"BREXIT" – POTENTIAL MARKET IMPACT

Prepared as of 5/20/2016

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On June 23rd, a public referendum will decide whether the United Kingdom remains in the European Union (EU). Britain's possible exit from the EU, popularly named "Brexit", has been the subject of heated debate with a number of high profile supporters on either side. While the referendum will add uncertainty to UK markets in the short-term, the UK's economic fundamentals should remain intact long-term with a localized impact on equity markets. For this reason, we believe making portfolio changes is unjustified at this point.

A vote to leave the EU in June would trigger a minimum two-year withdrawal process, making June 2018 the earliest the UK could technically exit the EU. During this withdrawal process, the UK and EU would renegotiate its current relationship. These negotiations would be long and drawn-out with well telegraphed outcomes, leading us to believe they would have limited surprise power on UK and European markets.

The Referendum's Likely Outcome

The results of public referendums are difficult to predict, although betting markets currently assign a 70-80% chance the UK remains in the EU. Polls show a closer decision but are notoriously less reliable. During the UK's May 2015 General Election, polls showed a neck-and-neck race leading into the election, but drastically underestimated the Conservative vote. Likewise, polls before the 2014 Scottish Independence Referendum showed a closer decision for Scotland staying in the UK than results actually yielded. Meanwhile, betting markets were far more accurate.

Although today's unique considerations ultimately make the Brexit difficult to predict, inertia could nudge UK voters toward staying in the EU. Considering the UK's last vote to exit the European communities was in 1975, the heightened uncertainty about life outside the EU may cause some voters to default toward staying. Historically, the status quo tends to prevail in independence referendums. Since the mid-19th century, past referendums worldwide resulted in the status quo more often than independence; roughly 70% of the 92 independence referendums since 1846 resulted this way.

Trade

Trade has been one of the most tangible benefits of EU membership. In the long-term, we expect the UK will likely have similar trade agreements as it does now, regardless of the referendum outcome. However, a Brexit would likely disrupt trade and supply chains temporarily for certain UK businesses. As an EU member, the UK currently enjoys free trade access with the 27 other EU member countries. This single market is the UK's largest trading partner, to which nearly half of UK exports are sent. Furthermore, the UK also has trade agreements with 53 outside countries through its EU membership. Losing this trade access temporarily would disrupt business for certain UK companies.

However, the decision to leave the EU does not immediately imply the nullification of trade agreements. According to Article 50 of the Lisbon Treaty, the UK will have at least two years to negotiate a new relationship with the EU, during which all treaties will remain in effect. This means June 2018 would be the earliest date the UK could actually exit the EU.

Even in the event that a new trade deal does not materialize within two years, Britain has the added advantage of having a "most favored nation" status at the World Trade Organization (WTO). This status gives Britain access to low tariffs and minimal administrative barriers with fellow WTO members and acts as an effective safety net for trade.

Economic Impact

As with the outcome of the referendum, economic impacts, especially in the short-term, are difficult to predict. Mark Carney, Governor of the Bank of England, argues these effects could add a "risk premium" to UK assets.

The broken tie with its major trading partner could temporarily weaken the UK economy, resulting in a weaker pound and higher UK interest rates. Even if higher interest rates marginally pressure the UK's twin deficits – its current account and budget deficit – markets will likely still see the UK as a safe investment. Even amid the Brexit hype, net capital flows into the UK as a share of GDP are near multi-decade highs, and 10-year gilt yields have fallen 50 bps year-to-date (as of early May), indicating markets still view the UK favorably.

Over the long-term, we believe the UK economy is too strong and resilient for any of these potential negative effects to last. Even in the event of a credit downgrade, we think its free markets, rule of law, stable property rights, liquid capital markets, low corporate taxes and a highly trained work force ultimately make the UK a desirable place for investment. These should remain intact regardless of the outcome of the referendum, especially after the UK renegotiates any broken trade contracts. We do not expect any significant impacts on the EMU outside of trade and possible currency effects.

