AMG Market Commentary

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UK Vote to Leave and Its Implication

The result for EU Referendum
The EU Referendum has been completed on 23 Jun 2016 (according to BBC News, 17.4 million vote “leave” [51.9%] while 16.1 million vote “remain” [48.1%]). The result was that UK people decided to “leave” the EU.

What does it mean?
Although the UK parliament does not necessary to follow the result of Referendum and pass the “leave” policy, it is almost impossible to change “UK will leave EU within the coming 2 years” (even though shortly after the vote to leave, more than 2.5 million people have signed a petition calling for a second EU referendum; Scottish cabinet said that it was "democratically unacceptable" that Scotland faced being taken out of the EU against its will and a second independence referendum was "highly likely").

What will be the next step?
At this moment, UK remains an EU member country. But according to Article 50 of the Lisbon Treaty, UK and EU will begin negotiations on a withdrawal agreement that will last no more than two years (unless the Council and the UK agree to extend the negotiation period) which will ultimately lead UK to an exit from the Union.

As Prime Minister David Cameron announced he would stand down by October. Thus, it is expected that the negotiations can only begin after the new Prime Minister was selected.

Before UK and EU have finalized the withdrawal agreement, UK still can enjoy the free trade status in EU. However, it does not mean that it can remain status quo in the coming months or the coming 2 years. It is because that the uncertainties will significantly affect the trade between UK and EU and UK’s export of financial services to EU.

What does “EU” mean?
The European Union (EU) is a politico-economic union of 28 countries in Europe.

The EU has developed an internal single market through a standardized system of laws that apply in all member states. ***EU policies aim to ensure the free movement of people, goods, services, and capital within the internal market, enact legislation in justice and home affairs, and maintain common policies on trade, agriculture, fisheries, and regional development.*** A monetary union was further established in 1999 and came into full force in 2002, but just 19 EU member countries which eventually decided to use the EUR.

To be honest, most of the EU member countries regard EU is more like a trade union rather than a politico-economic union. Because of different races and cultures, it is different for EU to develop into a single country (as different member countries have their own personal interests, it is almost impossible to integrate them in a single country). Thus, for most EU member countries, EU is just a “free trade zone” for them which they can enjoy to trade without any tariff or any trade barrier with other member countries (the cost is the member country needs to follow the common decision made by all the EU member countries on policies, such as trade agreement with non-EU countries, trade rules within the EU, the requirement of free movement of persons between the member countries, etc.).

What is the implication for UK leave?

The implication is UK will give up its “right” to enjoy the free trade (including both physical trade and export of services) status with EU member countries. However, after leaving EU, in order to continue the trade activities with EU member countries, it needs to negotiate and sign a new trade agreement with EU on different area, such as tariff, custom requirement, etc..

After leaving the EU, UK does not need to fulfill the “responsibility” any more, such as allowing the free inflow of persons from other EU member countries, follow the trade agreement made between EU and other non-EU countries, etc. After leaving EU, UK can restrict the number of immigrants from EU. It can also freely negotiate and sign any trade agreement with different countries.

What is the impact to UK?

As mentioned above, according to Article 50 of the Lisbon Treaty, UK and EU will begin negotiations on a withdrawal agreement that will last no more than two years.

Before the withdrawal agreement was completed, UK can still enjoy the free trade status in EU. However, it does not mean that the UK export sector will not be affected. It is expected the uncertainties will reduce the demand for UK export (from EU). In 2015, UK exported GBP 134 billion of goods to EU member countries (which is 47% of UK total exports of goods). It is quite logic to see some of these trades will be affected as it is not known when UK will lose its free trade right in EU and after that, its goods may be levied an unknown tariff from EU (even though UK and EU can complete the negotiation and sign the new trade agreement). The value of exports of goods is about 15% of UK GDP.

In addition, it is very likely that UK will be at disadvantage when negotiating a new trade agreement with EU. It is because the UK export sector is more dependent on the EU market. In 2015, 47% of UK exports were exported to EU. On the other hand, only 17% of EU exports were exported to UK. Besides, UK banks and financial companies will put a great pressure on the British Government as they would like to reduce the harm (due to the leave) as much as possible.

When compare to the UK export sector, it is highly likely that the UK banking and financial sector will suffer more significantly after UK leaving the EU. Being an EU member country, UK banks and financial companies exported many financial services to other member countries. However, after leaving the EU, these UK banks and financial companies can still export financial services to EU member countries. However, it is expected that they will face trade barriers or even required by EU to move their operation to EU (if UK fails to retain its so-called “passporting” capability which allow UK financial companies to operate across the EU without having to set up local subsidiaries). Before the Referendum, HSBC has already warned that it may need to move 1/5 or more its UK workforce to EU once UK decided to “leave”. Thus, UK’s role of being the European financial center must be affected after the vote to leave.

