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Should I Stay or Should I Go? Making Sense of Brexit

“Darlin’, you got to let me know/ Should I stay or should I go?” – The Clash, a celebrated British punk band

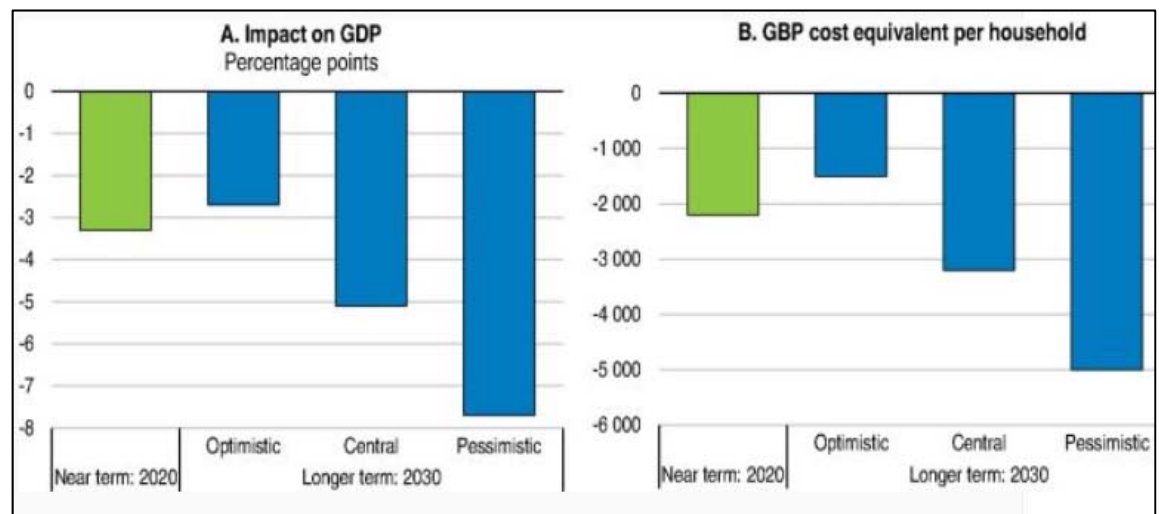
Britons are awaiting June 23rd with baited breath – and it’s not because that date marks the birthday of King Edward VIII (who ruled England for less than a year back in the 1930s). Rather, June 23rd is the day of the UK’s historic referendum vote on whether to exit the European Union (EU) – “Brexit”, in market parlance. This vote carries major implications for both the UK and the rest of the world, so market focus will only intensify in the last two weeks. **In this piece, we will discuss why Brexit might occur, its likelihood, its potential implications for the UK economy and risk markets, and Riverfront portfolio strategy if it comes to pass.**

WHY DO SOME UK CITIZENS WANT TO EXIT THE EUROPEAN UNION?

The complaints of the “Leave” camp (as personified by London’s colorful former mayor Boris Johnson) are generally cultural and geopolitical. They argue the UK overpays for membership in an overregulated trade bloc, that UK interests are often steamrolled by the EU, and that the UK would have better control of their own borders and safety on their own. This acrimony comes as no surprise; the UK’s relationship with the rest of Europe has been a complicated one for centuries. In fact, since Britain’s referendum for inclusion into the European Commission in 1975, Britain’s role has remained contentious.

On the other hand, the “Remain” camp, which includes the Prime Minister, Chancellor, most UK employers, the Bank of England, and a host of non-partisan economic think-tanks, argue that Brexit is calamitous for the UK economy. The OECD argues that the UK’s potential GDP would be reduced by 3 percentage points by 2020 should Britain leave – suggesting the cost of Brexit is equivalent to approximately £2200GBP per UK household. Longer term, this deteriorates to a 5% reduction by 2030 in their base case scenario (see chart below).

