June 8, 2016

Brexit referendum – three scenarios

1. Introduction and scenarios outlined

UK voters go to the polls on June 23 to vote in the so-called Brexit referendum held under the European Union Referendum Act of 2015. Voters will answer a single question: "Should the United Kingdom remain a member of the European Union or leave the European Union?"

This is a simple majority vote. The result – "remain" or "leave" – will be adhered to, however small the majority either way. The overall result is likely to be declared after European and London market-opening on Friday morning.

Unusually for the UK, there will be no "exit poll" immediately after the polls close on Thursday evening. This is apparently because polling experts are not confident in the ability of an exit poll – however structured and conducted – to give a dependable result. However, declarations by the local centers throughout the night may start to give an indication of the likely outcome.

While the result of the vote is binary – "remain" or "leave" – the economic and market implications are less clear cut. They may be affected, for example, by the size of the majority, either way, and the reactions to the referendum result within British political parties.

We therefore follow an initial discussion of the referendum campaign and the state of the British economy with three broad scenarios, as below.

Clear "remain"(i.e. more than 55% of those voting vote to "remain", the "Brin" scenario)

Narrow "remain" (i.e. between 50% and 55% of those voting vote for "remain")

"Leave" (i.e. more than 50% of those voting vote "leave")

Please note that we do not attach a probability to each scenario, and the ordering of the scenarios is not meant to imply their relative likelihood. We do not have a "narrow leave" scenario as we believe that the results under this scenario would be very similar to the "leave scenario" – with one important possible exception relating to Scotland, as is discussed below. We provide two time periods for each scenario - the next three months and the longer-term. We look first at the political implications, then the likely economic and market outcomes.

To summarize our conclusions: do not assume that the referendum will fix everything immediately. Under two of the three scenarios ("leave", "narrow remain") volatility is likely to remain high, but should subside under the latter; volatility should be much lower under the "clear remain" scenario, but even this has its risks. In the case of a "remain" or "narrow remain", the initial market rally may also be lower than some are anticipating; the markets will move quickly on to focus on other issues.

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CIO insights NOTE

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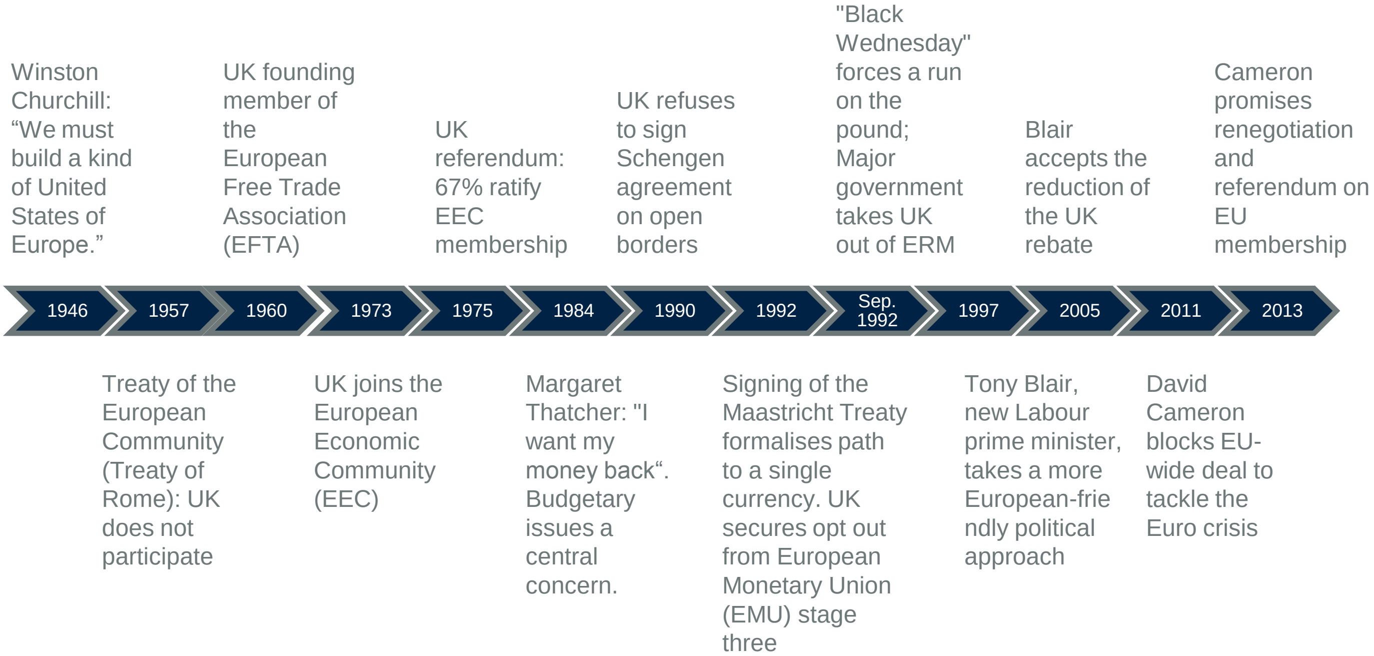
The UK and EU: Sixty years of ambivalence

Britain was not a signatory to the Treaty of Rome in 1957 that established the European Community. Membership of what had by then become the European Economic Community (EEC) had to wait another 16 years, to 1973. However the Conservative government that had negotiated membership was shortly afterwards forced from office and the incoming Labour government honored its manifesto commitment to hold a referendum on EEC membership. This took place in 1975 – the first referendum ever held across the whole of the UK. The Labour government was itself split on the issue (as the Conservatives are today); nonetheless a substantial (67%) majority of those voting opted to stay in the EEC.

