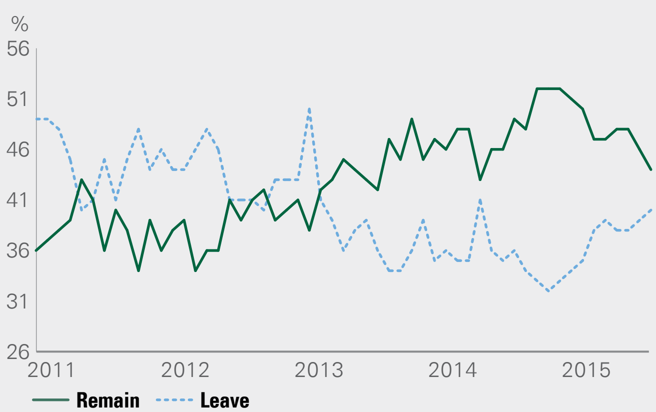
[1] As of December 31, 2013. Import and export values include that of all intra-EU27 member nations. Source: Eurostat

[2] Bank of England. "E.U. Membership and the Bank of England." October 2015.

increase of those voting for leaving to 40% versus 44% for remaining (Exhibit 2). We would note that poll accuracy can be poor and that polls currently show a high number of "undecided" voters (up to 25% in the YouGov poll from February 23), which implies things can change quickly. In last year's general election, polls suggested a tight contest, with the Conservative Party winning handily in the end. Meanwhile, in the Scottish referendum, early polls showed a dominant "in" vote but the gap closed in the month leading up to the vote as the "out" vote gathered steam. It will also be important to monitor the views and proclamations of the political parties and heavyweight politicians. As things stand, the U.K. government, Labour Party, Liberal Democrats, and Scottish National Party all are in favor of the "in," while the U.K. Independence Party is clearly "out." Additionally, any changes in the migrant situation with regard to more pressures on the borders or increased concern with regard to domestic terrorism would likely increase the sway of those voting for Brexit. To the extent that economic growth deteriorates, more populist sentiment may emerge and may also increase the focus on the costs of the EU's immigration policies.

Exhibit 2: Recent polls show a narrowing of votes for remaining in the U.K. versus leaving

Monthly Average of Opinion Polls on U.K. Membership in EU

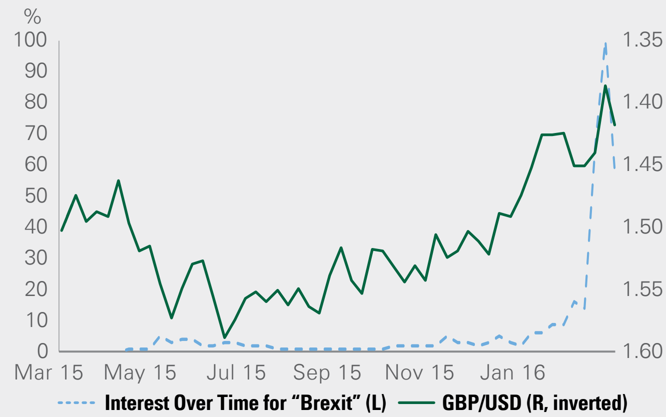


As of February 29, 2016.

Source: Credit Suisse, ICM, Ipsos, Survation, Yougov

Exhibit 3: An increase in fear of a Brexit has led to weakness in sterling versus the U.S. dollar

Google Search Interest for Term "Brexit" Versus GBP/USD



As of March 3, 2016. Google's interest over time index represents search interest relative to the highest point on the chart. For instance, if at most 10% of searches for the given region and time frame were for "Brexit," Google considers this 100. The number doesn't convey absolute search volume and ranges from 0 to 100.

Source: Bloomberg, Google

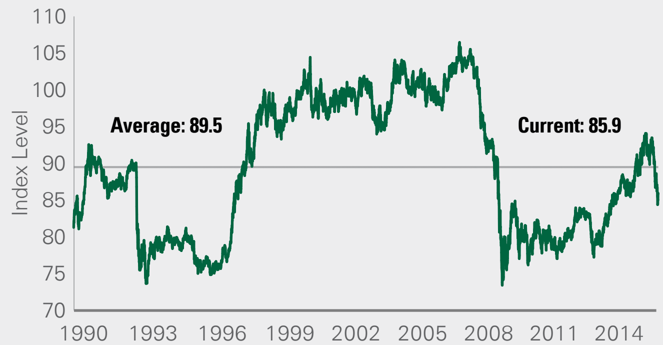
We expect the uncertainty related to the Brexit risk to remain a weight on U.K. equity markets until the referendum vote for the aforementioned reasons. That said, some sectors are more exposed than others to this negative outcome, and hence to increased probability of an "out" vote. We believe that a more vulnerable sector is financial services, especially investment banks who would rely on access to the single market for many of their product lines. Exporters are also a clear loser if the U.K. leaves the EU, given the ease of currently distributing product to this large market. (The one caveat would be that a decline in sterling likely to accompany a U.K. exit eventually could provide a boost for exporters.) Relative winners would be sectors that are domestically focused (utilities, for example), businesses currently constrained by EU regulation, or diversified large-cap companies with significant international operations, such as pharmaceuticals or resources.

