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Vontobel Viewpoints

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Brexit Risk

A national referendum set for 23 June 2016 will ask United Kingdom (UK) voters a single question: "Should the United Kingdom remain a member of the European Union or leave the European Union?"

This is an important vote. If a British exit, or "Brexit," occurs, the UK would be the first country to leave the European Union (EU), and it will affect how the UK develops over the coming decades. We believe the vote is about more than just economics. In this paper, we focus on the risks posed by the referendum to the growth prospects of the companies in which we invest.

We believe the referendum could have a noticeable impact on the long term growth of a number of UK focused industries if a "Leave" vote is followed up with a trade agreement that raises barriers to trade and constricts the free movement of labor between the UK and the EU. Our UK holdings are predominately multinational corporations with broad geographic diversification. As a result, we do not anticipate an important impact on our holdings from a Leave vote. However, we also hold a selection of UK focused businesses and we are looking at each company carefully to build a solid assessment of the risks to our current view.

The impact from the referendum could be influenced by a number of factors. The high level variables, as we see them, are:

1. The referendum: binary outcome, Remain in the EU or Leave
2. If Leave wins: what trade terms with the EU replace the current structure
3. If Leave wins: how long will it take to exit – we believe it could take three to five years
4. If Leave wins: what deals could the UK make to boost its non-EU trade

1. The Referendum – a Remain vote leads to no change in our previous views as, in effect, very little will change. A Leave vote leads to a range of outcomes, none of which appear dramatic from a gross domestic product (GDP) forecast standpoint, but could cause a noticeable impact at a company level.

2. A Leave vote follow-on negotiation throws a variety of possibilities open. First, it is not clear how the UK government would react as the Prime Minister and Chancellor of the Exchequer (finance minister) are both lobbying hard to remain and not discussing what they would do on a Leave vote. Soon after the vote, it would become quickly evident what stance the negotiations will take – friendly or hostile.

   A friendly negotiation, in our view, would result in the optimal economic outcome for both the UK and the EU. However, even with a friendly outcome, there will likely be a divergence from what the UK economy would have done if it had remained in the EU – primarily from a cut to immigration levels, leading to fewer new skills arriving into the country, and associated consumer demand for housing, etc.

   A hostile negotiation could be driven by an EU stance to deter others from considering leaving and/or an attempt to pull business and investment away from the UK on competitive grounds. There is a lot at stake: the UK attracted 23% of the EU's €4,242bn total non-EU foreign direct investment (FDI) over the past 10 years. The broad risks we see stemming from a poor follow-on trade deal with the EU include:

   - new tariffs on UK exports;
   - UK-based banking operations having to shift to an EU country; and
   - visa requirements or other reduction in flow of labor/consumers into the UK

   We believe all of the above would lead to lower job creation and less housing demand than under a Remain scenario.

3. How long would it take to leave the EU? Article 50 of the Lisbon Treaty sets an exit time frame of two years to negotiate an exit and follow-on framework for a future relationship. This can be extended if both sides agree. In our opinion, two years seems like a tight schedule given the sheer quantity of items to agree on between the UK and the 27 members of the EU.

Lord O'Donnell, the former cabinet secretary and head of the Home Civil Service guessed it could take up to 10 years, given it took Greenland, with a tiny population, three years to exit the European Economic Community (EEC – EU predecessor) when the only big issue they had to work through was fish. For us, three to five years seems like a sensible assumption.

4. What agreements could the UK make to boost its non-EU trade? In our opinion, potential economic benefits from a Leave vote include the ability to negotiate new free trade agreements without 27 other EU nations having to sign off and without pulling along strong exporters, such as Germany, that might make a future partner more cautious. For example, the UK could negotiate its own free trade deal with the U.S.

   Other potential benefits include what would be avoided by exiting the EU. The 'Vote Leave' campaign has stressed its concern that each new EU Treaty has taken more power from the nations and might move to add taxation powers. We see this as a daunting prospect given the socialist leanings of some EU members, not to mention years of underinvestment into defense in many EU countries.