This did not stop continuing British skepticism about the EU. During the 1980s, the Conservative prime minister, Margaret Thatcher, took a particularly tough line on budgetary issues - although this did not stop the UK playing a constructive role in other EU developments, notably regarding the single market. In 1990, the UK did not sign the Schengen agreement (on the free movement of people) and in 1992 secured an opt-out in the path to monetary union (before leaving the exchange rate mechanism, ERM, later that year). The return of a Labour government in 1997 was accompanied by more European-friendly rhetoric, but the emergence of a Conservative-led government in 2010 coincided with the escalation of stresses in the EU in the wake of the financial crisis, reopening old divisions within the party. The prime minister, David Cameron, committed himself to renegotiate the UK's membership terms and then hold a referendum to ratify this. Complex political maneuverings followed, with renegotiations concluded at a European Council summit in February 2016. Cameron immediately announced a June 23 referendum date, confirming that the government would support the "remain" option. However, cabinet ministers were to be free to campaign on either side (as in 1975). This decision acknowledged the profound splits within the Conservative party on the issue.

Figure 1: The UK and Europe – a political time line



2. The Referendum Campaign

In February 2016 Mr. Cameron had in fact won some meaningful commitments from the European Union on various issues including migration and migrant benefits. However these concessions were set out in a very broad-brush way without much detail. Some also argued that several of the concessions could be challenged in the European Courts. In the event, Mr. Cameron's February 2016 achievements failed to win over doubters in his Conservative Party and probably have had little impact on general voting intentions.

The referendum campaign got properly underway on April 15 and quickly slotted into a predictable pattern. One initial focus was on the economic benefits/costs of leaving, with "remove" campaigners relying on analysis from H.M. Treasury and various international organizations for "remain"; analysis for the "leave" campaign has generally been provided for by private sector economists. "Remain" supporters have put the emphasis on the potential disruption from a "leave" decision; "leave" supporters the possible longer-term gains from moving to a lower-regulation, independent regime.

After the conclusion of regional and local elections on May 5, the gloves came off within the ruling Conservative party – the obvious split being between Cameron and his Chancellor, George Osborne (both "remain") and Michael Gove and Boris Johnson (the justice secretary and former mayor of London respectively, both "leave"). As a result, attention has broadened out from just the referendum itself to the result's implications for the Conservative Party itself. The party has a long history of splitting over trade issues – notably over the Corn Laws (1846) and Imperial Preference (1906).

One notable non-participant in the debate has been the European Union institutions or other European countries – although President Obama has recommended a "remain" vote. Any intervention from the European Union or an individual European leader (e.g. Mrs. Merkel) would need to be carefully calibrated in order not to prove counter-productive.

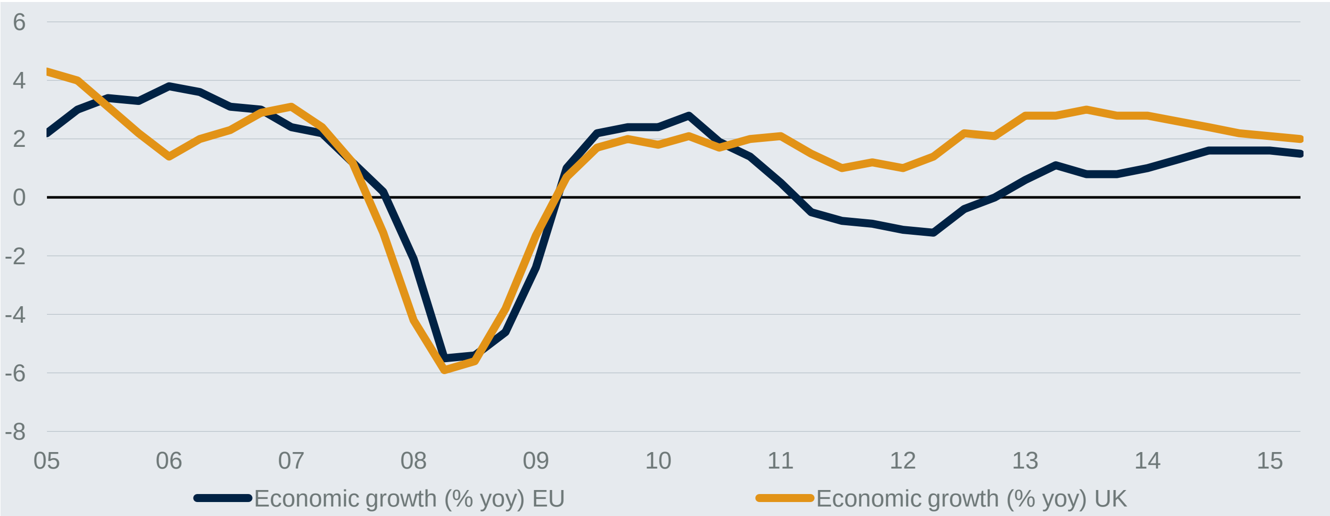
The tone of the campaign may become increasingly acrimonious in its closing weeks, with voter alienation a real concern, particularly if the scheduled TV debates prove scrappy. Opinion polls have been widely distrusted in the UK since their performance in the 2015 general election, meaning that even if they reveal a major shift to "remain" or "leave", few will see the result as a foregone conclusion until the polls have closed. Voter turnout may prove a key factor: older voters are seen as more likely to be "leave" and more likely to turnout on the day, with younger voters "remain" but perhaps less likely to vote. So this should be an electoral oddity: the old perhaps voting to overthrow the status quo, the young to keep it.

3. The state of the UK economy

To understand the possible impact the referendum outcome may have on the UK economy, it is necessary to understand its current state.

