GENERALI INVESTMENTS

Focal Point

Brexit: What is at stake?

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- On June 23, British voters will decide on whether the UK will leave the EU.
- Recent polls point at a tight race. While the reform agreement between the EU and the British PM David Cameron has helped to strengthen the 'Remain' camp, immigration concerns may favor a 'Leave' vote amid the EU refugee crisis.
- A 'Leave' vote would be followed by up to two years of negotiations over the terms of the 'Brexit'. Investment and overall growth in the UK may suffer on high political and legal uncertainties.
- In the longer term, growth would soften from receding immigration, trade barriers for financial services and less foreign direct investment.
- On financial markets, the strongest initial response would be seen in the exchange rate. The British pound may weaken noticeably on ebbing capital inflows while UK Gilts and equities in local currency may be less affected.

On June 23, British voters will decide in a referendum whether the UK will leave the EU. The date was announced by PM David Cameron after he re-negotiated the terms of Britain's EU membership at the European summit on February 18/19. The EU partners compromised, motivated by fears that a Brexit would strengthen eurosceptics among Europe at a time in which the refugee and other crises prove worrisome. The most important results of the deal were:

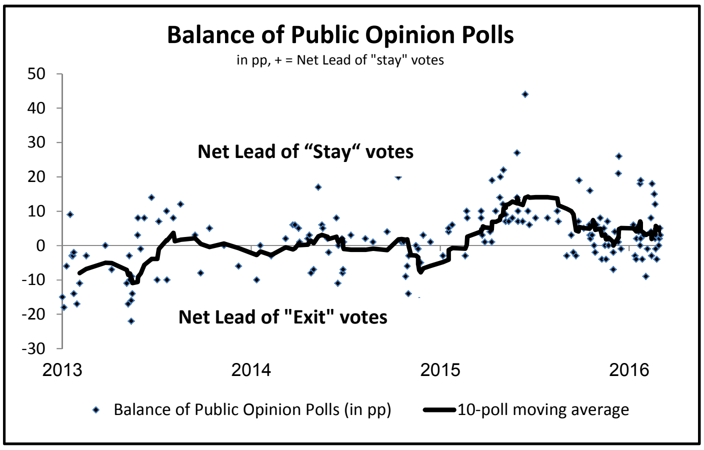
- The UK extends its "special status" within the EU, including an exemption from being part of an 'ever closer union'.

- As a safeguard for the City of London, the deal affirms non-discrimination for non-eurozone members by decisions regarding the euro and the European financial rules.

- Countries can be authorized to limit non-contributory in work benefits to newly arriving EU workers up to four years. Special regulations were found for child benefits.

Polls suggest material Brexit risk

The last topic is of special importance, as it is intended to limit immigration, a key concern driving many people's voting decisions (which is likely negatively influenced by the EU refugee crisis). However, limiting EU immigration runs against the principle of the free movement of labor, which together with the free flow of goods, services and capital is at the heart of the Single Market. The way out of this dilemma was to limit social benefits. Long-term net immigration rose in the year ending June 2015 significantly to 336K (from EU 180K, Non-EU 201K, British -45K), a record level. However, studies show no major evidence that the UK benefit system is a significant driver of migration, while the availability of jobs and relative wage levels clearly are. Immigration is thus unlikely to diminish much short-term and the topic will continue to drag on polls. Currently, there is no major lead of any camp, but up to 25% undecided voters. This clearly points at a material Brexit risk that we would put at 30-40%.



Economic risks tilted to the downside in our view

A Brexit decision will be followed by an up to two year period of negotiations with the EU (Article 50 Lisbon Treaty) about the definite exit terms from the Single Market. This will be a period of high uncertainty while EU regulations continue to be applied.

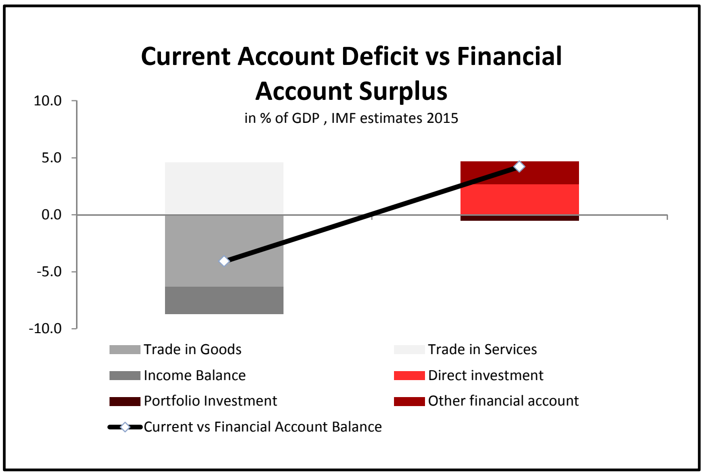
Goods trade: The EU is UK's largest trading partner (54.1% in 2014). In the worst case, the UK would fall back to WTO status with an average EU tariff of about 4% (but individual sectoral tariffs may be much higher). However, as goods trade is mutually beneficial, we see an EFTA solution (continued free trade in merchandise products) as more likely. It may also be possible that the UK joins the EEA (European Economic Area) but this is less likely since it would imply continued free labor mobility and British contributions to the EU budget. In either case, UK exporters will need to continue to comply with all product rules of the EU. Moreover, the UK or England (if Scotland separates from the UK) will have to replace existing free trade agreements with other countries or join trade blocs (e.g. NAFTA), but would lose the EU negotiation power. All in, we consider goods trade as only mildly affected.

