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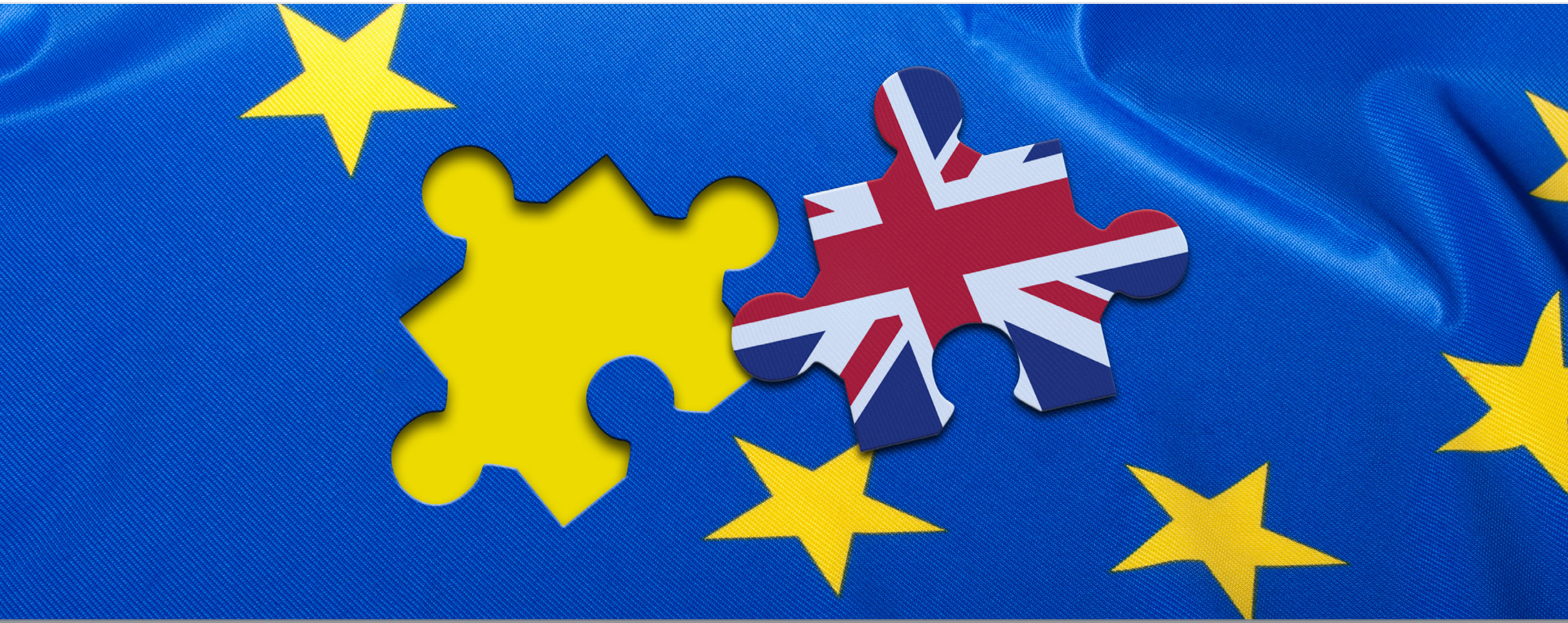

Brexit or Bremain: Impact on the U.K. and Beyond

A special report by RBC Wealth Management

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RBC Wealth Management

Brexit or Bremain: Impact on the U.K. and Beyond

Brexit or Bremain? That's the question confronting the U.K. But this is far from a parochial debate on the ramifications for the U.K.'s economy and markets. The political and economic implications of a potential divorce would ricochet across the Continent and beyond.

On June 23, Britons will go to the polls to vote on whether or not to remain a member of the EU, a membership which gives the U.K. unfettered access to the world's largest common market. Currently, the "Remain" and "Leave" camps are running neck and neck. A vote to leave is not our base case, but with odds of some 35%, it is a significant risk. The repercussions would be felt not only in the U.K. and in the EU, but also possibly globally. For now, we expect volatility to increase for U.K. and European assets ahead of the referendum.

In this report, we explore the likely reactions of financial markets under the Leave or Remain scenarios for various asset classes.

What would the U.K. wake up to on June 24 if the country votes for Brexit?