For some years, the UK has grown more strongly than the aggregate Eurozone economy (Figure 2) and inflation has remained low. However, more recently, there has been considerable debate as to whether Brexit-related uncertainty has hurt the UK economy. There is some evidence that it has, but this is not conclusive. GDP growth (QoQ) dropped to 0.4% in Q1 2016 from 0.6% in Q4 2015. Wages growth has also slowed slightly, to 2.1% in the three months ending in April 2016 from 2.2% in the equivalent period ending in March, but other labor market measures remain solid and unemployment remains low. This is important as UK growth is heavily dependent on a continued expansion in private consumption: government consumption provides no boost to growth.

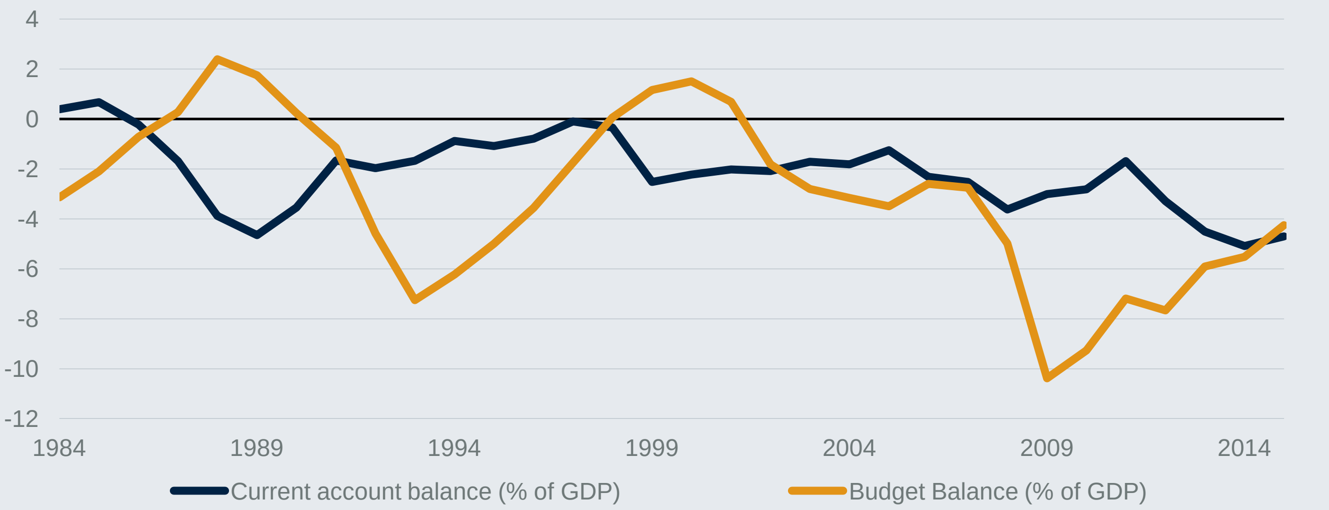
Figure 2: UK and EU growth rates compared



Source: Bloomberg Finance L P. Data as of June 1, 2016.

The two obvious pressure points are the UK's current account deficit (5.2% of GDP in 2015) and its budget deficit (4.9% in 2015). Recent trends here are illustrated in Figure 3

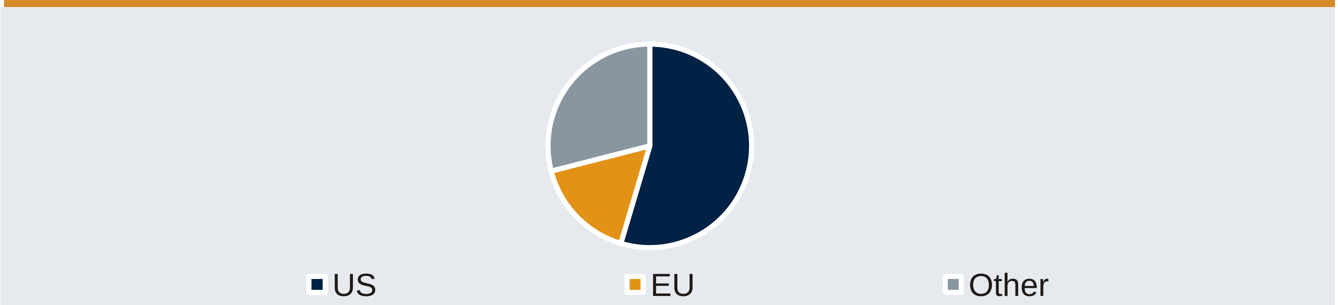
Figure 3: UK and EU growth rates compared



Source: Bloomberg Finance L P. Data as of June 1, 2016.

The current account deficit must be financed, loosely speaking, by investments from foreigners in the UK. To some extent, government spending is also impacted by foreign portfolio investments as this enables the private sector (which does not need to buy government bonds to enable government spending) to consume more as well (in the form of imports). This excess spending must be equal net saving of the private sector and net government borrowing abroad. This has focused attention on the likely impact of the "Brexit" decision on foreign direct investment. At present net foreign direct investment flows are increasingly from the United States while the EU's share has declined – in 2014 the US accounted for 54.6% of net FDI flows (Figure 4). Nevertheless, the EU still has the largest total foreign investment position in the UK (48% in 2014).

Figure 4: Net FDI Flows by Origin in 2014



Source: U.K Office for National Statistics, Deutsche Bank Wealth Management. Data as of June 1, 2016.