Service trade: Service trade – esp. financial services – is particularly important to the UK and the City. The UK has attracted international financial firms not least by the fact that EU membership carries the passport to operate cross-border in all other EU member countries. It seems likely that financial services based on the euro would, in part, relocate from London to Frankfurt or Paris. On top, the UK would lose its influence to shape EU financial legislation.

FDI: Finally, a similar argument applies to foreign direct investment (FDI). The UK has likely benefitted from FDI of non-EU multinational firms as a platform to access all EU.

Growth to slow amid uncertainty and FX shock

In 2015, UK realized a current account (C/A) deficit of 4.1% of GDP. The goods trade deficit of 6.3% was mitigated significantly by positive net services exports. While financial services account for about 22% in total services exports, its share in the net service balance is even 42%.



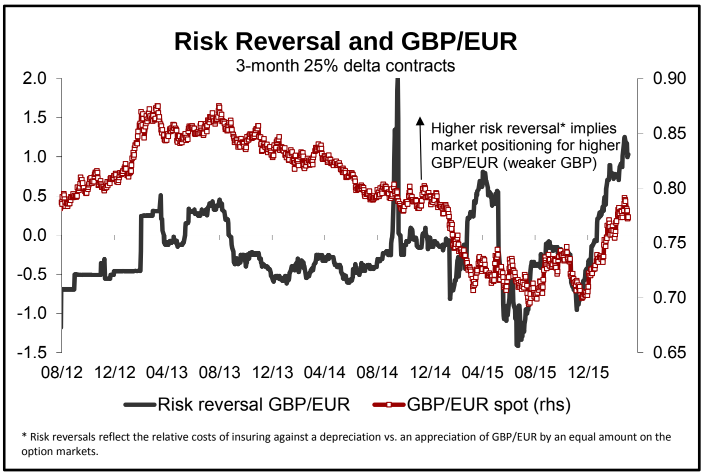
Given that funding sources of the large trade deficit would come under pressure in case of a Brexit, a strong depreciation of the British pound is likely, with a temporary intitial undershoot (see further below). This would increase the competitiveness of UK exports, but should also raise import prices. The BoE sees (rough and ready) an exchange rate pass-through on CPI inflation of about 20%-30%. A 15% weaker sterling may thus increase inflation temporarily by roughly 3.5 pp. High economic and political uncertainty (PM Cameron would likely have to resign) would also negatively affect investments (and to a less extent consumption). This would push the BoE into a stagflation dilemma, to either fight rising inflation (by raising rates and support capital inflows) or support growth. However, as the inflation effect will be only temporary, we would expect the BoE to stay put or respond only very mildly. Fiscal policy is not in a good position to help as well, due to a budget deficit of around 3% of GDP in 2015. Given the strong rise in uncertainty, BoE and IMF "uncertainty models" predict a loss in GDP growth by 1-1.5 pp with a maximum impact after four to six quarters. Thus our 2017 forecast would drop from 2.3% to around 1%.

Potential growth likely to be dented mildly

Long-term, the impact on potential GDP growth (IMF estimate 2.1%) will be key. This will depend very much on the exit deal and new British legislation. The major impact is likely to come from reduced immigration. The UK Office for Budget Responsibility estimates that inward migration adds on average 0.5 pp per year to potential growth over the next five years. A sharp cut-off of EU migration would certainly reduce this number. However, the UK is also likely to change immigration legislation to more cherry-picking the "brightest" around the world, instead of shutting off completely. Thus, this contribution to growth might be reduced to about a half while labor productivity could even benefit slightly. With regard to financial services, we deem loss of potential growth of 0.1-0.2 pp realistic. In sum, we see potential growth reduced by 0.3 -0.4 pp, resulting in 1.7-1.8% growth per year over the medium term.

Strongest financial market impact on FX

On financial markets, a 'Leave' vote would likely impact the foreign exchange markets most strongly. 'Brexit' uncertainties have made the British pound suffer already meaningfully over the first two months of the year, making it the worst performing G-10 currency (-4.6% vs. US dollar). This was associated with a sharp increase in the costs of insuring against further sterling depreciation on the option markets, as reflected in risk reversals (see chart).

