PERENNIAL VALUE MANAGEMENT

Perennial Perspective

Always have an exit strategy: unless you are the UK!

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Brexit is indeed big news and it is true to say that at the moment, uncertainty rules as there is no clear road ahead. The European Union (EU) is caught between a "rock and a hard place"; on one hand it needs the UK on a number of fronts however to offer the UK too many concessions in the exit negotiations would be seen as a slap in the face for the current members who pay substantial amounts for perceived EU benefits.

Hopefully my summary below will help put everything into perspective with some relevant facts and analysis.

What does Britain Lose?

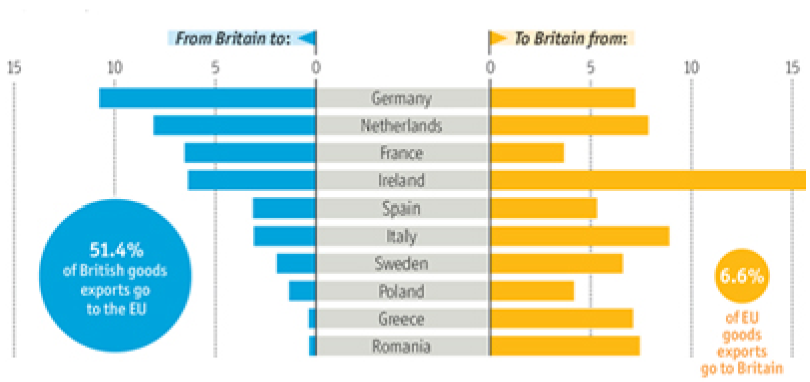
- "Easy" access to the $16.6 trillion European Single Market (essentially a free-trade agreement with no major tariff, tax, customs and product regulation barriers). Currently the EU (ex UK) exports around 7% of goods to the UK although others put this number a little higher. Over 50% of UK goods exports are headed for EU countries (see '**They need each other**' chart below). These numbers refer to goods only and one must remember that the UK economy is around 80% reliant on services, not goods.
- "Easy" access to labour to and from EU countries.
- The pro EU group say that the benefits of the EU member equates to 4% to 5% of Gross Domestic Product (GDP) per annum, however this number is hard to estimate and no-one knows what the UK post exit scenario looks like (see the section entitled '**the future**' below) to do a comparison. More considered estimates state the GDP effect could be around 0.5% to 3% per annum lower depending on how tough the EU are in negotiations. In any case it will be a negative shock to UK growth.
- "Easy" access to the EU for London's massive financial and banking industry. London is effectively the focal point of the financial world (even more so than New York) and the future here is also unclear. Ireland in particular as well as Germany, Spain and

France have extensive financial banking asset/liability obligations with the UK.

- Falling currency will make imports more expensive.
- A loss of wealth due to stockmarket falls.
- Loss of jobs in the affected sectors or jobs moving to continental Europe.

THEY NEED EACH OTHER

Exports of goods between Britain and EU, 2014, % of national totals

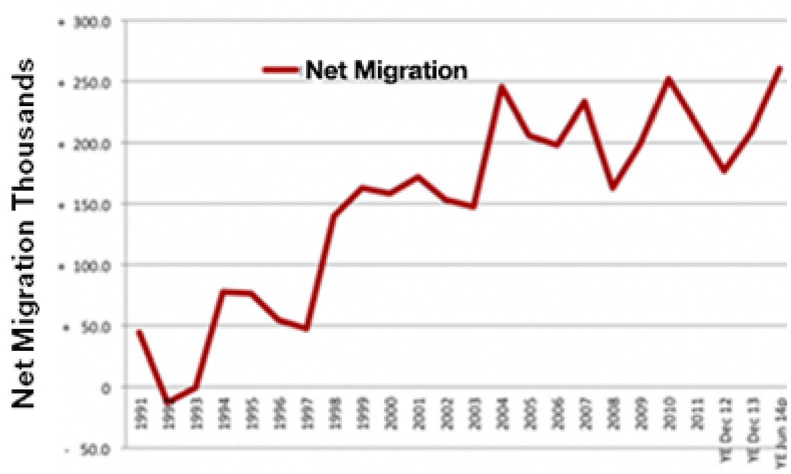


Source: IMF Direction of Trade Statistics, Economist.com.

What do they Gain ?

