



Great Britain Votes to Leave the European Union

June 24, 2016

Global economic and political uncertainty has increased in the wake of the United Kingdom vote to leave the 28-nation European Union (“EU”). With 51.9% voting to “Leave,” the referendum has divided the country by age and location, with only London and Scotland overwhelmingly favoring “Remain.” Conceding defeat, Britain’s prime minister, David Cameron, has announced his resignation.

Market Response

Risk premia are rising as investors flee to perceived safety assets. Other than bonds, gold, Japanese yen and Swiss francs, most other assets, especially risk assets such as equities, are sliding in global markets. The British pound reached a 31-year low versus the US dollar in intra-day trading. Within the UK, financials shares are among the hardest hit, while companies with globally diversified economic exposure have proven more resilient. Central banks globally are demonstrating their commitment to maintaining financial stability. Bank of England (“BoE”) Governor Mark Carney emphasized the ability of the BoE to infuse the markets with liquidity if needed, pledging an additional £250 billion of funding for the financial system. The US Federal Reserve promised to provide funding to other central banks, if necessary.

The Withdrawal Proceedings and Broader Implications

The referendum has committed the UK to severing its 43-year EU membership, but the withdrawal process will take time. In the Lisbon Treaty, Article 50 provides that the EU will negotiate a new agreement with the withdrawing country over two years. The article also specifies that, while agreeing to a new deal, the EU acts unilaterally, without any obligation to consult with the country that is leaving.

No one knows what type of relationship a departed Britain will have with the EU. There is no precedent except for Greenland, an almost insignificant comparison with the UK. The other EU countries have little incentive to act generously toward Britain. Negotiations will be tough, as Britain’s referendum decision could spark a populist wave of disillusioned European voters. Imminent elections in Spain, France and Germany may clarify the mood of the Continental European voters, who may also lean towards nationalism and anti-immigration platforms.

A key risk to the UK is a reduction in trade with EU countries. Over half of all British exports go to the EU, yet Britain accounts for only 10% of EU exports. Will the leadership from industries critical to Europe, such as automotive, push the EU negotiators to strike favorable trade terms with the UK? Given the interdependency between the UK and the EU member countries, we should expect some concessions on both sides. Shrinking trade implies a further deterioration of Britain’s current account deficit, and downward pressure on the pound sterling (“GBP”). The UK is the largest net foreign direct investment recipient in the EU and will likely make every effort to ensure that level of investment continues. The departing member also risks exclusion from EU-negotiated free trade deals with the US, China, and India. Finally, Scotland which voted to stay in the EU, may call another referendum to leave the UK.



For all of Europe, a further decline in bond yields and even flatter yield curves suggest additional headwinds to economic growth and credit creation. In order to counter the negative effects of Brexit, we would hope that Germany boosts fiscal spending and the major European countries accelerate reforms to make the EU more cohesive. This crisis could provide the political capital needed for pro-growth measures in the EU.

Eurosceptic movements among remaining members may further strain the bloc. Greater integration among member states would be a beneficial outcome, but for the EU to move forward, it must overcome deeply entrenched opposition to change. Further adjustments in relative costs and prices are required, as is an agreement on a joint-and-several-liability mechanism for Eurozone debt. Since this requires some form of supra-national control over fiscal policy and with it a loss of fiscal sovereignty, progress will likely be painfully slow, and require many political negotiations.

Causeway Equity Strategies: Portfolio Analysis

We expect markets will adjust to a new level determined by the ramifications of the leave vote. We have no immediate changes to implement in client portfolios until prices stabilize and policy makers respond. We conclude, however, that, in the short-run, a slowdown in UK investment is likely. The long-run implications are less clear. Irrational selling of equities will probably uncover some buying opportunities for our fundamental value portfolios—across several industries and regions. As occurred in the Asian Crisis of 1997, the bursting of the telecommunications-media-technology bubble in 2000, the global financial crisis, the euro crisis, and this historic UK vote, investors typically sell indiscriminately. In that scenario, we are ready to add some of the world's best positioned companies to our client portfolios. We prefer companies with robust balance sheets, generous dividend payouts and the capacity to engage in share repurchases, in this period of uncertainty in Europe. If these buy opportunities arise, we would fund these purchases with the sale of stocks with inferior risk-adjusted return potential.

Below, our fundamental and quantitative investment team provides additional analysis of the challenges and opportunities presented by the Brexit decision.

Cluster 1: Financials and Materials

European and UK bank stocks in the portfolio have swooned in price in the wake of the UK vote. However, several of these stocks have only just returned to price levels of one week ago. Unlike the 2008 global financial crisis, we do not expect the fracturing of the EU to drive the large European banks to the brink of insolvency.