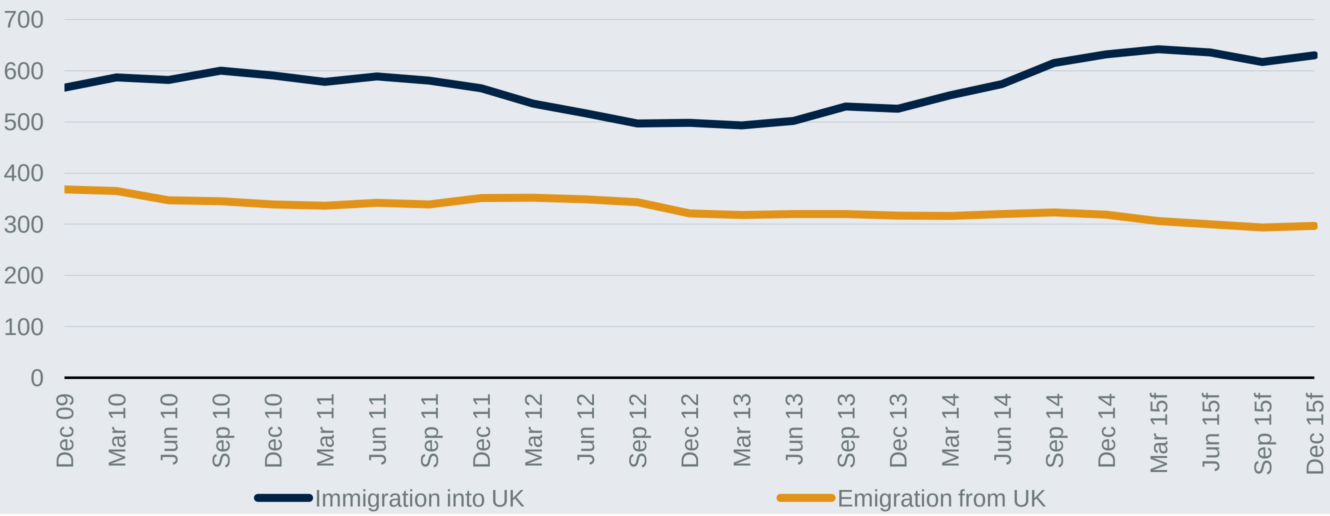
If the current account deficit – and thus the dependence on inward investment to finance it – is to be reduced, then government spending would in theory need to decrease or private saving would have to increase – both of which look unlikely in the short term and would have a negative effect on growth.

However, a range of other factors will also affect the UK's current account. At present the UK runs a slight surplus in services trade with the EU, mainly from likely financial and business services. One concern therefore has been that the impact of a "leave" decision on regulatory issues (e.g. passporting, i.e. carrying out business in other EU countries; the Markets in Financial Instruments Directive, MiFID, which governs the provision of financial services) could force corporations (especially banks) to relocate to the EU or lead to a costly adaption of necessary measures to overcome regulatory hurdles (at a national and/or corporation level)

By contrast, the UK has a large deficit in merchandise trade with the European Union. But the existence of a deficit does not necessarily imply that the UK is the only vulnerable party: the Brexit decision will may have major implications for the rest of the EU, and Germany and Ireland in particular.

According to a Centre for Economics and Business Research (CEBR) study, published back in 2011, roughly 4.2mn jobs (13% of total employment) depend on exports to the EU: 75% are directly attributable with the reminder as a second-round effect. Around one quarter of all jobs in the financial sector are thought to depend on the EU. (This is not to imply that a Brexit would put all these jobs at risk, as some form of trade relation would be maintained.) In regards to population, the UK Office for National Statistics estimates that population growth under a "zero-migration" scenario could come down from 0.7% YoY in 2016 to 0.3% YoY in 2020 and this could lower potential GDP growth by 0.1% per year; set against this could be the increased economic dynamism that "leave" supporters claim would come from the move to a less-regulated, freer-trading economic environment outside the EU. Figure 5 gives recent net migration data.

Figure 5: UK migration data



Source: UK Office for National Statistics, Deutsche Bank Wealth Management. Data as of June 1, 2016.

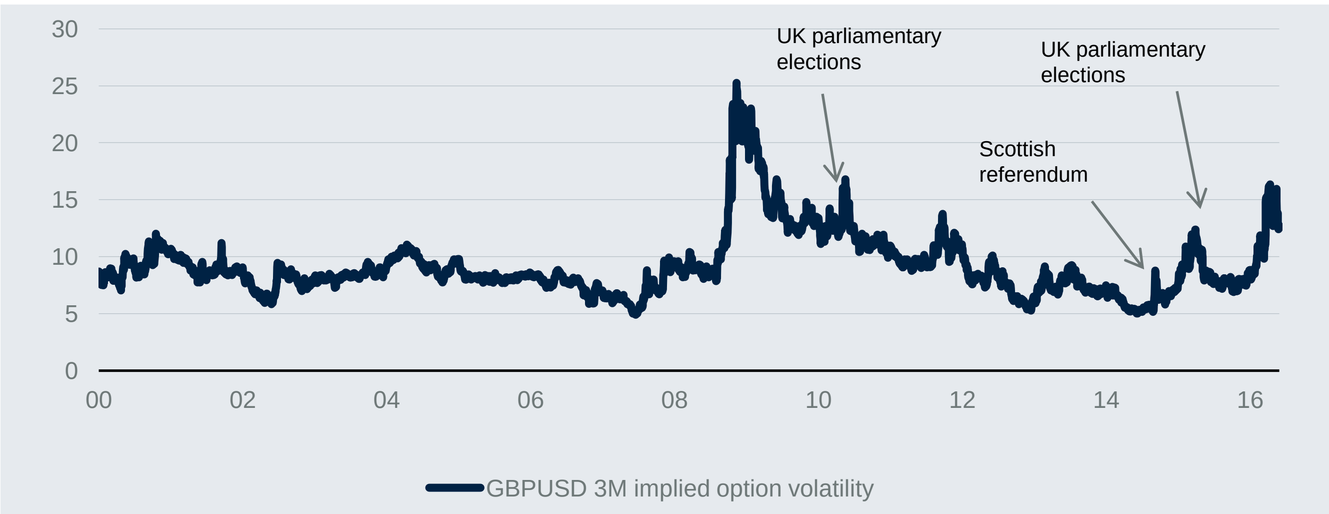
As the referendum campaign has heated up, its obvious impact has been on sterling (GBP) – which is likely to remain a key transmission mechanism after the referendum, whatever its the result. This is not unprecedented: the currency has reacted in the past to periods of political uncertainty or economic regime shift, as is shown in Figure 6.