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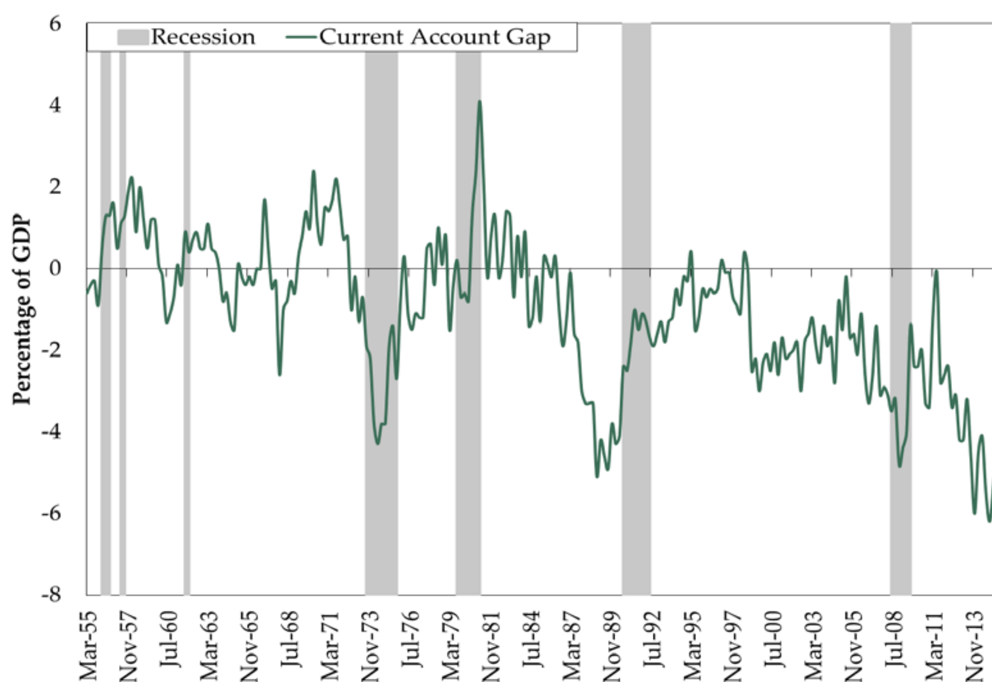
Current Account Deficit

Many Brexit concerns address the current account deficit, suggesting that an increase in the deficit (in the event of losing a major trading partner) may suppress economic growth and have impacts on gilt yields and exchange rates. While this may or may not be true, the presence of a deficit is not a negative indicator by itself. Exhibit 1 displays that historically, the UK has run deficits and surpluses (as a percentage of GDP) in both up and down markets.

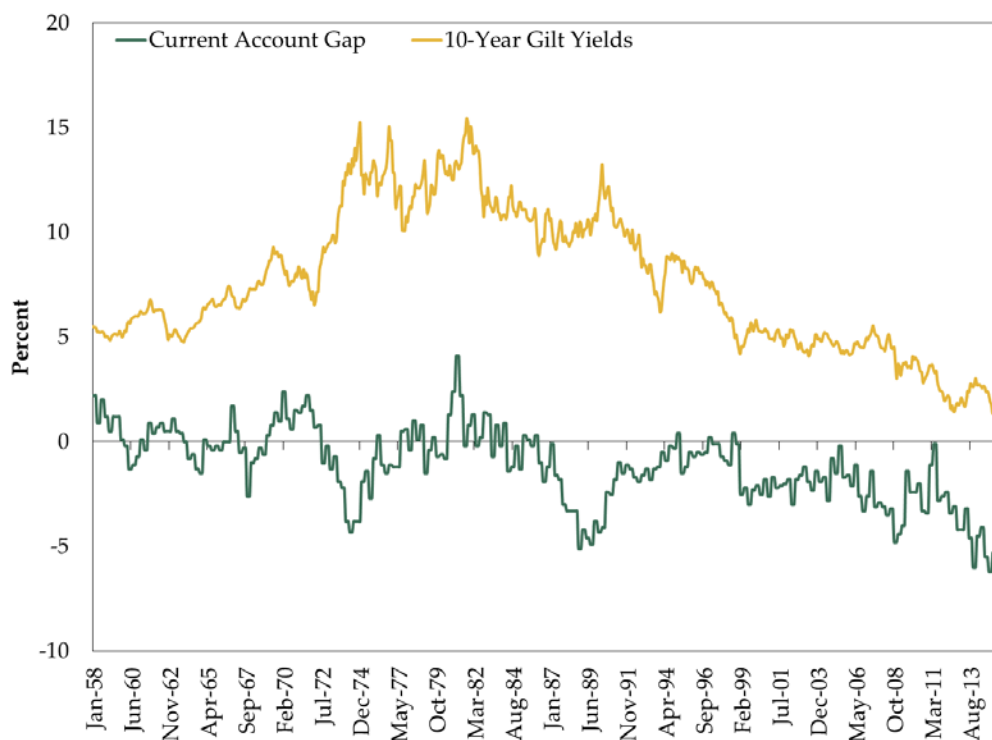
Exhibit 1: The UK’s Current Account and Recessions