CHART 1: OECD ESTIMATES OF NEGATIVE GDP DRAG FROM BREXIT

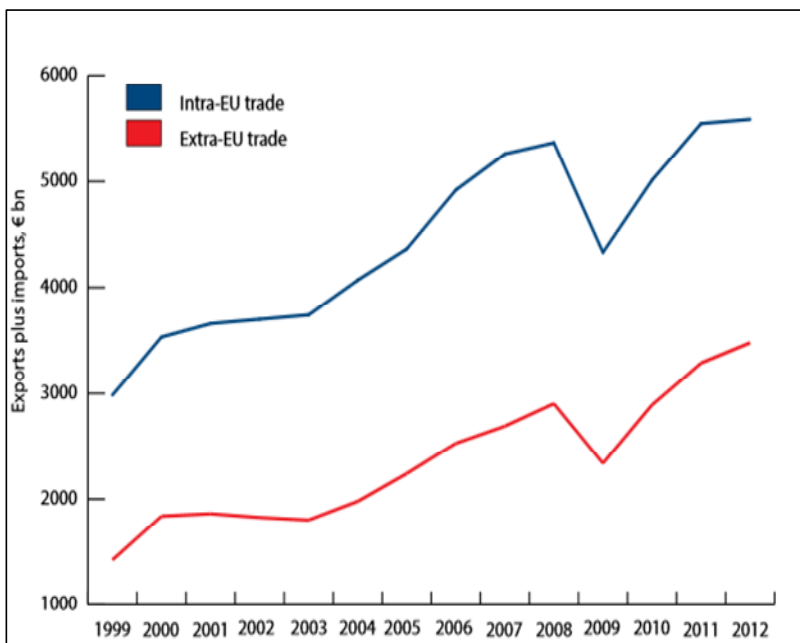


Source: OECD. Study published April 2016. For a full copy of their report, please visit <https://www.oecd.org/eco/The-Economic-consequences-of-Brexit-27-april-2016.pdf>. See page 4 for additional disclosure information.

The OECD's forecasts above are based in the potential for decreased trade, the possibility of capital outflows, the cost of higher corporate bond spreads due to uncertainty, and the risks that all the above could damage business and consumer spending as well as foreign direct investment. In addition, the OECD suggests that the positive benefits the UK has experienced historically from immigration would also be reduced going forward. This is important, as by their estimates, immigration accounts for one-half of UK GDP growth since 2005.

Regarding RiverFront's opinion, we are ideologically in the "Remain" camp, as well. Our view is based primarily on the fact that Britain is greatly dependent on the rest of the EU for trade. **According to the Centre for European Reform, as of 2012 the EU represented approximately half of the UK's total trade (see Chart 2 below), a huge number in our opinion. Put another way, we think the UK needs the EU more than the other way around, and thus anything that disrupts trade into the EU will diminish UK productivity and growth.** Under Brexit, the UK will be forced to renegotiate trade pacts on contentious terms with the EU over the two year post-Brexit grace period. Also likely in this scenario are Conservative party rifts (and maybe even a new election). Both of these reactions would create uncertainty, which equity markets do not like.

CHART 2: UK TRADE HIGHLY DEPENDENT ON THE REST OF THE EUROPEAN UNION



Source: Center for European Reform. Eurostat. Chart published January 2014.

CHART 3: PREDICTION BETTING MARKETS STILL IN "REMAIN" CAMP, BUT BY LESS THAN BEFORE



Source: Hypermind Prediction Markets. Data as of 6/13/16. For information on Hypermind's prediction process, see www.hypermind.com.

HOW LIKELY IS BREXIT?

Public opinion polls suggest a vote coming right down to the wire. The *Financial Times*' poll of polls on Brexit suggests 45% for Remain, 43% for Leave, and a large 12% still undecided (*ft.com*, 6/10/16). But, if markets learned anything from the Scottish referendum vote on UK membership last year, it's that it is dangerous to place too much trust in popular opinion polls. In that case, although public polling suggested a close vote, in the end an overwhelming majority of Scots voted to stay. The history of referendums suggests that people may talk with their heart but tend to vote with their head in the anonymity of the voting booth.

At this point, professional bookmakers and crowd-sourced prediction betting markets place the odds of Brexit lower than polls – roughly 60% probability of "Remain" vs. 40% "Leave" at the time of this writing, depending on the source.

Our own internal probability of Brexit aligns more closely with the bookmakers' views, but we acknowledge that it's impossible to rule out Brexit given the potential for public debate or something exogenous – scandal, geopolitical event – that could meaningfully change public opinion between now and June 23rd. Interestingly, UK credit default spreads (the cost of protection against a credit event in UK sovereign bonds), while elevated relative to last summer, have been contracting since April, suggesting the market's view of Brexit spillover risk to sovereign credit has actually been decreasing. Similarly, credit default swaps (CDS) in large Eurozone countries thought to be political "flight risks", such as Spain, have also stayed range-bound recently, and at much lower levels than during the 2011-12 Eurozone split scare.

HOW MIGHT MARKETS RESPOND IN THE EVENT OF BREXIT?

Likely Market Effect: Negative everywhere, but acutely felt in the UK. In the event of Brexit, we believe there would be a near-term increase to the risk premia across all European markets, and probably risk assets in general. We believe markets would likely start to further extrapolate not only lower economic growth in the UK and in the Eurozone, but also more political uncertainty for other nations with fringe political issues surrounding continued membership in both the EU and the Eurozone.

We believe near-term dislocation would be particularly acute within the UK, where political uncertainty around Prime Minister David Cameron's future would add to economic concerns. For consumer-facing companies, post-Brexit uncertainty will likely lead to a negative effect on both UK consumer spending habits and business confidence. Indeed, there is some evidence that uncertainty over Brexit has already started to have an effect, with a recent slowdown in the CBI UK Industrial Trends and Consumer Services Surveys (source: Ned Davis Research).