Figure 6: GBP vs. USD since 1990

Source: Bloomberg Finance L P, Deutsche Bank Wealth Management. Data as of June 1, 2016.

However, the risk premium on the FX options market is now higher than in former politically-induced periods of uncertainty (Figure 7), reflecting the seriousness with which markets regard the issue. As the currency will likely be affected by the decision, the level of option volatility has reached similar or even higher levels than in recent elections

Figure 7: GBP risk premium on FX options market



Source: Bloomberg Finance L P, Deutsche Bank Wealth Management. Data as of June 1, 2016.

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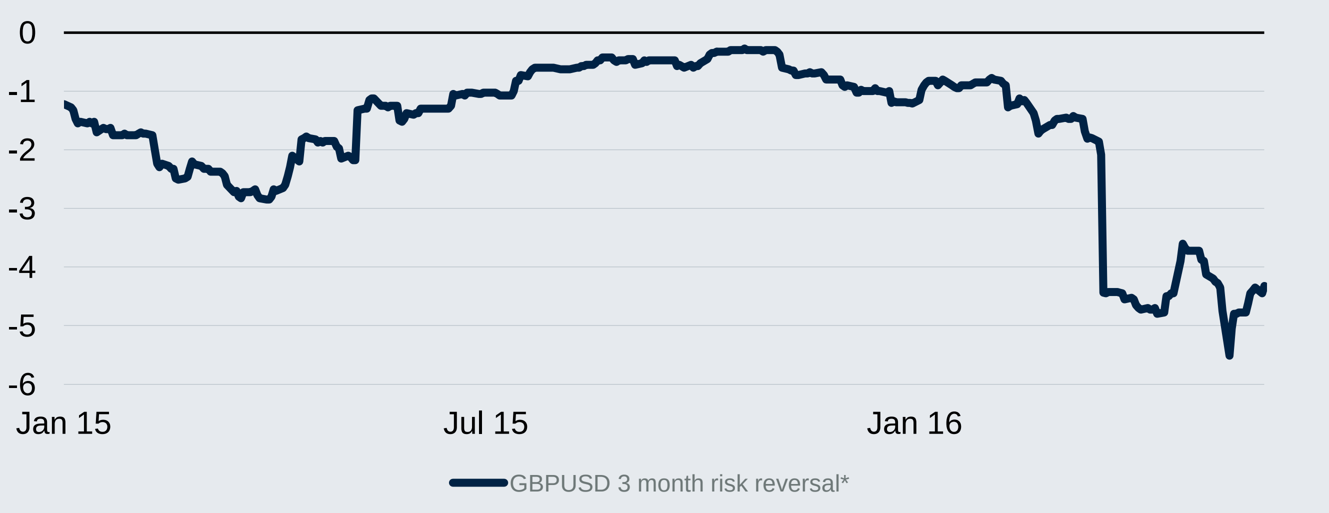
This increased level of concern has also resulted in demand for protection against currency movements. The GBPUSD 3 month risk reversal (Figure 8) is a measure representing the difference in the implied volatility for call and put options in the forex market. More negative values signal demand for buying downside protection for GBP.

Figure 8: GBPUSD 3 month risk reversal in 2016



Source: Bloomberg Finance L P, Deutsche Bank Wealth Management. Data as of June 1, 2016.

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Figure 9 provides an overview of recent UK data.