   These benefits are hard to anticipate, let alone forecast at a company level. As a result, we have not anticipated any benefits will be seen by our companies on the back of future EU bullets dodged or new non-EU trade deals.

The EU and the UK: A Long and Complex Relationship

The EU is a 28 country trading block, with a combined GDP greater than the U.S. and a population over 500 million. It is supervised by a set of bodies including the European Commission, Parliament, Court of Justice and Central Bank.

The EU is loosely grouped compared to a federal republic such as the U.S. All member countries operate domestic political and legal systems as well as central banks; however, EU law rules supreme and the EU Court of Justice is the de facto interpreter of European Economic Area (EEA) law.

The UK did not join at its outset which was the European Coal and Steel Community (Treaty of Paris) in 1951 that supported the rebuild post World War II. The British were vetoed twice by the French before finally able to join in 1973. This referendum is the UK's second on EU membership, the last was in 1975 when 67% voted to stay.

One of the central debates since its founding is whether the EU should continue to integrate to the point of becoming a single state, which would require each nation to cede national independence. As the former Mayor of London, Boris Johnson, has pointed out the enormity of this proposal can be hard to grasp for people who have grown up in nations, such as the U.S., as it is highly unlikely that a country such as the U.S. would ever allow a united group of nations to dictate or challenge its independence in making decisions across important policy areas, such as: agriculture, budget, energy, environmental protection, maritime affairs, trade and foreign affairs.

The UK and EU are large trading partners. In 2015, exports to the EU accounted for 44% of the UK's total, according to the UK's Office of National Statistics (ONS) and the UK accounted for approximately 10% of EU exports (Eurostat). In 2015, the UK ran a large current account deficit with the EU of around £108bn equal to 6% of domestic GDP, according to data from the ONS. As a result, the UK is an important EU client, which should support future negotiations should the UK vote to Leave.

The UK has been an EU member for 43 years and morphed its regulatory structures and laws towards EU directives. The British public has never understood the EU workings well, partly because EU Directives are carried out through British institutions. A couple of popular complaints surround welfare immigrants taking advantage of a more generous welfare system than their home EU market, and what seems like frequent attacks on the free working of UK banking – a core pillar of the British economy and source of pride some of the time.

The coincidence of the Referendum vote, that was originally offered as an election pledge by the Conservative government ahead of the 2015 election, alongside the recent immigration crisis and Germany's open door policy, in our opinion, has awoken British fears of cultural shift beyond comfort and the real prospect they will vote to leave as long as the outcome is not an economic collapse.

The UK is a net contributor to the EU budget. Between 2010-2015 the average annual net payment to the EU averaged around £9bn equal to just 1.3% of the UK government's £709bn average annual spend (total managed expenditure) according to figures from the Office for Budget Responsibility and HM Treasury. On exit, this payment would probably go substantially lower or to zero depending on the follow on deal.

Follow-on Trade Agreements

There is no way of knowing what follow-on trade agreement the government would push for, let alone negotiate, if the UK voted to exit. There are a number of potential outcomes. In broad strokes, we see four main avenues:

1. Join the European Economic Area (EEA) – the Norwegian model. This is the model used by Norway, Iceland and Liechtenstein, and the one that would lead to the least change while exiting the EU. This model maintains open access to the EU markets. The UK would not be at risk of new trade barriers with the EU, and trade agreements with third parties would likely need to be renegotiated. However, the downside is the UK would be required to follow most of the EU rules – which would probably go against the public's wishes. We see this outcome as unlikely.

2. A set of bilateral deals – the Swiss model is a slow option. This requires setting up a collection of individual agreements. In the case of Switzerland, this has been done largely on a sectorial basis. A further issue is the Swiss had to agree to the free movement of persons principle in order to achieve access to the single market. The UK should have a stronger negotiating position given, for example, its large current account deficit with the EU.

3. Free trade agreement. The EU and UK are large trading partners and this seems the logical best fit for both sides from an economic view. However, this is complicated by politics and making the point that anyone wanting open access to the EU markets must follow EU law could stop this outcome. There is a broad range of potential outcomes for a trade agreement. The worse outcome is if the EU plays hard ball and takes a lower economic benefit from the relationship. Trade would continue between the two areas, but probably at lower levels as a result of trade barriers.