In addition, it is expected the foreign investment to UK will decrease due to the UK leave. It is because the uncertain trading environment with EU will discourage foreign investment in UK. Besides, loss of EU membership will also weaken the advantage of investing in UK (as the foreign company can no longer locate in UK as the headquarter and further expand the business in other EU member countries).

Some people may argue that the UK economy can benefit from the leave by re-gaining the independence to decide all its policies (both internal and external). To be honest, we did not see any way UK economy can benefit from the leave. After leaving EU, UK can regain its control on immigration policy and limit the number of immigrants from EU (one of the major reasons for people voting “leave”). It may save some government expenditure as it no longer needs to provide the social benefits to these immigrants. However, whether it will bring any net positive impact to the UK economy is still an unknown. It is because to limit the immigrants from EU may be negative to the UK economy as the immigrants can increase the UK working population and production capacity.

Besides, some people may also argue that after leaving EU, UK can freely negotiate and sign any trade agreement with other countries. Thus, UK can have a more independent and flexible trade policy. However, it does not mean that UK can really benefit too much from it. When compare to EU, the UK market is much smaller (the GDP for UK is US$ 3,000 billion while the GDP for EU is US$13,400 billion). It is very unlikely that UK can enjoy the “bargaining power” as strong as what EU is enjoying now.

In conclusion, we believe it is almost sure that the UK economy will be suffered (at least in the coming 1-2 years) after UK leaving EU. It is because the benefit from leaving EU is not evident (or only happen in long-term). However, the pain from leaving EU is immediate and substantial. It is expected the “leave” decision may lower the

UK GDP by 3-5% in the coming 2-3 years. Thus, leaving EU must lead to negative impact to the UK economy. The only problem is by "how much"?

What is the impact to EU?

The impact to EU is more on political side rather than on economic side. Although UK is also a major market for the EU export sector, when compare to UK, the EU export sector is less dependent on the UK market. In 2015, EU member countries exported EUR 308 billion of goods to UK. However, it is just 17% of EU total export (and the value of exports of goods is about 12% of EU GDP) while UK exported about 1/2 its export to EU. Besides, EU is a significant net importer for UK's financial services. Thus, the EU banks and financial companies should not be very afraid that they will lose many UK businesses after UK vote to leave. In contrast, the EU banks and financial companies will become more competitive (vs. UK banks and financial companies) when competing in EU.

As mentioned above, according to Article 50 of the Lisbon Treaty, UK and EU will begin negotiations on a withdrawal agreement that will last no more than two years (unless the Council and the UK agree to extend the negotiation period) which will ultimately lead UK to an exit from the Union. In the meantime, UK and EU need to negotiate and sign a new trade agreement so that they can continue to trade with each other. However, it is very likely that EU will be at advantage when negotiating a new trade agreement with UK. It is because the UK export sector is more dependent on the EU market. In 2015, 47% of UK exports were exported to EU. On the other hand, only 17% of EU exports were exported to UK. Besides, UK banks and financial companies will put a great pressure on the British Government as they would like to reduce the harm (due to the leave) as much as possible. Thus, although the UK leave will lead to a negative impact to the EU export sector, we believe the impact will be substantially smaller than the impact suffered by the UK export sector.

Apart from the export sector, many investors are afraid that the leave of UK will lead to the collapse of EU as other member countries may follow UK and ask for leave. We think that it is possible but we would like to point out that UK is different to other member countries. First of all, UK was a world superpower before and after the World War II and always be the leader in Europe. It is logic for it to feel unhappy under the current structure (Germany being the leader). Such kind of feeling will be less prevailing in other EU member countries, such as Spain, Portugal, Ireland, etc.. Besides, for those member countries using EUR, it is much further difficult for them to leave. It is because after leaving EU, they do not just need to deal with the trade problem, they also need to deal with the currency problem (they need to create a new currency to replace the EUR). The potential risk/ impact will be significantly more serious as an unstable currency system will easily lead to financial crisis. In addition, most of the member countries are small in size (in terms of GDP). They are not strong enough to afford the short-term fluctuation from leaving EU.

In conclusion, we believe the leave of UK will have a negative impact to the EU economy but the impact should not be disastrous (the impact may be disastrous to UK but will not be disastrous to EU). Indeed, the EU export sector will be affected by the UK leave but the impact should not be too significant. Thus, the UK leave will lead to more psychological impact than real economic impact to EU. We believe that the most significant impact to EU will be a short-term fluctuation in the financial market (including but not limited to European markets). Due to risk averse, investors may reduce their risky investment and lead to a substantial downward pressure to stocks, corporate bonds, commodities (exclude gold as gold serves as a safe haven), etc.. In short-term, EUR may face a substantial downward pressure as investors were afraid the UK leave will hurt the EU economy.