Figure 9: Recent UK data

	Q2 15 May	Jun	Q3 15 Jul	Aug	Sep	Q4 15 Oct	Nov	Dec	Q1 16 Jan	Feb	Mar	Q2 16 Apr	May
Consumer Prices													
Consumer Price Index (yoy %)	0.1	0	0.1	0	-0.1	-0.1	0.1	0.2	0.3	0.3	0.5	0.3	
CPI ex-Food & Energy (yoy %)	0.9	0.8	1.2	1	1	1.1	1.2	1.4	1.2	1.2	1.5	1.2	
Producer Prices													
PPI Mfg. Input Prices (yoy %, nsa)	-11.9	-13	-12.8	-14.6	-13.4	-12.3	-13.1	-10.4	-8.1	-8	-6.1	-6.5	
PPI Mfg. Output Prices (yoy %, nsa)	-1.6	-1.5	-1.6	-1.9	-1.8	-1.5	-1.6	-1.4	-1	-1.1	-0.9	-0.7	
PPI Output Core (yoy %, sa)	0.1	0.1	0.2	0	0.2	0.3	-0.1	0.1	0.1	0.2	0.3	0.5	
Economic Activity													
Industrial Production (yoy %, sa)	1.4	1.5	0.6	1.6	1.3	1.6	0.9	-0.2	0.6	0.1	-0.2		
Manufacturing Production (yoy %, sa)	0.2	-0.1	-1.4	-1.1	-0.5	-0.2	-1.2	-1.7	-0.4	-1.6	-1.9		
Index of Services (avg 3-mo % chg)	0.3	0.6	0.7	0.8	0.7	0.6	0.7	0.8	0.9	0.8	0.6		
Business Conditions													
Markit/CIPS UK Composite PMI (sa)	55.8	57.4	56.7	55.3	53.3	55.3	55.7	55.2	56.2	52.7	53.6	51.9	
Markit/CIPS UK Manufacturing PMI (sa)	51.9	51.6	52.1	51.8	51.7	55.2	52.4	51.8	52.9	50.7	50.7	49.2	
Markit/CIPS UK Services PMI (sa)	56.5	58.5	57.4	55.6	53.3	54.9	55.9	55.5	55.6	52.7	53.7	52.3	
Leading Indicators													
OECD UK Leading Indicator	110.6	110.6	110.7	110.6	110.6	110.6	110.7	110.7	110.8	110.9	111		
OECD UK Leading Indicator (yoy %)	1.2	1.1	1	1	0.9	0.8	0.7	0.6	0.6	0.5	0.6		
Housing Market													
Nationwide House Price (yoy %, nsa)	4.6	3.3	3.5	3.2	3.8	3.9	3.7	4.5	4.4	4.8	5.7	4.9	
RICS House Price Index (% balance)	33	40	43	52	44	49	49	50	48	50	42	41	
HBOS House Price Index (yoy %, 3-mo avg)	8.6	9.6	7.8	9	8.6	9.7	9	9.5	9.7	9.7	10.1	9.2	
Retail Sector													
Retail Sales (yoy %)	4.2	4	4.4	3.2	6	3.3	3.4	2	4.9	3.8	2.6	4.2	
Financial Sector													
BoE Base Rate (%)	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
3-Month Libor Rate (%)	0.57	0.58	0.58	0.59	0.58	0.58	0.57	0.59	0.59	0.59	0.59	0.59	0.59
10-Year Gov't Bond Yield (%)	1.81	2.02	1.88	1.96	1.76	1.92	1.82	1.96	1.56	1.34	1.41	1.6	1.44
Equity Market (FTSE 100 Index, 000s)	6.98	6.52	6.7	6.25	6.06	6.36	6.36	6.24	6.08	6.1	6.17	6.24	6.27
USD/GBP Exchange Rate	1.53	1.57	1.56	1.53	1.51	1.54	1.51	1.47	1.42	1.39	1.44	1.46	1.46
Pound Major Currency Index	90.7	92.7	93	91.5	90.7	92.8	92.9	90.3	87.2	85.1	84.6	85.8	87.7

Source: Bloomberg Finance L P. Data as of June 1, 2016

4. Scenario 1: Clear "remain"

First three months

Politics: Status quo preserved, for now.

In this scenario – which could be labeled "Brin" – the assumption would be that Mr. Cameron and his strongly pro-"remain" Chancellor, George Osborne, stay in office, and that the ruling Conservative party can patch over their internal differences, allowing them to remain a functioning government. (They only have a majority of 17 in the House of Commons, so cannot afford many defectors.) However, this cannot be guaranteed.

A warm – if carefully crafted – response from other European leaders and EU officials would aim to reintegrate Britain into the European political process, and possibly offer some more detail on the concessions obtained by Mr. Cameron in February 2016.

Economy: Modest positive effect.

A clear "remain" decision could have a positive effect on the economy, if delayed foreign investment then goes ahead and consumer and business sentiment recovers. However, the direct impact on a clear "remain" on household consumption – the key driver of GDP growth is expected to be minor, particularly as the improvement in the labour market could moderate and wages growth could also slow further. GDP growth is forecast at around 2.0% in 2016 and 2.1% in 2017 under this scenario. (The 2016 forecast had already been revised down slightly because of uncertainty around the Brexit campaign.) Consumer price inflation is expected to average around 0.6% in 2016 and 1.8% in 2017.

Markets: Initial rally

The immediate market response would generally be positive, although the size of the rally would depend on to what extent the markets had already factored in a "remain" vote. It may only be modest. The most obvious (and rapid) response would be a bounce in the GBP (and EUR) vs. USD. U.K. government bond yields are expected to move higher due to less "safe haven" demand and as the focus is likely to turn back to the inflation outlook and monetary policy. U.K. and European equities would rally as uncertainty and risk premium is removed from markets. Less market and economic uncertainty might make a UK interest rate rise feasible - but we think BoE will sit on its hands for now.

Strategic implications (3+months)

Politics: No guarantees

UK domestic political risks would be lower than in the other two scenarios, but still remain. Mr. Cameron's continued leadership of the Conservative party would be more likely than in the other two scenarios but cannot be guaranteed. Political risks within other European countries would, everything else being equal, be lower than under the other two scenarios.

Economy: Half steam ahead

The assumption would be that foreign direct investment would remain at recent levels and that UK consumers would remain confident enough to spend. The Bank of England also seems likely to stay on hold for some time with a rate rise not expected before year-end (and this will be data dependent). The growth outlook will depend strongly, however, on developments in the European and global economies.

Economy: Half steam ahead

In this context, we note the "leave" supporters' argument that Britain could suffer in the long-term from being tied to a slow-growing region such as the Eurozone, rather than interacting more with faster growing regions.

Markets: More of the same

GBP would likely strengthen – we have an end-March forecast of 1.50 against USD and 1.43 against EUR. UK 10-year yields would rise, but only modestly – our end-March 2017 forecast is 1.90%. Core Eurozone yields would be likely to remain low. Investors would refocus their attention on UK and European corporates' fundamentals and the economy; substantial further gains in equities prices are unlikely over next 12 months. The Bank of England could raise rates in early 2017 if economic potentially recovery continues.