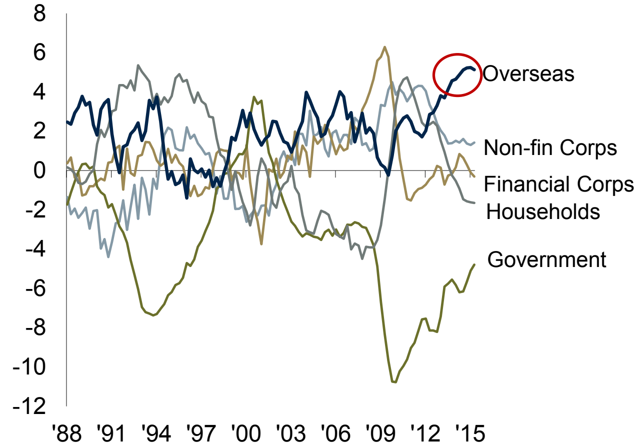
In the short to medium term, we would expect a Brexit vote to lead to weaker economic activity. In fact, RBC Capital Markets forecasts the U.K. economy would contract by 2%–4% over a two- to three-year horizon for two reasons.

First, capital investment would likely be affected. Indeed, delays are already occurring as the referendum approaches. This is key as the U.K. has been a large recipient of foreign direct investment (FDI), as it is seen as a market with flexible labour laws with full access to the European single market. Without this access, we would expect FDI to be deterred, though incentives, such as tax breaks, could soften the blow.

Lower FDI would be a concern to the U.K. economy, which depends on it to fund its yawning current account deficit that is the largest in the developed world at 5.2% of GDP (see chart). With lower FDI, we would expect the GBP to have to weaken in order to redress balance, raising the prospect for episodes of intense currency volatility. Volatility and GBP weakness would likely dent consumer confidence as well. We would expect the Bank of England's (BoE) monetary policy to remain loose even though inflation may increase due to a weaker pound.

Overseas Inflows Are Key to Finance External Balance

U.K. Sector Financial Balances, % GDP



Source - RBC Capital Markets

Second, U.K. exports, roughly half of which are currently sent to the EU, would likely fall as they would no longer benefit from reduced trade barriers. A weaker currency may offer some respite, but probably not enough to compensate for rising trade barriers in the U.K.'s largest export market.

What would be Brexit's long-term impact on the U.K. economy?

In the long term, the economic impact of Brexit would depend on the kind of new relationship a departing U.K. would form with the EU.

Maintaining access to the EU's single market would be vital, yet it may be largely out of the post-Brexit U.K.'s hands. The EU is unlikely to offer better terms to the U.K. for fear of encouraging other potential leavers. Negotiations would be lengthy and complicated, and could drag on for a number of years. The lack of clarity would continue to crimp economic growth before the new political order is established.

This could be exacerbated by the potential political fallout from Brexit. Scotland, traditionally more Europhile than the rest of Britain, could seize the opportunity to call another referendum on independence, subjecting the national economy to similar jitters and disruption as it did in 2015.

What would be the implications of the referendum on the U.K.'s currency and fixed income markets?

The uncertainty has already been weighing on GBP, which has devalued as much as 9% against the USD since the prospect of a referendum became clearer last December. In the aftermath of a vote to leave, we would expect further weakness against the USD given economic uncertainty and a loosening bias of the BoE. Conversely, we would expect the GBP to bounce back should the probability of Brexit decline.

For fixed income, we would expect risk aversion to increase Gilt yields and credit spreads to widen if the probability of Brexit increases. In a Brexit scenario, credit downgrades should not be ruled out. Should the nation vote to remain in the EU, however, we would envisage a relief rally in both Government and Corporate bond markets.

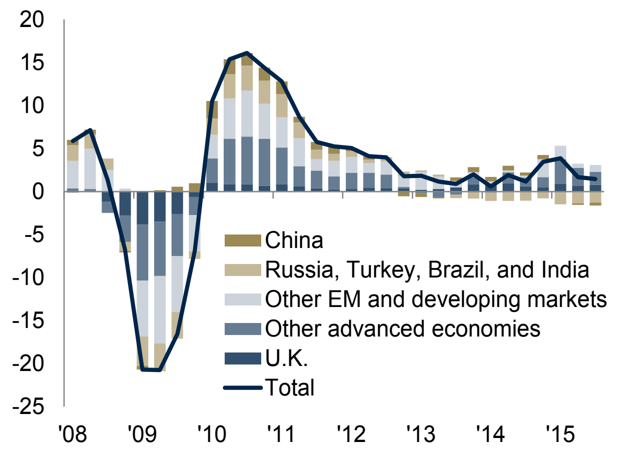
How about for equities?

