Special report- Brexit Blues

The referendum on whether the UK remains part of the European Union is set to take place in a few weeks’ time on Thursday 23 June. This is as significant as the 1975 vote to join the European Economic Community, which won 67% approval. The implications of a Brexit, if it occurs, are likely to be profound.

The former British Prime Minister Harold Macmillan was once asked by a journalist what was most likely to blow governments off course. His reply is reported to have been “Events, dear boy, events.” The knocks that the stock market has endured so far in 2016 show how events can also blow investors off course. Media alarmists often blow unexpected events out of proportion while pundits often claim to have anticipated them.

The risk for investors is that they sell out at the worst time and then see markets rally afterwards. Getting the timing wrong is the reason that private investors on average perform poorly versus a buy and hold strategy.

Turning to the possible exit of the UK from the European Union and clearly this is a major event for financial markets. However, we would first and foremost highlight the Warren Buffett quote below: “Over the long-term the stock market news will be good. In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recession and financial panics; oil shocks; a fly epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497.”

The Great Crash and the Great Depression didn’t kill the stock market

Source: Google images
A UK exit from the European Union may hit economic growth in the Eurozone and would most likely destabilise the UK in the short-term. However, it would most likely be a protracted process with a two-year window to negotiate the terms.

Recent opinion polls show almost an even split between the “Out” campaign and the “In” camp. Given this backdrop the upheaval that a Brexit would involve may tip the balance towards the “In” campaign as the vote draws near.

In terms of investing our view is that following the wartime advice to “Keep Calm and Carry On” remains sound. Globally diversified companies will see little impact and may even benefit from the recent weakness in sterling.

Clearly we have seen a market impact from a possible Brexit this week but markets tend to overact in the short-term. Housebuilders, for example, weakened on Monday but bounced back on strong results later in the week.

In our view, markets can give a misleading impression as everyone heads for the exit at the same time. When the Swiss National Bank stopped supporting the Swiss Franc the euro exchange rate moved from 1.2 to 0.99 but is now at 1.1.

**What to do about a Brexit: Keep calm and carry on**

Source: Google images
In the face of investor anxiety, whether warranted or otherwise, it has generally been a good move to buy when sentiment is weak. We are not yet at the stage advocated by Baron Rothschild who advised to buy “when there’s blood in the streets” though.

However, the Warren Buffett quote to “be greedy when others are fearful” is starting to become relevant. This doesn’t mean that share prices won’t decline further but buying in times of stress does tend to do well in the long-term.

**FTSE 100 since 1990: from dot-com boom to the financial crisis**

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Global defensives

The European Union as an economic block is a significant chunk of the global economy. However, it is the UK that is likely to be most affected by a Brexit and most of the largest listed UK companies are globally diversified.
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Defensive companies that fit this billing include the consumer staple groups Reckitt Benckiser, Unilever and Diageo. Two additional consumer staple companies are the tobacco giants British American Tobacco and Imperial Brands.

Reckitt Benckiser since 2007: what financial crisis and Brexit scare?

Other resilient businesses in the FTSE 100 include the medical equipment company Smith & Nephew. We would also argue that Sky is defensive given the willingness of people to subscribe for premium TV content.

The software group Sage is globally diversified although 53% of revenue was generated in Europe in the last fiscal year. However, the shift to a subscription payment model provides a strong recurring revenue stream.

The crux is that it is possible to navigate the political and economic uncertainty with a strong portfolio position in resilient stocks. These kinds of companies make the future of the UK economy less important for portfolio performance.
Our recent special report on compounding stocks in the FTSE 100 identified 15 candidates. These are companies with very low “blow up risk” and the ability to compound returns over time.

Brexit impact on Monday (February 22): sterling and house-builders.

It is, though worth noting how the equity market has reacted to the threat of Brexit. The pound has fallen to a seven-year low against the dollar this week at under US$1.39 and is at its lowest point since the start of 2015 against the euro.

**Sterling dollar since 2000**

![Graph showing USD/GBP exchange rate from 2000 to 2016 with a low of under US$1.39 this week and its lowest point since the start of 2015 against the euro.](image-url)
While this may not bode well for British holidaymakers travelling abroad it does boost the value of profits earned outside the UK. Smith & Nephew, for example, generates half its revenue in the United States.

The shipbrokers Clarkson and Braemar Shipping, meanwhile, earn nearly all of their revenue in US dollars. Both companies have their headquarters of in the UK and as such the fall in sterling should boost their profit margins.

As the blue chip FTSE 100 index is dominated by global companies the recent fall in sterling is likely to boost profit growth. As such the talk of Brexit is not all doom and gloom for UK equity markets.

Monday also saw UK housebuilders weaken, as a Brexit would most likely hit the demand for housing. However, there is already such a significant demand to supply imbalance that the UK housing market is unlikely to be derailed.
Falling new home supply and a growing population

![Graph showing new supply vs population trend in the UK.](image)

Source: Grainger strategy presentation

It is also worth being cautious on the share price moves for just one day with the home builder Persimmon bouncing back on Tuesday. Markets are often volatile and are can also be wrong in how they view the impact of events.