5. Scenario 2: Narrow "remain"

First three months

Politics: Domestic politics in the spotlight

Mr. Cameron and Mr. Osborne would remain under heavy pressure from within the Conservative party. Mr. Cameron could face a challenge to his premiership: a small number of Conservative MPs can force a vote of confidence in the parliamentary party and if Mr. Cameron loses this, he is out and cannot stand again. (What then happens is that Conservative MPs whittle down new prospective leadership candidates to two: the party's broad membership then chooses between them.) The replacement of a party leader does however not necessarily imply a new general election. Indeed, the Fixed-term Parliaments Act of 2011 means that a prime minister can no longer call an early general election. Instead, it requires two thirds of the House of Commons to vote for one, or for it to pass a vote of no confidence in the government (by a simple majority) and then to fail to pass a motion of confidence in a new government within 14 days. These new rules are untested.

Under this scenario of political uncertainty, other European Union leaders may find it difficult to deal with the British government, both while the Conservative party leadership election process goes on and after it concludes – particularly if Mr. Cameron's successor is committed pro-leave supporter. Within the UK, there could be calls for another Brexit referendum – but this would be most unlikely to happen but we believe this, at least over the short and medium term.

Economy: Less relaxed about the data

The general economic upward trend is likely to be maintained, but much will depend on the extent and duration of political uncertainty. This may also make everyone less relaxed about new economic data: it will likely resulting in additional scrutiny for evidence as to whether the economy is suffering from the political uncertainty.

Markets: Expect periods of volatility

An immediate positive market reaction to a "remain" vote may therefore be tempered by subsequent market considerations about what happens next, both in regard to the UK economy and UK politics. So, for example, the GPB would likely initially move higher but then be vulnerable to periods of volatility as the political situation unfolded.. The tendency for higher rates would remain, but the Bank of England would be unlikely to act. The presumption is that, as in the first scenario, gap between export and domestically-oriented UK companies, which had opened in the run up to the referendum, is likely to get tighter.

Strategic implications (3+months)

Politics: Searching for a new status quo

It is difficult to see how the political situation would adapt; party realignments and restructuring are possible. What is certain is that a "pro-Brexit" group would remain in the Conservative party and could dominate it. Splits could also appear in the opposition Labour party, with divisions between the left of the party (which remains skeptical about Europe) and pro-"remain" centrist MPs, who may congregate around the pro-"remain" new mayor of London, Sadiq Khan.

Economics: No quick fix

The hope would be that continuing improvement in data in the UK, Europe and the rest of the world would offset the impact of continuing political uncertainty in the UK.

Markets: Volatility could subside

A similar pattern as in the three months after the referendum decision, although volatility could start to subside as the domestic political situation becomes clear. For example, GBP strength is still likely, but the currency will remain vulnerable to domestic political developments. The Bank of England will be moving towards raising rates, but could be more cautious if political uncertainty is still seen as impacting the economy. A slight rise in U.K. 10-year yields is still possible. Focus on corporate fundamentals will continue, with a risk that uncertainty could particularly impact the UK domestic market; the FTSE 250 could therefore will likrly be a relative underperformer.

6. Scenario 3: "Leave"

First three months

Politics: the EU faces major difficulties

The consensus view is that Mr. Cameron would step down immediately from office following a "leave" vote. The same general political concerns would exist as in Scenario 2, but would be greatly amplified. One possibility is worth paying particular attention to: were voters in Scotland to vote "remain" while the U.K. as a whole voted to "leave", then this might trigger a further campaign and referendum on Scottish independence, as the Scottish government is presumed to want to remain in the EU.

The European Union would find itself in a very difficult situation. It would have simultaneously have to start "leave" negotiations with a potentially-unfriendly UK government while also having to deal with increasingly confident nationalist parties in other member states. A resurgence of underlying EU problems (e.g. related to migration) would lead to increased questioning of its long-term future.

Economy: negative effect despite GBP fall

The immediate economic impact would be negative. Foreign direct inward investment would likely to be delayed or diverted. U.K. consumers could cut consumption – the key driver of economic growth – in anticipation of hard times ahead and fixed investment could be reduced.

A weaker GBP could provide a boost to the economy through boosting exports, but this would likely fail to offset the other effects.

Markets: Bank of England supports

Capital outflows would be likely to put significant downwards pressure on GBP and, to a lesser extent, the EUR. The Bank of England would keep rates low or possibly likely put them to support the economy; further quantitative easing is also possible, as is emergency liquidity provisioning. 10-year gilts would be likely to sell off.

Global **equity** markets would initially sell down, Eurozone and UK markets over-proportionately. As a rough estimate we would a apply an additional 1 price/earnings (P/E)-point discount of the FTSE100, Eurostoxx50, DAX and Stoxx600 to the P/E appliy relative to the US market, to reflect the higher required risk premium in Europe. A 1 point fall in P/E ratio would equate to ~ -6% lower targets.

Of course, the impact of a "leave" decision on UK and European corporate EPS might not be wholly negative, thanks to expected currency movements - at least in the longer term. (In the short term, the adjusted forex rate is immediately applied to exports and imports, whereas the company contract prices on export and import goods are fixed. Therefore it is possible that the trade balance could initially worsen in case of a significant currency devaluation. Only in the medium to longer term, when company contracts are adjusted to the new exchange rate, may the positive effects of an improving competitive position and trade balance kick in. Economists sometimes call this lag the "J-curve-effect".)