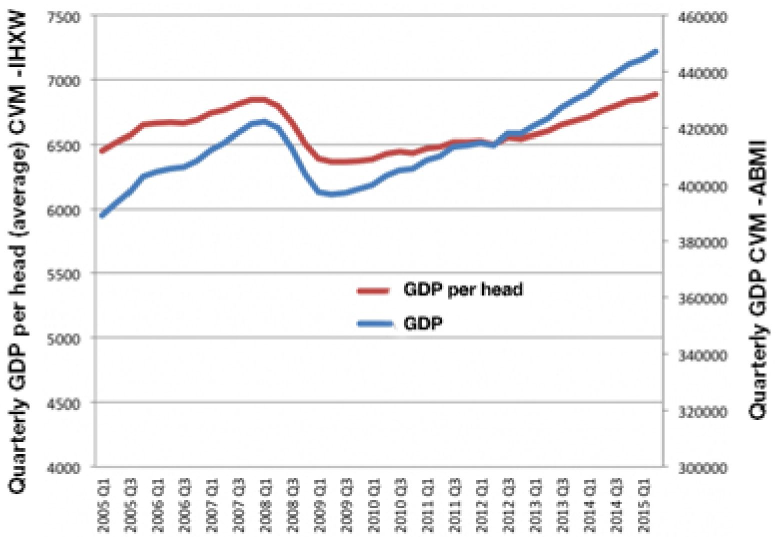
- There will be no requirement to pay their net contribution to help fund the EU bureaucracy of just over 7 billion Euros (around 0.4% of GDP) although it is true to say that there will be future costs such as increased tariffs, loss of trade, taxes, exit costs etc. *A cynic may say the costs that Europe may effectively impose could amount to around 7 billion Euros!*
- There will be no pressure towards austerity or to make spending cuts to meet EU targets.
- Greater sovereign control of their country with the people able to decide on policies that were the domain of the EU (trade, immigration etc.) through their own political processes. Whilst generally immigration is a good thing in terms of boosting notional total growth (e.g. It is generally accepted that Australia has benefitted overall from immigration), the actual GDP per head or wealth per person has been growing at a slower rate. There are many reasons for this, including poor productivity etc. however this issue seems to have struck a chord with many Britons.

NET MIGRATION - UK



Source: www.economicshelp.org, Office of National Statistics (ONS) - Long Term Migrants

UK GDP vs GDP PER HEAD



Source: www.economicshelp.org, Office of National Statistics (ONS) - ABMI - IHXW

The future

Short term uncertainty is likely to:

- See Sterling weaken (it has fallen 7.4% against the Euro, 9.8% against the US Dollar and 7.6% against the Australian Dollar as at 30 June 2016.)
- Delay any rate rises in the US to well after September, possibly now in December or even early next year depending on how things play out.
- Reduce share valuations as uncertainty is priced in.
- Significantly increase the likelihood of more rate cuts in Australia, potentially in August.
- Force the Bank of England to cut rates further to around zero and make further asset purchases.

Long term ramifications:

- There is a two year negotiation period once the UK gives notice of its intention to leave although this can be extended if both parties agree.
- The crucial issue here is whether the negotiations are amicable or confrontational in nature.
- The future relationship could be along the lines of other countries who are not full members of the EU and don't use the Euro but who do participate in the common market at a different level under a treaty arrangement (Norway, Sweden, Iceland, Liechtenstein) or a bi-lateral trading agreement such as Switzerland but all this is unclear at the moment.
- Brexit affects the market through:
  - General uncertainty;
  - The "new" negotiated trade rules;
  - The "new" negotiated financial rules;
  - Politics, as interest groups in other nations look at this as a key test case for sovereignty and how to handle (mishandle?) middle class dissatisfaction.

Implications for Australia

- Despite our colonial history only 2.8% of our merchandise trade goes to the UK and only 4.1% of imports are UK sourced (**Source:** Department of Foreign Affairs and Trade 2015) so the effect will not be as dramatic as the press have been indicating.
- Stockmarket – The biggest initial impact is the currency effect for those companies which receive large Sterling earnings as they translate their earnings back into less Australian dollars. Having said that, more sluggish growth generally and the uncertainty as well as possible contagion effects will also hold back valuations over the short term. In our portfolio the vast majority of our stocks are not affected directly with Henderson (UK based investment manager) and Clydesdale Bank (Scottish Bank) potentially the most affected on our initial analysis. These stocks represent less than 2% of our core portfolio. To manage risk given the uncertainty around the vote we sold some of our holdings in both stocks before the vote and we have subsequently bought back into these stocks, albeit not aggressively, at share prices some 20% lower post the vote.
- Fixed Interest – Australian 10 year Bonds are now trading at record low yields just below 2% with markets now pricing in 100% chance of a rate cut to 1.5% by year end and a significant chance of another cut next year.

Conclusion

It's seen as a victory for sovereign rights, immigration control and democracy for some and a backward looking, "turning away from the World" loss to others. Whatever your view Brexit is 99% closer to reality.

Whichever way you look at it, the UK needs Europe and the rest of the World and vice versa. Hopefully we see sensible negotiations ahead and not a rush to the "exits without an exit plan approach" from other nations. The World is waiting …..

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This article is an extract from Perennial Perspective July 2016.
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