Of the sectors, we believe UK financials would stand to lose the most. The City of London's economy is dominated by financial services, some of which may have to move outside of the UK post-Brexit (e.g., currency trading, international settlement). *The Economist* quotes CityUK data that suggests London has around 70% of the entire market for euro-denominated interest-rate derivatives and 90% of European prime brokerage (*The Economist*, May 28, 2016). Under Brexit, banks may be forced to move staff and comply with two separate sets of rules or lose business to Irish, German or French banks. One specific example is the statement in February from a large UK-based bank, HSBC, in which they suggested Brexit could cause them to shift 1,000 workers from London to Paris. These legal and operational issues add to an already unappetizing earnings profile for UK banks, in our opinion.

Likely Currency Effect: GBP down a lot, EUR by less: We believe that Brexit will be negative for the pound sterling (GBP) relative to the USD. In our view, the market would likely be forced to bake in greater uncertainty in the near-term, as well as a negative shock in terms of trade. It's also possible that the euro would suffer in sympathy with the British pound, though probably not to the same extent as the pound. Additionally, we think currency markets would start to again question the sanctity of the Eurozone as a construct, which would also negatively impact the euro.

How much could the GBP drop? Goldman Sachs and other currency analysts have suggested a meaningful immediate drop, predicting that GBP/USD could reach 1.15-1.30 under Brexit (10-20% downside from current levels) over an intermediate timeframe, similar to the GBP's performance during the credit crisis. This range is based on the principle that it represents the equilibrium rate needed to balance the current trade account, which strikes us as perhaps an overly pessimistic forecast given that the UK consistently runs trade deficits.

Some Important Counterpoints: Weakness in the British pound may eventually hold a silver lining for UK exporters. While exporters would be damaged initially by the lack of certainty around future European trade deals, it's possible that a major drop in the sterling may eventually sow the seeds of their own recovery; this is because a cheap currency would make UK exporters more competitive. This is in part what happened during the "black Wednesday" episode in 1992, when the Bank of England was forced by currency speculators to exit the European ERM (exchange rate mechanism), driving the pound down. While the incident was embarrassing and costly to the UK initially, it may have also helped usher in a long period of economic growth and strong stock market returns, though the economic dynamic then was admittedly different from today.

We would also note that in the event of Brexit, we expect a central bank response not only in the UK and the Eurozone, but also perhaps from the Federal Reserve, where tightening of financial conditions in the aftermath of Brexit may make the Fed less likely to raise interest rates. It's also worth noting that even if Brits vote in favor a Brexit, it would not happen immediately. Post-vote, there would be a 2-year negotiation period for exit terms, during which terms of trade would not likely change dramatically.

Broadly speaking, in the midst of hysteria we do think a deep breath is warranted – while Brexit would be disruptive, we do not think it necessarily spells the end of the Eurozone, as many have posited. Markets often overreact in the short-term to uncertainty, assuming the worst case scenario, but investors who have the ability to remain calm and focus on time horizons longer than a few weeks or months can often benefit from such emotional volatility.

HOW IS RIVERFRONT POSITIONING THE PORTFOLIOS FOR THE POTENTIAL OF BREXIT?

- 1. Underweight to UK stocks relative to our strategic and baseline benchmarks.** Despite an overall constructive view on European stocks at current levels, we have chosen to make the UK one of our largest country underweights. It is important to note that our underweight to UK stocks is not just because of Brexit risk; we also view the UK index's sector composition and earnings trajectory as unattractive.

- 2. Tilt away from UK and European financials.** European indices tend to be banking-heavy, and our belief is that these banks represent poor risk-reward potential at current levels. We believe that a combination of future capital raises, low/negative interest rates, and dislocation in the advent of Brexit make British and European banks unappealing.
- 3. Hedging European currency exposure.** Due to our underweight positioning in UK stocks, we therefore also have an underweight exposure to the pound. However, we also believe that in the aftermath of Brexit, the euro is likely to come under pressure for reasons presented above. We are currently hedging over 70% of our exposure to the euro in our portfolios, in part to help compensate for this risk.
- 4. Risk plan in place in the event of Brexit.** The uncertainty and binary risk associated with something like a referendum vote is one of the most difficult and complex risks for a portfolio manager to plan for, and we believe one has to be humble and prepared to act decisively if things turn out differently than expected, either with the outcome of the vote itself or the market reaction to it. Those familiar with Riverfront's portfolio management philosophy know that we have a disciplined risk management process in place for events like Brexit, and that we have predetermined risk trades set to execute in the event that particular triggers are hit.

Important Disclosure Information

Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.

High-yield securities (including junk bonds) are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities. In a rising interest rate environment, the value of fixed-income securities generally declines.

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

Using a currency hedge or a currency hedged product does not insulate the portfolio against losses.

Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

ETFs are subject to substantially the same risks as those associated with the direct ownership of the securities comprising the index on which the ETF is based. Additionally, the value of the investment will fluctuate in response to the performance of the underlying index. ETFs typically incur fees that are separate from those fees charged by RiverFront. Therefore, investments in ETFs will result in the layering of expenses.

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