As mentioned earlier, the risk of Brexit has clear currency implications. Since November of last year, GBP is already 9% lower on a trade-weighted basis (6% versus USD); we believe a good deal of this is related to Brexit fears (Exhibit 3).

Data show that speculative shorts in the currency have increased over this period, though they remain only half of the extreme levels reached in 2013. We believe there is further for the pound to fall as the referendum nears. Despite the large decline, GBP still is trading roughly in line with its long-term trade-weighted average and remains expensive versus some long-term "fair value" models (Exhibit 4). Part of this owes to the fact that the U.K. is highly dependent on foreign capital flows to support its balance of payments, with a current account deficit of 4.7% of GDP, the worst in the Group of Ten countries, or "G-10" (Exhibit 5). Overvaluation and vulnerability to outflows from foreign investors does not bode well for sterling heading into this uncertain period. We expect that an "out" vote could cause the currency to weaken by an additional 5% to 10%.

Exhibit 4: Sterling is roughly in line with its long-term average versus all trading partners, suggesting further downside risk

GBP Real Effective Exchange Rate



As of March 4, 2016.

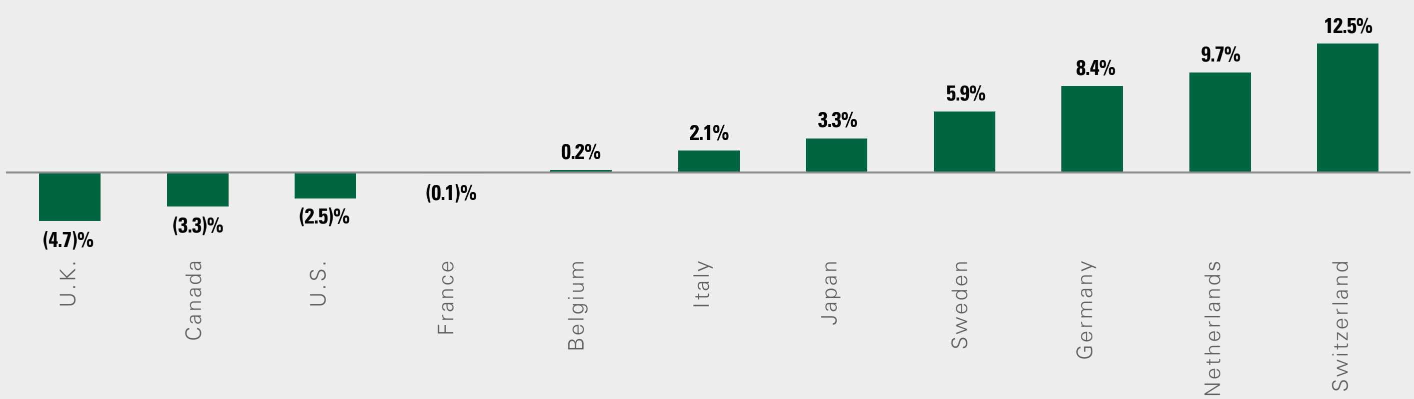
Source: Bank of England, Bloomberg

Bessemer Positioning Related to Brexit

Within a 70/30 Balanced Growth Portfolio at Bessemer, positioning is currently neutral to Europe and underweight the U.K.: versus benchmark U.K. equity exposure of 6.7%, Bessemer targets are 3.6% as of February 29, 2016. Within the U.K. holdings, there is a significant exposure to large-cap and international names that we think would be relatively less exposed to Brexit. Consider AstraZeneca, a top 25 holding in the Large Cap Core mandate. European revenue accounts for only 23% of global revenue, with end customers based in the U.K. accounting for roughly 3% of this. Given that the company's headquarters is in the U.K. and much of the research and development costs are based in sterling

Exhibit 5: The U.K. runs a large current account deficit, making the country more vulnerable to foreign capital flight

Current Account Balances of the G-10 Countries (Percent of GDP)



As of December 31, 2015, except for Belgium, Netherlands, Switzerland, U.K., and U.S., which are as of September 30, 2015.

Source: Bloomberg

(the country is actually loss-making for AstraZeneca), any depreciation in the pound would actually benefit the firm's bottom line. Another holding in Large Cap Core that is U.K. related (dual listed in the Netherlands and the U.K.) is Unilever. Europe overall makes up 25% of group sales and we would estimate that the U.K. is less than 6% of this. Once again, the U.K. bears a greater share of costs than this, which would be a benefit. There is the risk that in the event of Brexit, the market does not discern these positive characteristics of AstraZeneca and Unilever, causing these names to underperform initially with all U.K. stocks in a knee-jerk reaction to the negative news. This list is not exhaustive, but the stocks held in the mandate that are more acutely exposed to U.K. risk are smaller positions relative to the above-mentioned names.

More generally, we are monitoring developments and assessing what is being discounted in stock prices in evaluating opportunities in Europe. We are being cautious but are willing to act should opportunities arise. The investment team has hedged a portion of the currency exposure to European equities within the overall equity platform and could consider hedging our exposure to sterling if the risk of Brexit rises. As always, we keep a long-term perspective when investing and will keep clients apprised of portfolio changes.

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