



Causeway Capital Management LLC

Market Commentary: Brexit Threat

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In mid-2016, UK voters will likely go to the polls to decide on a British exit, or “Brexit,” from the European Union (EU). If the electorate choose the “leave” option, this may place a drag on both the UK economy and stock market. UK-listed firms in the financial sector would likely incur a setback to their earnings from economic disruption. However, the extent and duration of any ill winds from the “leave” option remain difficult to quantify. The specific terms of how a withdrawal from the EU would be implemented have not reached the public. Causeway believes the risk of a Brexit in the next five years is low. However, we include the possibility of a Brexit in our downside scenario analysis for UK financial sector portfolio holdings. We estimate that the share prices of our clients’ UK financial holdings already incorporate a significant amount of downside risk.

The UK’s Conservative Party has pledged to hold a referendum on UK membership in the EU by the end of 2017, but appears ready to advance the schedule to late-June. The referendum will ask the electorate: “Should the United Kingdom remain a member of the European Union or leave the European Union?” A simple majority vote will determine the outcome, and the referendum will be binding. If the upcoming EU summit does not lead to an agreement between the EU and the UK, then the referendum may be delayed by a month or more. The UK is seeking favorable political and economic concessions from the EU and increased control over migration to Britain. As the public’s anxiety over refugee inflows to Britain rises, Brexit supporters may gain momentum.

The consequences of a vote for Brexit would likely include a change of government in the UK (with the resignation of Prime Minister Cameron, a split within the Conservative Party) and a renewed threat to the Union. The financial implications would depend on the terms the UK negotiates for its withdrawal. In an optimistic scenario, the UK would remain part the European Economic Area (EEA)—Europe’s internal market—and the impact on the economy and our clients’ UK financial holdings could be limited to short-term reactions to the vote. British insurers would likely still be able to “passport” insurance products, allowing them to sell insurance policies in EU member states without establishing local entities. However, we find it unlikely that the UK would remain in the EEA, as membership status would fail to address the primary concerns of the electorate voting to leave. A more probable outcome would be a renegotiation of the terms of trade with the EU. In this case, we believe the UK could slip into a recession post-departure. Credit and funding costs would rise, growth would slow, and fundamental valuations for our UK bank portfolio holdings could fall substantially. Insurers would also suffer from lower growth, higher impairments on their investment books, and higher costs of equity.

Resulting currency weakness of the British pound (GBP) could offset some of these economic pressures, but would have punishing translation effects for non-GBP-based investors. This is one of many downside scenarios we consider when evaluating the risk/reward tradeoff of our investments in UK financial sector companies.



We currently believe it more likely that, after renegotiations are complete, the UK electorate will place sufficient value on EU membership to vote in favor of the status quo. At present, EU membership combines with the UK's other strengths (relatively low levels of regulation, established legal system, English language) and allows the UK to specialize in high value added sectors, especially commerce and financial services. This has contributed to making the UK a relatively prosperous developed market economy, and one that attracts large amounts of foreign direct investment. We estimate that Brexit could reduce the UK's real gross domestic product growth rates by 1-2 percentage points, with a 10-20% decline in the pound sterling's trade-weighted exchange rate. Fiscal contraction may prove to be the most unsettling prognosis for Brexit in the eyes of the electorate. Weaker growth typically depresses tax revenues, worsening the public sector deficit and impacting social welfare spending.

We believe that the UK electorate will likely follow the lead of the Scottish voters in their 2014 independence referendum. Despite the mixed poll data, the Scots voted definitively for the status quo, recognizing the benefits of remaining in a larger economic zone. As public campaigning accelerates, voters will learn that Brexit could do even more damage than simply handicap the UK economy. Brexit could embolden anti-EU movements across Europe, encourage more national referenda for separation, thwart intelligence sharing and compromise EU-wide security, and reverse the gains from an open market with rising protectionism.

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