As for equities, we would expect valuations to fall under a Leave scenario. A weaker pound would benefit non-commodity exporters and overseas earners, such as Health Care companies. Large-cap stocks, which tend to have a large international footprint, would likely fare better than mid- and small-cap stocks, which tend to be more domestically focused.

Facing an economic slowdown, domestic cyclicals would likely struggle. Banks could be pressured by higher

The U.K. Has Consistently Made a Positive Contribution to EU Export Growth

Regional contributions (pp) to annual euro area export growth (%)



Source - Haver Analytics, ECB, RBC Capital Markets estimates nonperforming loans and reduced net interest margins due to loose monetary policy. Real estate would likely also feel the pinch, as occupation needs might be reassessed to the benefit of the Continent. Construction could also suffer, were it to be deprived of the abundance of EU workers. The challenge of lower demand would be compounded by a weaker pound for two sectors in particular: non-food retailers, which import much of their merchandise, and transport companies, whose energy costs are largely USD-based.

Sectors that depend on European regulation would face added uncertainty, with banks being particularly vulnerable. EU regulators could opt to repatriate key functions from London to Paris and Frankfurt. Consider, for example, that the U.K. accounts for 78% of foreign exchange trading in the EU. Repatriation of key functions could diminish London's profile as a financial centre over time. Airlines would also endure a cloud of regulatory uncertainty and would no longer automatically have access to the EU market. And by virtue of the U.K. no longer being in the EU they would lose access to the U.S. market.

If Remain prevails, how would U.K. equities react?

Should the nation vote to remain in the EU, we would expect a relief rally in U.K. equities as some of the uncertainty seems to be discounted in share prices.

Would the repercussions of Brexit stay within the U.K.'s borders?

In our view, it would be wrong to assume Brexit is exclusively a domestic issue—repercussions could be felt far and wide, including on the EU's economy, politics, and financial markets, as well as potentially even beyond.

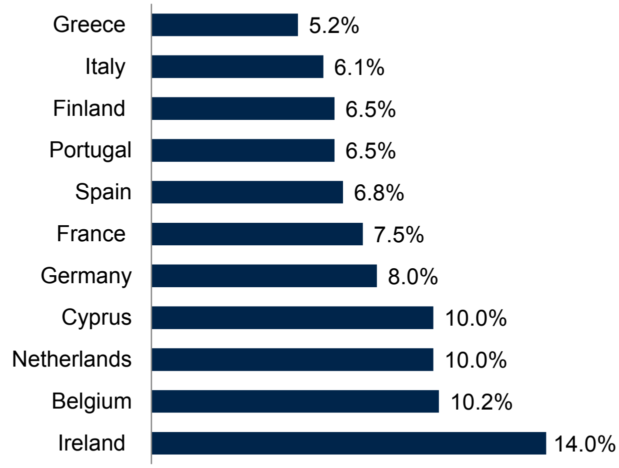
One impact of Brexit on the EU economy would be through the trade channel. The EU sends 10% of its exports to the U.K. and this has consistently made a positive contribution to EU growth. The expected fall in domestic demand in the U.K. following a Brexit vote could affect demand for these imported EU goods and services, and would endanger the EU's fragile recovery.

Ireland, with its strong economic ties to the U.K., would be particularly exposed: as much as 14% of its total exports are destined to the U.K., representing some 8% of its GDP.

Importantly, a vote to leave does not bode well for the cohesion of the EU. Other countries, emboldened by the U.K.'s move, could also demand special rights to better suit their own interests. Moreover, without the U.K., the EU would lose a reform-minded member, which could erode its resolve to move towards more market friendly policies in the long term.

Ireland Is the Largest Single Exporter to the U.K.

Exports to the U.K. as a % of total



Source - RBC Capital Markets

Finally, many in the EU see the U.K. as a counterweight to the dominating influence of France and Germany, and its absence would alter the delicate balance of power within the EU. For a region where political cohesion is key but facing a myriad of challenges, such as populist politics, a refugee crisis, and government bankruptcy in Greece and perhaps Portugal, this would be an unwelcome additional challenge. An eventual existential crisis cannot be ruled out.