Financial firms with more diversified sources of operations and income fared somewhat better but still were some of the worst performers on the day. This makes sense, given the sensitivity of profitability to the global economy. Today's performance was closely correlated with underlying income exposure to the UK and peripheral Europe. With London operating as one of the world's global financial hubs, most financials firms have some UK exposure.

Banks and insurance companies are in better balance sheet health to weather a deterioration in their profitability over the next couple of years. The two UK-listed banks in client portfolios, Barclays and Lloyds, will likely incur setbacks to earnings growth due to modestly rising credit costs. Their capital adequacy, however, should not be threatened. The most likely source of this deterioration will come from weaker



revenues and higher impairments. We are comfortable with the capital positions of our holdings but undoubtedly as profit growth slows, capital returns/dividends will be impacted. Depending on how the exit negotiations proceed, we will be monitoring other potential impacts such as “ability to operate/passport” in certain jurisdictions.

Regarding the materials sector, both our global and international portfolios have no direct exposure to non-chemical stocks in the materials sector. Most of these businesses are also very sensitive to global economic activity and could see a significant decrease in demand for their commodities if global GDP slows. These stocks all corrected significantly today, and we will be monitoring the market for any potential valuation opportunities.

Cluster 2: Telecommunication Services and Information Technology

Economic sensitivity, balance sheet strength, currency of listing, and underlying geographic exposure have driven price movement in stocks within the telecommunication services and information technology sectors. The portfolio’s telecommunication services holdings are modestly exposed to the UK and the EU, the areas that have the most medium-term operating risks. Vodafone is our only European telecommunications holding and has direct exposure to the UK and EU (and related currencies), but the business does not have significant currency mismatches. In addition, Vodafone’s balance sheet is strong and the operating characteristics of the business are stable. Our Asian holdings should have little direct impact and we remain confident in the short and long term fundamentals of these businesses.

In our global value portfolios, we have substantial US information technology holdings, primarily in mature, less cyclical, and well capitalized businesses, like Microsoft, Oracle and Qualcomm. These businesses do have some economic sensitivity, and have UK/EU exposure, but their business models are somewhat defensive. Our non-US information technology holdings are limited. Germany-domiciled enterprise software firm SAP does have general exposure to continent-wide economic weakness, but a large portion of its revenues are recurring. We do not expect Baidu, the Chinese internet search giant, to be significantly impacted. South Korea-listed Samsung Electronics is perhaps the most economically exposed of our non-US technology holdings. However Samsung has structural advantages over semiconductor peers in cost, technology and financial strength, and has decent self-help opportunities in its handset business.

Cluster 3: Energy and Utilities

Economic uncertainty from the Brexit vote could impact oil prices, as global oil demand declines due to a more challenged economic outlook. A prolonged economic malaise in Europe, which comprises 15% of global oil demand, and the broader global economy would lower oil demand. The impact of demand reduction could be offset by a lower oil supply outlook, as the recovery in global exploration & production capital expenditures is further delayed by renewed macroeconomic uncertainty. Additionally, further strengthening of the dollar will likely put pressure on oil prices in the short term. We believe the recovery to a normalized oil price due to the rebalancing of supply and demand will still happen, though it may now take longer than the market previously anticipated.

Given the global nature of the businesses of energy holdings Royal Dutch Shell, Total, and CNOOC, except for the impact from oil prices, we expect only modest impacts from Brexit. The financial strength of these companies should allow them to withstand any short-term financial crisis in the market caused by Brexit



turmoil. For US energy companies in the global portfolio, the impact should be muted apart from volatility in commodity prices.

The story is somewhat different for the utilities we hold in the portfolio. SSE is a UK-integrated utility based in Scotland with a robust balance sheet profile. The immediate impact from Brexit is expected to be minimal due to the fact that 100% of revenues are from the UK and Ireland, and utility business sensitivity to macroeconomic weakness is relatively low; in fact, there is likely a modest positive earnings benefit from higher power prices and inflation caused by the weaker Sterling. However, another Scottish referendum would increase uncertainties surrounding the remuneration schemes for renewable assets (20% of earnings) currently integrated with the broader UK system. Engie is a French-integrated utility with assets globally, also boasting a strong balance sheet. With its global portfolio of regulated assets, commodity price sensitive businesses and US dollar denominated business, the direct impact from Brexit is expected to be relatively modest. Though Engie's European business is 50% of profits, two-thirds of those profits are regulated. About 20% of profits are US dollar-based and therefore may benefit from the depreciation of the euro.

Cluster 4: Industrials and Manufacturing

Our industrials and manufacturing holdings are diversified by both industry and geography. Many of the businesses in client portfolios, like East Japan Railway and Japan Airlines, have limited exposure to Europe. Others, like Akzo Nobel and Linde, are large and diverse businesses that maintain substantial presences across the European continent, but also in the UK specifically. For these businesses, we believe that management can temper any impact on profits, the outlook remains encouraging, and the price movement of today has, in our view, more than compensated for a slightly weaker outlook.

