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Brexit vote – A post mortem

1 Introduction

On Thursday 23 June the UK held a referendum on whether it should remain part of the European Union (EU). The referendum was commonly referred to as 'Brexit'. The outcome of the referendum saw 51.9% vote for the UK to leave the EU, while 48.1% voted to remain. The referendum had been the subject of intense analysis in press and investment commentary in the lead-up to the vote. The surprise outcome has generated an equally intense debate within Europe and sharpened the focus of policymakers and investors globally as all parties digest the near and longer term implications for Europe, the global economy and investment markets.

2 The Brexit vote

In order to appreciate the ramifications of this decision, it's important to understand what the EU is. The EU is a "single market" allowing goods and people to move around, basically as if the member states were one country. It is an economic and political partnership involving 28 European countries and, based on this combined economic output, the EU has grown to become an economic powerhouse that is comparable in economic scale with the US economy. The EU has its own currency, the euro, which is used by 19 of the member countries, its own parliament and it sets rules in a wide range of areas - including environmental, transport and consumer rights.

The case for the UK to leave the EU is based on a view that the UK would gain greater control of its destiny and no longer be bound by the rules and regulations of the EU. There is also a direct financial incentive for the UK to leave, as the amount the UK contributes directly to the EU budget per annum is well in excess of the direct payments they receive from the EU (i.e. they are subsidising other EU members). It is, however, very difficult to measure the many indirect benefits of EU membership for the UK economy. The most obvious has been the establishment of London as the financial services hub servicing the entire EU. The UK accounts for almost 25% of the EU's financial services and 40% of its financial service exports. In addition, financial services represent 8% of UK GDP.

Apart from economic considerations, one of the other key issues in the mind of UK voters has been immigration and the view that EU membership has played a role in exposing the UK to the mass movement of economic and political refugees in Europe.

3 So what does Brexit mean?

From a global perspective, the UK is the fifth largest economy and the second largest in the EU behind Germany. That being said, the UK is not a big driver of global economic growth and only represents 4% of global GDP so the direct economic effects of the UK's decision to leave the EU are likely to be contained primarily to the UK and Europe. The world's other large economies, including the US, China and Japan, have only minor trade linkages with the UK so the direct trade related economic impact of the expected slowing in the UK is expected to be relatively limited. Similarly, the EU has a small reliance on the UK as a driver of export demand. To put this into perspective, while nearly 50% of all British exports go to the EU, the UK only accounts for approximately 10% of EU exports.

The bigger concern for global markets and investor sentiment is the potential for the UK's decision to provide momentum to other separatist and anti-establishment movements in Europe, thereby further undermining the EU structure. If other countries perceive they can also leave the EU without disastrous consequences there is likely to be increased pressure for similar votes in other countries across the region, in particular France, Netherlands and Italy.

The biggest implication for the UK is that the outcome could well lead to the breakdown of the UK itself. While England and Wales voted to leave, Scotland and Northern Ireland voted to remain. In Scotland, the vote was 62% to 38% in favour of remain, and all districts recorded a majority for remain. Nicola Sturgeon, the First Minister and leader of the Scottish National Party, has said that it would be “democratically unacceptable” for Scotland to be “taken out of the EU against its will” and, that as a result, the Scottish Government would begin preparing legislation to enable another independence vote. The status of Northern Ireland is also being questioned.

4 What happens now?

Under Article 50 of the EU Treaty (the Lisbon Treaty), the UK must formally notify the European Council of its decision to leave. Once the notification has been provided, talks will then begin on a range of issues between the UK and the other EU members. Importantly, Article 50 gives no vote to the seceding country when it comes to the final terms of the departure. They are fixed by the majority in the European Council. If no deal is reached and there is no agreement to extend the negotiations, membership will automatically cease two years after notification. Over the intervening time the UK would continue to abide by EU treaties and laws.

There are two models being discussed for the UK's future economic relationship with the EU.

- The first is the ‘Norway solution’. Norway, like the UK will become, is not a member of the EU. It is a member of the European Economic Area (EEA) which grants Norway access to the EU's internal market through the European Free Trade Agreement (EFTA). While the EEA can adopt EU laws, all new legislation which has “significant new obligations” must be approved by the Norwegian Parliament. This arrangement facilitates free movement of goods, capital, services and people between the EU and EFTA members, including Norway. Free movement of people means that Norway is a part of the Schengen Area, which provides for free movement of EU citizens within the EU. In this regard, Norway is treated the same as EU members in that there is free movement of workers between the EU and Norway. This latter point is likely to be very contentious for the UK, given the UK has never been a member of the Schengen Area and that a major factor in the success of the Leave campaign was high levels of immigration and the argument that the UK had ‘lost control’ of its immigration policy through its membership of the EU.

- The second is a model based on the recent expansive EU free trade agreement with Canada, which in addition to traditional market access issues, includes areas such as trade and investment facilitation, competition, mutual recognition of professional qualifications, financial services, e-commerce, sharing science and technology and which also facilitates a regulatory co-operation framework.

Unscrambling more than 40 years of EU laws and regulations that have become enmeshed into the UK political and economic system will be incredibly difficult. This challenge is compounded by a shortage of requisite bureaucratic skills in British government as the UK have not had to negotiate a trade agreement since 1973 when it joined the EU.

5 The market reaction

In the days leading up to the referendum, polling suggested that the ‘remain’ campaign was in the lead. However, when the results of the vote started coming in and it became clear that there was a strong turnout for the ‘exit’ vote, the initial market reaction was firmly negative.

In the fortnight subsequent to the vote a more rational market response has emerged. This has primarily been driven by investors believing that central banks will provide additional support to ensure global economic growth is not materially impacted by the vote. In this context, non-European markets (Australia, US) have bounced back to pre-Brexit levels, while the UK market has moved higher on the back of the significantly lower exchange rate assisting company earnings. European markets remain notably lower but have pared back original losses. Global bond yields remain close to their lows on the expectation of continued central bank support.

Conclusion

In summary, investors were not anticipating a 'leave' victory and markets have reacted accordingly. It is not possible to predict market movements in coming weeks or months. As always, investor sentiment may yet move markets quite independently from (and further than justified by) the underlying fundamental story. At this stage we believe that the direct economic impact of the UK's decision to exit the EU will be felt mostly in the UK and to a lesser extent in Europe. While the decision is expected to deliver a small drag on global growth over the next year or two, the direct effect is not expected to be material outside the UK.

The indirect effects of this decision on politics and on investor risk appetites are more difficult to quantify and will become more visible in the months and years ahead. We must acknowledge again the backdrop of heightened political uncertainty in Europe as anti-establishment parties continue to gain popular support in a number of European countries. This decision only raises the likelihood that there will be more policy surprises in Europe and further challenges to European economic unity.

For some time JANA has highlighted a number of ongoing political, economic and policy related uncertainties associated with the post GFC recovery and our expectations for ongoing volatility in markets. We have highlighted the option value of cash and recommended a sufficient allocation to cash or other liquid assets to ensure currency hedging and other operational requirements can be met while still allowing flexibility to take advantage of market volatility at times like the present.

As we write today, markets and prospective investment fundamentals have not moved sufficiently to warrant any change in our overall recommended positioning.

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