So how would Brexit impact European financial markets?

For fixed income, following a Brexit vote, we would expect lower yields in both Government and Corporate bonds (excluding U.K. issuers with EUR-denominated bonds) as investors rotate out of GBP-denominated bonds into those that are EUR-denominated. A Remain vote could be moderately positive for the asset class.

With respect to the currency, we would expect the EUR to weaken following a Brexit vote as second round effects on the economy get discounted.

For European equity markets, we would expect an initial negative knee-jerk reaction as little seems already discounted at current price levels. We have been advocating a bias towards domestic cyclicals in European portfolios. A Brexit vote would see us reduce this bias.

The grid below summarises our views on the effect on U.K. and European markets should Britain remain in or leave the EU.

Asset Classes' Expected Reactions to the Outcome of the Referendum

		Leave	Remain
Fixed Income	U.K.	Volatility in the Gilt market as investors assess the impact of uncertain economic growth in the future and as the tug-of-war between the sale of Gilts by foreign investors and the potential loosening of monetary policy by the Bank of England begins. Corporate spreads are likely to widen on a selloff of bonds issued by domestic and U.K.-based multinationals due to export uncertainties. U.K. banks are likely to be the largest losers due to reduced access to European markets.	Relief rally due to reduced uncertainty in both U.K. Gilts and Corporate bonds.
	Europe	Lower yields in both Government and Corporate bonds (excluding U.K. issuers with EUR-denominated bonds) as investors rotate out of GBP-denominated bonds into EUR-denominated.	Unchanged yield levels as pre-Brexit uncertainty is unlikely to have much of an impact on the EUR market.
Currency	GBP/USD	To move lower (weaker GBP); potential for a move towards 1.0500 should the U.K. experience a balance of payment crisis.	To move higher (stronger GBP); unwinding of Brexit premium and we would imagine a 5% rally in the immediate aftermath.
	EUR/GBP	To move higher (relatively weaker GBP) despite the recent rally, as markets would quickly re-price GBP lower. However, this is more difficult to call, as Brexit would also impact the EUR; so this move may be somewhat more muted than in GBP/USD.	To move lower (stronger GBP); markets would unwind the recent rally, with the potential for all of the move to be unwound over time.
	EUR/USD	To move lower (weaker EUR); EUR is likely to be impacted, as markets apportion extra caution towards the potential for a slowdown in euro area growth.	Largely unchanged, though potentially mildly positive for EUR.
Equities	U.K.	Weaker pound should benefit non-commodity exporters and companies with USD-denominated earnings (e.g., health care); cautious on domestic cyclicals including non-food retail, transport, real estate, and construction. Midcaps look more at risk than large caps. Regulation risk blurs the outlook for airlines and banks.	Relief rally expected as some Brexit uncertainty seems to be discounted in share prices.
	Europe	Reduction of bias towards domestic cyclicals and companies with large U.K. exposure; favour international exposure; Irish stocks appear most exposed.	Moderate relief rally expected as Brexit fears do not seem to have much affected European markets yet.

Source - RBC Wealth Management

Could the repercussions of Brexit ripple beyond the EU?

Yes, the ramifications may not stop at the EU. North American investors may also feel the sting of Brexit in their portfolios.

With just over 7% of S&P 500 revenues coming from the U.K. and Europe, the impact of a Brexit vote might seem inconsequential. Yet, we urge investors not to be dismissive. An expected setback in U.K. and European domestic demand due to uncertainty and potentially long negotiations following the vote would likely dent the profitability of U.S. businesses with British and perhaps European operations.

This would come at a time when U.S. corporate earnings growth is already showing signs of fatigue and is under pressure. Furthermore, it is also conceivable that the uncertain implications for the EU from Brexit could help push the U.S. dollar even higher, further crimping corporate earnings. We would thus be cautious on U.S. companies with particularly large U.K. and European exposures. Heightened volatility is also likely, in our view, and the prospect for weaker earnings could hurt investor sentiment.

Conclusion

Brexit is not our base-case scenario, but with odds at some 35%, it represents a significant risk, in our view. While the long-term implications are likely to remain unclear for some time, we would expect higher volatility in the short term in most asset classes in the run-up to and following a Brexit vote.

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