Our UK-domiciled holdings remain equally diverse. Professional publisher RELX (dually listed in the Netherlands and the UK--we own the Dutch shares) generates only 8% of revenues in the UK, but maintains 17% of its cost base in the country, and as the market leader in legal publishing should remain a primary beneficiary of the administrative complexity associated with Brexit. Similarly Cobham, the aerospace and defense supplier, generates only 11% of sales in the UK and 15% in Europe, while retaining 46% exposure to the US. Though the heavy US dollar exposure is largely offset by US dollar debt, the long term contract oriented nature of the business and the recently strengthened balance sheet gives us some comfort in the outlook for the business.

Companies with more UK exposure include: Page Group (27% of sales are from the UK, 37% from other Europe) and Balfour Beatty (60% UK sales). Professional staffing has benefitted greatly from the free flow of labor between the UK and Europe, and the current situation promises to not only disrupt that dynamic but also lower business confidence at a critical time in the hiring cycle for Page. Similarly, Balfour will likely see uncertainty weigh on construction and civil spending until the political landscape stabilizes. While this should be somewhat offset by the foreign exchange benefits of a sizable US business, political brinksmanship and the ensuing gross domestic product ("GDP") deceleration add uncertainty to earnings forecasts.

Cluster 5: Consumer

Our consumer exposure can broadly be dissected into three distinct groups: 1) companies with minimal or no UK exposure, 2) large multinationals that operate "locally" across dozens of countries, and 3)



smaller, more domestically focused businesses. Our global portfolio is significantly weighted toward the first group with holdings like Cabela's (0% UK sales), Advance Auto Parts (0% UK sales) and PVH (3% UK sales), while our international portfolio remains heavily weighted to the second group. For instance, British American Tobacco, common to both international and global value strategies, generates 99% of its operating profit from outside the UK and 85% from outside Europe, and should not be significantly affected by recent events. Similarly, Diageo, as an exporter of Scotch, may see EPS upgrades as a result of a weaker sterling, while Carnival remains one of the most US-dollar exposed businesses in the FTSE Index.

More domestically exposed businesses, however, may encounter a challenging environment but comprise only small portfolio weights. Travis Perkins, as a business that is 100% exposed to UK construction and housing markets, faces a very unclear future in the face of slowing GDP, weakening consumer confidence, and political uncertainty. Also negatively impacted, Marks & Spencer, will see product costs increase on the back of a weaker sterling, as most clothing sold in the UK is imported from dollar based production facilities in Asia. While the direct impact on Marks & Spencer should be partially mitigated by the company's strong grocery franchise, and both companies retain strong balance sheets and sophisticated management teams, the uncertain consumer environment that will surely evolve over the next several quarters concerns us.

Cluster 6: Health Care

Healthcare stocks across our portfolios have shown little sensitivity to the outcome of the Brexit vote. The main issue for the portfolio holdings is related to currency. Our pharmaceutical holdings are global companies, where the UK is only a part of the overall revenues. Across our holdings, UK exposure is in the low single digits for both sales and earnings. Any slowdown in sales or impact of the weaker GBP are not material to reporting currency forecasts (with the exception of GlaxoSmithKline, which reports in GBP). GSK may actually see a benefit from currency moves (GBP is 5% of sales and 13% of costs). Bayer could also incur a modest positive impact from currency. We expect companies currently engaged in mergers & acquisitions (Bayer and Sanofi) to see more volatility given the impact of the macroeconomic uncertainty on these deals. We expect our US holdings, as well as our Swiss holdings, to see modest impact from the Brexit vote, mostly driven again by the currency.

Emerging Markets Equity

At present, emerging stock markets have fared better than Europe following the Brexit results. Of chief concern are the transmission links of any European fallout to emerging countries. Prices have declined the most in those countries with close ties to the UK (Poland, Hungary, Czech Republic), high-beta economies with susceptible currencies (South Africa, Turkey), and large foreign-denominated debts (Malaysia). However, we believe that the impact on emerging markets may be relatively less severe than in some European markets, for example. Central banks in the developed world have already indicated their readiness to provide liquidity where needed, which should calm global markets, and many central banks in emerging markets have the ammunition to ease monetary policy and/or intervene in FX markets to stabilize their currencies in the short term. The majority of Emerging Asia and Latin America, whose stock markets have held up well today, should be relatively unaffected unless there is a significant impact on global capital flows. Today's events highlight the importance of including top-down inputs in our



quantitative emerging markets alpha model, which penalize stocks in countries with unattractive macroeconomic characteristics and negative currency outlooks.

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