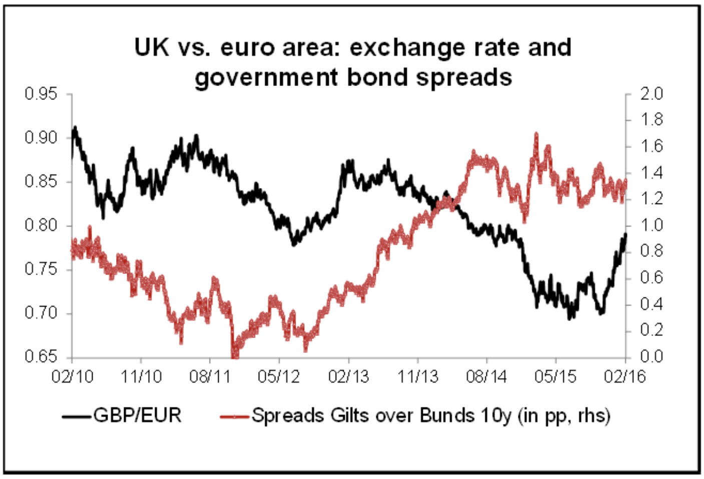


Key reason is Britain's current C/A which requires continued capital inflows. A 'Leave' vote runs the risk of draining these inflows, forcing the currency to weaken. In an extreme case, a forced sudden closure of the C/A deficit (of 3.7% of GDP in Q3 2015) may require a roughly 16% weaker trade-weighted sterling if sensitivity estimates from the IMF are applied.

This scenario of a full drain of capital inflows may be exaggerated. However, in the short term, sterling may need to undershoot temporarily to levels low enough to compensate foreign investors for the higher risk premium on GBP to allow for subsequent gradual appreciation.

With the euro area accounting for almost 50% of the trade with the UK, the depreciation would need to be reflected in a lower GBP/EUR. From current levels at around 0.77 GBP/EUR, 16% weakness would be consistent with readings close to 0.90 GBP/EUR, around the levels last seen in mid-2011. However, depending on the political response to the task of negotiating the terms of the 'Brexit', the temporary undershoot could easily be stronger.

Further out, with a 'Brexit' also raising doubts about the stability of the rest of the EU, we may also see the euro more severely affected. With disintegration forces and economic uncertainties rising, the ECB may again be in the focus, as the ultimate institution guaranteeing a smooth functioning of the economy. This means that, in the medium term, sterling weakness should prove more pronounced against the US dollar than against the euro.



Impact on Gilts and equities more moderate

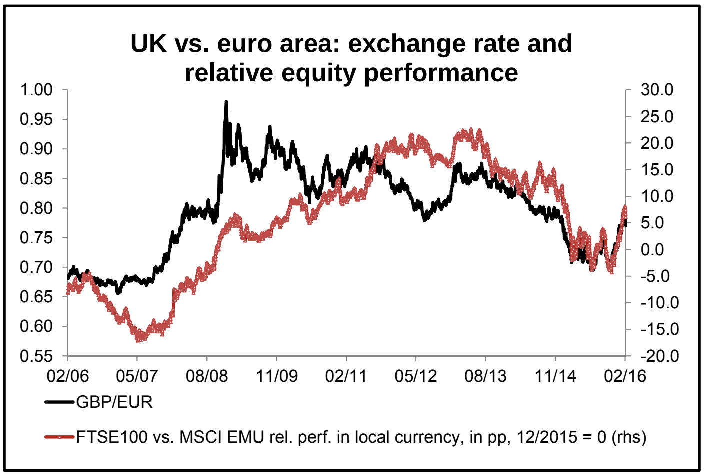
Short-dated British government bonds will remain tied very much to the outlook for monetary policy. With the BoE likely to tolerate a temporary inflation overshoot instead of hiking rates prematurely, we do not expect a 'Leave' vote to strongly impact short-dated Gilts.

Regarding longer maturities, a sharp drop in the exchange rate and the resulting rise in inflation uncertainties may raise the Gilts' term premium. There may also be concerns about a deteriorating fiscal position of the UK on receding immigration and a generally weaker growth outlook. That said, these upside forces on yields may be partially offset by a safe haven flight to Gilts among domestic investors given political and economic uncertainties. Similarly, the weaker growth outlook is likely to keep a lid on real yields.

Resilience of Gilts has also been a striking feature of recent weeks. Despite the slide of the British pound, spreads of Gilts over Bunds have remained in a very tight range despite the rise in 'Brexit' concerns.

Broader uncertainties would make both British and European equities suffer amid rising risk aversion. In euro terms, UK stocks' would be harmed additionally by a weaker pound, the legal and political uncertainties and a deteriorating growth outlook, with banks particularly vulnerable to the uncertain future of the City.

In local currency terms, however, losses on British equities should be more moderate. With more than three quarters of revenues of FTSE100 firms coming from abroad, a weaker exchange rate will help to cushion the impact on earnings and value of stocks in GBP terms.



Imprint

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