Source: FactSet, as of 2/4/2016. Current account balance as a percentage of GDP and UK recessions, Q1 1955 – Q3 2015. Recession dating from UK Office for National Statistics, based on quarterly GDP at factor cost.

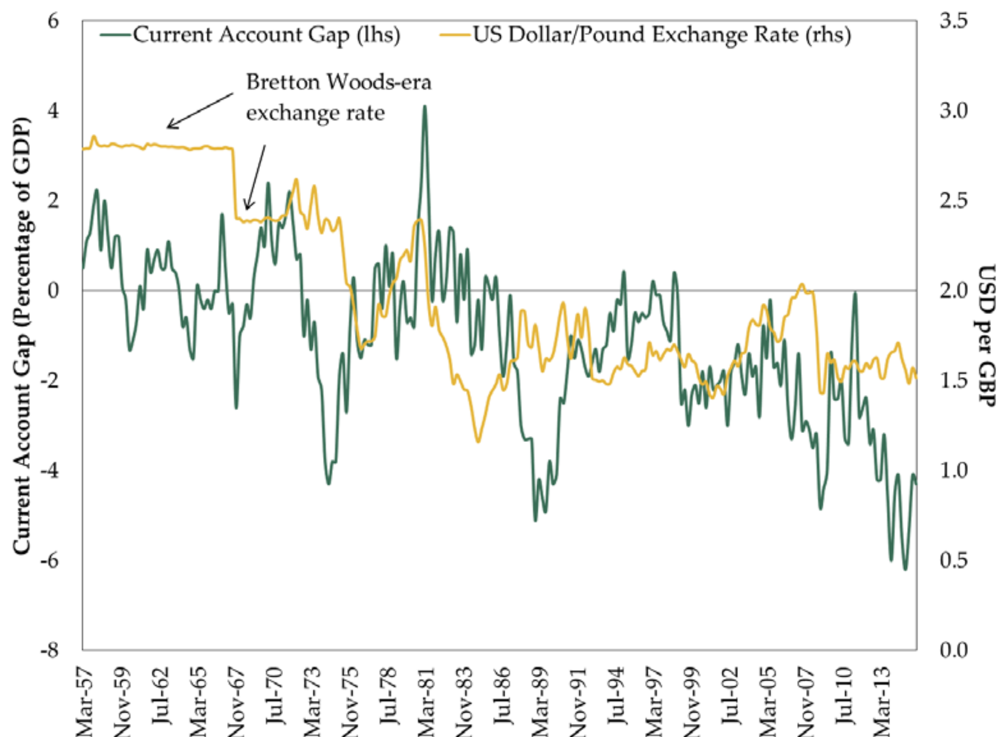
Additionally, concerns over the effects of a current account deficit on gilt yields and exchange rates may have merit, however historically, there has not been a strong connection between the UK current account and either gilt yields or the pound exchange rate (Exhibits 2 & 3).