**Brexit speculation: the sum of all fears**

Moving into the “parallel universe” of Brexit speculation it is possible to forecast that any negative scenario will occur. What is clear is that a vote to leave the EU would mean significant uncertainty and that would hit UK economic growth.

Companies making investment decisions are likely to view the UK as less attractive if it is not part of the European club. This is likely to the case in the short-term but in the long-term it is harder to make a judgement call.

The difficulty in forecasting the impact of Brexit is because we don’t know what our revised relationship with the EU would look like. It is therefore not possible to say whether the long-term effect of a Brexit would be beneficial or not.
What is clear is that consumer and business confidence are both very sensitive to events. As such there would most likely be a meaningful slowdown in the UK in the event of a vote to leave the European Union.

The credit rating agency Moody’s has warned that it may put the UK credit rating on negative watch in the event that the Out campaign wins. This is because it believes that UK exports will suffer unless a robust EU trade deal is agreed.

HSBC Bank has also warned that the value of sterling could fall by a further 20% in the event of a Brexit vote. A number of international companies have also stated that they would move workers from the UK to the EU.

It is very easy to build on this “scaremongering” to create a negative cocktail of events that could hit the UK. This could include higher interest rates, a jump in inflation, a slump in investment, rising unemployment and a fall into a recession.

This scenario is entirely possible but with two years to renegotiate a new relationship with the EU a market panic appears to be unlikely. The UK is likely, though, to see an impact on the pace of economic growth from a Brexit vote.

Looking at the latest forecasts and the IMF expects the UK to grow by 2.2% in both 2016 and 2017. This pace of expansion should be sufficient to absorb the changes involved in a UK Bexit vote without the UK falling into a recession.

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**Stock market sectors**

The impact of a Brexit is best considered by looking at the different stock market sectors. Clearly UK focused businesses will have the most to lose and as such it is not surprising that they are overwhelmingly supporting the “In” camp.

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**UK consumer focused groups**

Economically sensitive businesses focused on the UK consumer may see an immediate impact from Brexit. They include the pub groups like Greene King and Marston’s along with the leisure business PPHE Hotel Group.

The price comparison site Moneysupermarket is also likely to feel the pinch in reaction to any fall in UK consumer confidence. The same goes for Cineworld given that cinema trips are a discretionary activity.
European Budget airlines

The budget airline sector has been a child of the European Union and the open skies agreements. Brexit is likely to hit demand for travel to and from the UK but in the long-term the airline industry is still one that sees passenger growth.

We also note that while low oil prices are benefiting the sector the price of oil is in US dollars. As such the weakness of sterling and/or the euro against the dollar makes it more expensive to buy jet fuel.

EasyJet recently celebrated its 20th birthday.

Source: easyJet website
UK homebuilding and construction

A key driver for the UK population over the last decade has been net immigration from the European Union. This has pushed up demand for housing and so Brexit speculation saw homebuilders sell-off on a few months ago.

This is a volatile sector and in our view the overall balance of supply to demand will continue to support homebuilders. However, if Brexit leads to higher interest rates then it will become less affordable to buy homes in the UK.

The construction sector is driven by homebuilding, civil construction and commercial construction. All three of these will be hit by a Brexit and this will hurt demand for Travis Perkins and Norcros.
Real estate

The valuation and demand for real estate in the UK is likely to suffer from a Brexit. A number of international firms have already warned that they would move staff elsewhere if the UK leaves the European Union.
There is already significant new supply set to come on stream in the London office market over the next few years. The market for large real estate transactions is likely to dry up leading up to the EU vote.

**Brexit vote outcome**

It is more likely than not, in our view, that the outcome of a vote will be to stay in the European Union. The polls are equally split at the moment with around half of respondents supporting Brexit and half supporting the In camp.

Against this backdrop the potential impact of leaving the EU is likely to push the swing voters towards the In camp. Voting for short-term economic pain in return for greater sovereignty is likely to give pause for thought at the ballot box.

At the same time net migration to the UK in the year to September was the second highest on record at 323,000. It is up 11% on the same time a year ago and may shift public opinion towards leaving the EU.
The UK government targets a net migration figure of below 100,000 by 2020 but it is hard to see this being achieved without a Brexit. The key driver of net migration has been from the EU with 165,000 new arrivals in the period.

**Summary**

A vote for Brexit is likely to hit UK economic growth and the performance of UK focussed businesses. At the same time the weakness of sterling is boosting the value of the profits that UK multinationals earn from abroad.

What exactly Brexit means is unclear, as we don’t know the terms of any new deal that would be negotiated with the EU. However, the UK will be less attractive to investors looking to achieve a foothold in the European Union.

Our overall view is that the wartime advice to “keep calm and carry on” makes sense. Global defensives, like Unilever and Reckitt Benckiser, will help to insulate a portfolio and should deliver strong results no matter what happens.

A Brexit cannot be ruled out and it may have dire implications for the UK economy. It is worthwhile, therefore, being cautious towards stocks that are driven by UK economic growth and consumer/business confidence.

Accordingly, we will monitor the opinion polls as we move towards the EU referendum in the UK in four months on 23 June.
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