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Notes on the UK Referendum

Geneva, May 2016

UK Referendum on EU Membership

Context

A referendum is being held on Thursday, 23 June to decide whether Britain should leave or remain in the European Union. Prime Minister David Cameron promised to hold one if he would win 2015 general elections, amid growing discontent about low growth since the great financial crisis and recent concerns about refugees.

In this context the UK negotiated with the EU and agreed in February on more favourable conditions for the UK, giving it a "special" status, including changes in benefits for workers from other EU countries, more independence for the financial industry from European regulation, etc.

However, the UK has always had a special relationship with the EU, opting out from many agreements (eg. Schengen, EMU, Charter of Fundamental Rights, area of freedom, security and justice).

What has happened so far

PM David Cameron is now campaigning for the UK to stay in the EU. However, given uncertainty about what would happen should the UK leave the EU, companies have postponed investment decisions, confidence has deteriorated and consumption slowed, with both hard data (eg. GDP) and surveys showing this trend.

In financial markets, investors are demanding a premium to hold UK assets, with the pound, for example, falling c. 6.4% since the beginning of the year in trade-weighted terms.

What are the odds of a stay or leave vote

Most polls show that more people will vote for Britain to stay in the EU than to leave and this is our baseline scenario. However, about 35% of respondents to pools say they disapprove EU membership, which makes it a relevant possibility.

What would happen if the UK chose to leave the EU

The UK would have to negotiate with the EU the terms of leaving and new cooperation agreements (eg. like Norway or Switzerland) which could take at least 2 years. During this period, uncertainty would persist and investment and consumption decisions could continue to be affected. GDP would grow slower or there could even be an economic recession. Due to the expected depreciation of the pound, inflation would be higher, according to the Bank of England. The central bank would then be left with the dilemma or tackling low growth or high inflation.

As the post-EU landscape becomes clearer, the immediate negative macroeconomic effect could fade gradually, depending on the outcomes of the agreements reached. In the long term, growth could still be impacted by corporates and individual investment decisions, with the financial industry and real estate potentially the most affected sectors.

If the UK leaves the EU volatility in financial markets would likely spike in the short-term, with the pound likely to depreciate further, perhaps sharply, and UK assets probably losing more value. Depending on the subsequent negotiations with the EU, some of these impacts could reverse. Nonetheless, several UK listed companies are multinationals, leaving them less exposed to the slowdown in domestic economic activity.

EU asset prices would go through a period of increased volatility due to inability to assess the full ramifications of a Brexit in the stability of the European Union project. The UK would be the first member to leave the EU and other countries could consider holding similar referendums.

On a Brexit scenario, safe haven assets such as US Treasuries and core EU government bonds would likely outperform. The US dollar would likely benefit from flows leaving Europe.

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In our view, the negative impact from Brexit in the UK economy would be significantly higher than in the European Union.

Potential negative impacts of the UK leaving the EU

For the UK

- Relevant economic impact with a likely recession
- Corporate decisions regarding the relocation of headquarters to outside the UK
- London financial industry would be severely affected
- Loss of influence in the rest of the world
- Loss of influence in EU rules
- Increased risk of fuelling independence movements within the UK (eg. Scotland)

For the European Union

- Mild macroeconomic impact, due to temporary lower trade with the UK
- Potential for the postponement of investment and consumption decisions

What happens if the UK chooses to stay the EU

If UK voters choose to stay in the EU, as expected, some of the risk premia priced in should fade.

Investment considerations

We recommend being underweight UK equities since April 2015. Initially, this was related to negative developments in UK corporate profitability, given that the UK equity market has a relatively high proportion of companies from the energy and materials sectors.

The referendum adds another layer of risk and hence we continue to recommend being underweight. Moreover, the UK has some macroeconomic imbalances such as a high current account deficit (5.2% of GDP) and a public deficit (4.4% of GDP) that create a drag on economic growth.

If the UK remains in the EU, investors should expect a relief rally in UK assets. However, we consider that the risks are asymmetric, therefore we keep our underweight stance.

If the UK leaves the EU, investors should expect UK assets to underperform. If investors think that this scenario is more likely and want to add a defensive bias to their portfolios, investing in safe havens would be appropriate, such as US Treasuries and core EU government bonds.

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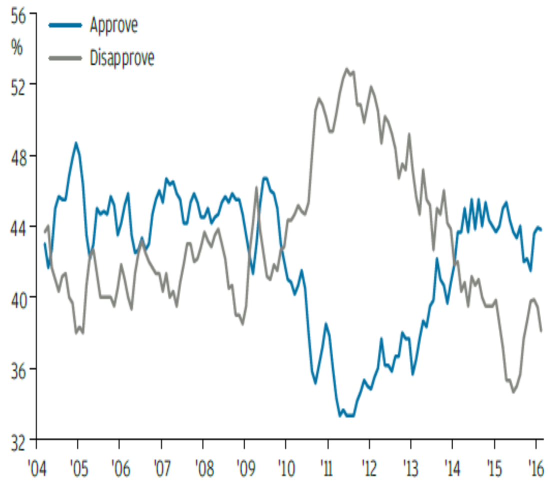
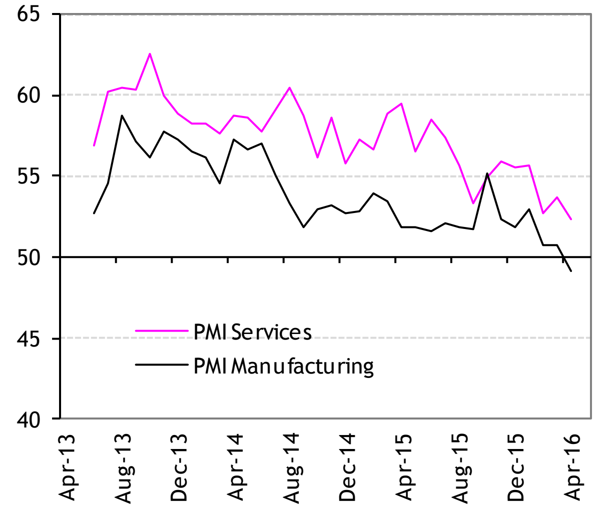
Responses to "Overall do you approve or disapprove of Britain's membership in the EU?" (3 month moving average)



UK confidence indicators (PMIs, below 50 consistent with contraction)



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Millennium Banque Privée
Place du Molard, 4
1204 Genève, Suíça

Tel.: +41 22 318 92 92
Fax: +41 22 318 92 99
www.millenniumbp.ch
E-mail: contact@millenniumbp.ch