4. No trade agreement. The UK would trade with the EU under the World Trade Organization most favored nation (WTO MFN) treatment. This is the base case worst outcome as there is no benefit of EU market access beyond that enjoyed by any other WTO MFN country, even though location and 43 years of working together will mean the two areas are likely to remain important trading partners. The advantage of this scenario is the UK would not be bound by EU law.

Economic Headwinds on Exit

A number of comparative studies forecast UK GDP growth will be slower over five years with a Leave vote. But, the difference in Leave vs Remain forecasts are not dramatic, with the slower growth ranging typically between -0.5% to -1% of GDP for a number of years.

We see the impact occurring in two phases:

1. Near term. The uncertain period until the structure of the follow-on trade deal becomes apparent is likely to be much shorter than the time for negotiations to conclude. Near term uncertainty and directional market bets will likely lead to "risk-on" movements. We anticipate foreign exchange (FX) will have the primary macroeconomic impact on USD investment returns. Over the half year to 31 March 2016, the GBP fell 6% against the US dollar and 7% against the euro (Bloomberg) as poll numbers for the Leave vote have risen. We typically do not act on short-term currency volatility. Over the longer term, we believe FX is an effective valve that offsets different inflation rates and the core returns driver is earnings growth in real terms.

   If the currency remained weak for an extended period as a result of a structural change in the demand for GBP from falling exports or FDI, this would pose a reset on valuation. Against this, there would be an offset for the British multinational corporations (MNCs) as their central UK costs are diluted relative to their foreign denominated earnings.

2. Long term. The structural risks to growth resulting from a follow-on trade deal that might impact our holdings include:

   Trade barriers: tariffs would make UK exports to the EU less competitive and likely result in production being moved to EU sites.

   Banking shift to EU: depending on the agreement, banks with large EU footprints may need to relocate teams to an EU market, which may be potentially damaging to the London banking job market.

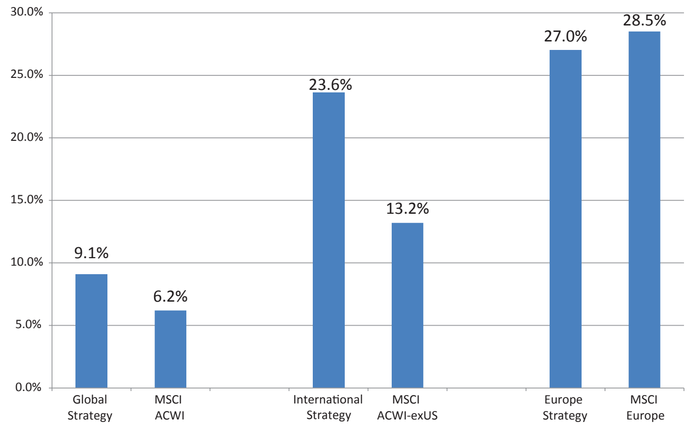
   Work Restrictions (visas/quotas): if the UK did not remain in the EEA, there is a chance employees wanting to cross the UK/EU border to work might require a visa. This could slow the flow of skilled labor into the UK.

   The common denominator appears to be job losses and reduced inflow of labor. Both would likely slow economic growth, negatively impact the demand for property (particularly in London and the South East), as well as create challenges for industries with heavy staffing needs such as hotels, retail and construction.

Impact of a Brexit on UK holdings

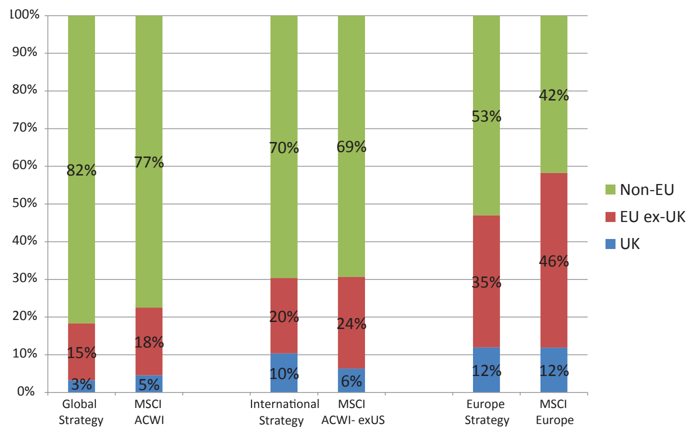
There are two areas of exposure – direct holdings of UK-based companies, and the total UK business exposure across the portfolios including that from non-UK companies. Our Global and International strategies are both overweight the UK by country