What is the impact to the World?

The impact to the World is further minimal. First of all, UK is not a global economic superpower anymore. A lower GDP in UK will not lead to any significant impact to the whole world (In 2015, the UK GDP is US$3,000 billion which is only 3.8% of global GDP). Besides, after leaving the EU, although the trade volume between UK and EU must be affected, it also will not lead to any significant impact to the global trade volume as well as the global economic growth. It is because during this uncertain time, UK corporate may switch their trading to other non-EU countries while EU corporate may switch their trading to other countries as well. Thus, in aggregate, the global trade volume may be affected, but the size of the impact should not be very significant.

In conclusion, we believe the leave of UK will not have any significant impact to the global economy. Thus, the UK leave will lead to psychological impact rather than real economic impact to the World. We believe that the most significant impact to the World will be a short-term fluctuation in the financial market (including but not limited to European markets). Due to risk averse, investors may reduce their risky investment and lead to a substantial downward pressure to stocks, corporate bonds, commodities (exclude gold as gold serves as a safe haven), etc.. On the other hand, in short-term, the safe haven, such as Japanese yen, gold, US and German government bond will enjoy a capital flow in. On the other hand, some investors think that the US Fed will delay its interest rate raise due to the UK leave. It will help to offset some of the negative impact to the global economy and to stabilize the financial market fluctuation due to the UK leave.

The market reaction after the UK "leave"

On 24 Jun, the global financial markets were shocked by the UK "leave". It is because before the EU Referendum, it is widely expected that UK will vote "remain". Thus, when the result showed that UK will leave EU, the market has become very panic. At most, the Hang Seng Index has dropped 1,200 points (-5.8%), the Nikkei 225 Index has dropped 1,350 points (-8.1%), the DAX index has dropped 1,030 points (-10.0%) and the Dow Jones Industrial Average Index has dropped 650 points (-3.6%). Although the drawdown has decreased during the market close, most of the markets still recorded 3-8% drawdown.

To be honest, although the UK economy may suffer substantially in the coming 1-2 years and the EU economy will be slightly affected, we do not think the UK leave will lead to any significant impact to the global economic growth. Thus, the impact to the financial market should be due to risk aversion rather than any significant deterioration in economic fundamentals.

However, please remind that the drawdown on 24 Jun may not fully priced-in the potential fluctuation caused by the risk aversion. For example, although the Hang Seng Index has dropped 2.9% on 24 Jun, the 2.9% drawdown just equals the gain recorded the few trading days before the EU Referendum. Although the Dow Jones Industrial Average Index has dropped 3.3% on 24 Jun, it is still trading at the relative high level as the Dow was at 18,000 (near the historical high) before the EU Referendum. Thus, we expect the risk aversion will continue to lead to more short-term pressure to the stock markets.

Hang Seng Index: Although it has dropped 2.9% on 24 Jun, it just equals the gain recorded the few trading days before the EU Referendum (Sources: Bloomberg)

Dow Jones Industrial Average Index: Although the Dow Jones Industrial Average Index has dropped 3.3% on 24 Jun, it is still trading at the relative high level as the Dow was at 18,000 (near the historical high) before the EU Referendum (Sources: Bloomberg)

Again, as we believe the leave of UK will not lead to any significant impact to the global economic growth, we are confident that the massive selloff will be relative short-lived (except UK). We expect the market can be stabilized within 1-2 months. We expect the global stock market may have a 5-10% short-term drawdown due to the massive risk aversion (in the coming weeks). **<u>However, the medium to long term (3-6 months) impact to the European or Global stock market should not be more than 5%.</u>**

Apart from the stock markets, FX and gold market is also affected by the UK “leave” and its short-term movement may be more volatile than the stock market. The uncertainties emerged due to the Brexit will lead to a sell pressure to GBP and EUR. It is expected that the GBP may depreciate to 1.3 or even lower. On the other hand, the safe haven, such as Japanese yen and gold price will continue to be pushed up by the capital inflow. It is possible that the demand from risk aversion will force the Japanese yen to rise to 100 or below and the gold price to US$1,400 or above. However, we still believe the yen and the gold price cannot sustain at such high level in a medium to long term perspective.

British Pound: The selling pressure will continue for a while as the UK “leave” will lead to many uncertainties and real negative impact to the UK economy and the financial market (Sources: Bloomberg)

Japanese Yen: Will remain very volatile in the coming week; the demand for risk aversion will continue and it may push up the Japanese yen to 100 or below (Sources: Bloomberg)

Gold Price: The risk aversion may push up the gold price to US$1,400 or above. However, we still do not believe the gold price can sustain at such high level in a medium to long term perspective (Sources: Bloomberg)

* Unless otherwise stated, all figures and information are collected from WSJ, Bloomberg or Haver Analytics.

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