Exhibit 2: Current Account and Gilt Yields



Source: FactSet and Global Financial Data, as of 2/4/2016. Current account balance as a percentage of GDP and 10-year gilt yields, January 1958 – October 2015.

Exhibit 3: Current Account and USD/GBP Exchange Rate



Source: FactSet, as of 2/4/2016. Current account balance as a percentage of GDP and USD/GBP exchange rate, Q1 1957 – Q3 2015. USD/GBP rate used in lieu of a trade-weighted currency basket due to its longer data set.

Political & Sentiment Impacts

In the event of an exit, Britain will reclaim a large portion of control over its regulation, specifically on financial and immigration policies. Any claims that regulators in London will do a superior job to those in Brussels are highly politicized and speculative by nature. Many Brexit proponents argue that the £18 billion in annual EU membership fees could be better spent at home. Not only is the gross figure misleading, as it doesn't account for rebate and public sector receipts, there is no evidence that the addition to the UK budget would have prevented certain benefits cuts. The net figure amounts to £13 billion, or 0.5% of UK GDP.

In the long-term, Brexit could provide a blueprint for other countries to leave the EU, especially if the UK were to do so without any major negative repercussions. A number of populist political parties could gain momentum and legitimacy from Brexit (e.g. France's National Front and Denmark's People's Party). No country outside of Greenland has ever left the European community since its inception, and a successful British example could embolden other countries to try.

Regarding sentiment, the overarching theme of the Brexit scenario is uncertainty. In the short-term, this uncertainty could weigh on sentiment and cause investors to shift assets away from the UK. Likewise, companies may delay hiring new workers, expanding capital expenditures or signing new business contracts until the uncertainty is lifted. If Britain stays, markets will likely continue as normal. However, many view Brexit as the worst-case scenario. This fear makes any outcome other than financial crisis a positive surprise. Stocks move on the gap between reality and expectation, allowing for opportunity amid the uncertainty.

Sector & Country Impacts

Brexit would not affect all sectors equally. The potential temporary disruption of trade between the UK and EU would naturally have a disproportionately large impact on sectors that rely on these lines of trade. UK industries that export large percentages of production to the EU include machinery & transport/automotive companies (41% head to EU), chemicals companies (57%) and manufacturers (53%). As a second-order effect, banks that heavily lend to these types of exporters could face increased risk of default.

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Financials as a whole could stand to lose, as a number of financial institutions engage in "passporting" - a practice by which companies with a branch in the UK can operate throughout the EU. A Brexit could stop this practice (barring a negotiated deal) forcing UK financial institutions to shuffle staff around. Despite this risk, we believe it is unlikely London will cease being a financial hub as a result of Brexit. The accumulation of human capital and infrastructure in an English-speaking country cements London's place as a financial center for the foreseeable future.

A number of surrounding countries may also face disproportionate effects from an exit scenario. As with sectors, trade is the primary issue for most of the UK's neighbors. Both Ireland and the Netherlands have significant trade relationships with the UK. For Germany, the UK is not only its largest trading partner in Europe (particularly for the automotive sector) but also a political ally in the European Parliament. Germany and the UK have traditionally been the pro-free market voices in the Council of Ministers, counterbalanced by the French led pro-regulation forces. A Brexit would shift this balance, potentially lowering Germany's political influence.

Conclusion

In summary, we do not see any actionable information out of the current Brexit situation. The outcome of the referendum is highly uncertain at this point. If a Brexit were to occur, we expect any meaningful changes to be implemented in slow, well-telegraphed pieces, limiting market surprises. While a Brexit may certainly create winners and losers, we expect most effects will be temporary and localized. Markets move on probabilities, not possibilities. At some point, should Brexit become high-probability, markets will begin pricing in various outcomes, good or bad, as they slowly figure out whether leaving would be a positive or a negative. But that time probably is not here yet.

Source: FactSet, Bloomberg, ETF.com, Fisher Investments Research

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