UK Portfolio Weight - Strategies vs Benchmarks[1] (March 2016)



Source
FactSet

Revenue Exposure Vontobel Strategies vs Benchmarks (March 2016)



Source
GeoRev FactSet

weighting, but underweight by underlying revenue as a result of our exposure to UK listed large cap MNCs, such as SAB Miller Plc and Diageo Plc.

In general, UK large caps are dominated by MNCs, while the smaller caps are more UK exposed. Approximately one quarter (26%) of FTSE 100 revenues derive from the UK, which is half the 49% for the FTSE 250, according to figures calculated by UBS.

Direct holdings: Our Global and International strategies are overweight vs their benchmarks, while the European strategy is just below. However, our holdings look quite different than the benchmark. For example, we only hold two UK names in our Global portfolio, and both are multinational corporations. Our International strategy holds eight UK names, with 19% of the 24% UK weight from MNCs. Across our portfolios, holdings in UK focused businesses (UK > 25% revenue) include: Lloyds Banking Group Plc, home builder Persimmon Plc and pizza delivery chain Domino's Pizza Group Plc.[2]

Our UK focused holdings are well capitalized and dominant players in their markets and include the following:

Lloyds Banking Group Plc is, in our view, probably the most solid domestic retail bank in Europe. The company has 25% of the UK savings market, 20% of UK mortgages and is capitalized with a strong Tier 1 capital ratio of 13% at year end 2015. We anticipate a domestic focused retail bank such as Lloyds would be less impacted from EU barriers than a regional or investment bank. The main risks we see from a Brexit would be to consumer confidence and a falling demand for mortgages and credit in general, as well as a continuation of low interest rates.

Persimmon Plc is a leading UK homebuilder with a nationwide presence outside of London. The company focuses on lower priced units and was the only major UK homebuilder that did not raise equity during the slowdown. The UK demand is currently above new

[1] *UK portfolio weight of comparable Virtus Funds subadvised by Vontobel, as of March 31, 2016: Virtus Global Opportunities Fund: 9.2%, Virtus Foreign Opportunities Fund: 24.2%, and Virtus Greater European Opportunities Fund: 29.0%.*
[2] *Respective portfolio weights of Domino's Pizza Group, Lloyd's Banking Group, and Persimmon in Virtus Funds subadvised by Vontobel, as of March 31, 2016: Virtus Foreign Opportunities Fund: 1.5%, 1.8%, 1.9%; Virtus Global Opportunities Fund: 0%, 0%, 0%; Virtus Greater European Opportunities Fund: 1.3%, 2.2%, 2.0%.*

build rates, supported by government incentive programs for first time buyers. We believe the focus on lower price points and operations outside of London should help limit the risk of London banking jobs shifting overseas or from slower immigration flows. However, homebuilders are sensitive to consumer confidence and if this was negatively affected for an extended period of time, we would expect Persimmon to see lower growth rates. **Domino's Pizza Group Plc** is not high-end dining. It is affordable convenience. While there is some cyclicality in eating out during a slowdown rather than a recession, we believe the company can successfully continue with its growth driven by: new stores (55 stores opened in 2015) and digital sales (supporting two years of double digit LFL sales growth). One of the main risks we see for the company is on the cost side if a fall in immigration leads to higher salary demands.

In summary, we believe there is fundamental risk of a slower growth environment facing a number of industries if the UK voted for an exit. This is based on our conservative assumption that the follow-on trade agreement will be less attractive economically than that of a full EU member. Our UK holdings are, for the most part, businesses based in the UK but, as MNCs, tend to be well insulated from a potential Brexit due to their global diversification.

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