Despite such time lags, a stronger USD vs. EUR and GBP would mitigate some of the European weakness as most large caps are international companies. A weak GBP could lift earnings per share (EPS) for many FTSE100 international companies. But set against this, EPS would be negatively affected by lower economic activity in many segments. At a sector level, UK oil, tobacco, pharmaceuticals and FTSE100 (higher international exposure) would likely relatively outperform UK banks, UK real estate and FTSE250 (higher domestic exposure). Irish companies and other Eurozone companies with high UK export exposure would be particularly affected.

Strategic implications (3+ months)

Politics: All change

Major political realignments have followed previous major changes in the UK's trade regime (e.g. 1846 and 1906) and this could well happen now. Party realignments could precede a new election (see Scenario 2). Political stresses would likely remain high elsewhere in Europe, as nationalist parties sensed the opportunity for a breakthrough. This could impact the EU's ability to deal both with its standard business and specific problems (e.g. immigration). "Leave" negotiations could be protracted: see box below.

Economy: A bumpy ride

The "leave" campaign's main argument is that the UK economy will perform much better when freed from EU regulation and outside its tariff area: this may eventually be true, but for the next 3-24 months or more the UK economy may be vulnerable as "leave negotiations" continue. As noted above (in Section 2) the two obvious pressure points are the UK's current account and budget deficits. Section 2 also looks at the regulatory and other implications of a Brexit for services exports. But, in regards to merchandise exports, if firms and markets increasingly believe that the UK will be forced to trade with the EU under

WTO tariff rules, they will modify their behavior and the trade balance could start to improve, with imports discouraged (due in part to a weak GBP, as well as weaker consumption) and exports increasing (due to substitution effects). Uncertainty over the implications for the labor market and for future population growth could depress growth in the medium term. A range of organizations has produced longer-term forecasts on the impact of a Brexit on the UK economy: the range of outcomes is extremely wide.

The risk case is that the UK could suffer from a combination of growth stagnation and rather higher inflation in the medium-term. However our central forecast is that UK growth will continue, if only slowly. We think that a Brexit would have a significant impact on Eurozone growth through the trade channel.

Markets: Swayed by leave negotiations

Markets will remain unsettled, with upswings and down swings as "leave" negotiations continue. The Bank of England is likely to keep rates low during the process; this could encourage the ECB to keep monetary policy very loose. But if inflation picks up due to weak GBP, the BoE could be forced into a rate rise. If this is avoided, continued very loose policy from BoE is to be expected but yields would need to rise to a level where the risk premium adequately compensated investors. A weaker GBP would support UK exporters, but uncertainty likely to weigh on UK equities, unless we quickly get some clarity on the post-EU trade regime

The Leave Process

Article 50 of the Lisbon Treaty stipulates that when a country gives notice that it wants to leave, EU rules will apply for a maximum of two years. This period can be extended – but only if all EU members unanimously agree to it. (Greenland's exit from the EU took five years, but this was before the Lisbon treaty.)

Recently, sources in the European Commission have indicated that they would want to do the "divorce" as quickly as possible. They have also implied that the formal negotiations on some form of trade and partnership agreement between the UK and the European Union could begin only after the UK became a "third country" (i.e. left). The UK will not participate in the EC sessions on the terms of the withdrawal agreement.

We believe this two year period would be fraught with uncertainty, particularly as it would be highly likely that Mr. Cameron would leave office during this period and it is unclear who his successor will be. This uncertainty would have negative implications for the European economy and markets.

In regards to the UK's next trading relationship with the European Union, scenarios could range from a WTO Tariff through a bespoke deal (e.g. Swiss case) to an EEA-membership (Norway). It is worth noting that the latter two scenarios would require a financial contribution and the adoption of a wide range of rules – but would give the UK no participation on how they were drawn up.

From a purely rational economic perspective, the EU should indeed agree on a comprehensive agreement facilitating free trade. But for the EU, political considerations could outweigh economic considerations as the EU might fear that other member countries could follow the UK in exiting the EU. (If the EU offers a too good a trade agreement to the UK, this could provide an incentive for other countries to do the same as the UK.) Certainly too good of a there will be "no free lunch" for Britain, i.e. the more London seeks freedom from EU rules, the harder it will likely be to maintain market access to the union.

In particular, the EU could be much less inclined to co-operate if the UK chose to significantly restrict labor migration from the EU (as seems likely). Giving the UK access to the European single market without accepting free movement of people would be unprecedented. Already, French officials have warned Britain that a Brexit would threaten the Calais border arrangement between France and the UK. Wolfgang Schäuble, Germany's finance minister says Germany will be a tough negotiator if the UK decides to leave the EU.*

A smooth exit from the EU would also likely require repeal or reform of a large amount of EU regulation; a new immigration policy; and the effective allocation of Britain's EU contribution within the country. Concerns include bureaucratic overload, and difficulties in concluding trade agreements with other trading partners.

Sources include ft.com / theguardian.com

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CIO insights NOTE

June 8, 2016

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Asset class responses in summary

0-3 month time horizon	Clear "remain"		Narrow "remain"		"Leave"	
FX	Bounce in GBP (and EUR) vs. USD on relief and reduced uncertainty	↑	Initially slightly higher GBP as uncertainty reduced, but periods of volatility are likely over the next few months as political situation evolves	↗	Capital outflows likely to put significant pressure on GBP; significant devaluation vs. USD and JPY, which are seen as safe haven currencies; Euro initially weaker as well but less so than GBP	↓
Interest rates	Less market and economic uncertainty creates a better environment, but rate rise extremely unlikely	→	Much will depend on how the economy reacts to domestic political uncertainty; tendency toward higher rates likely to remain, but no BoE action	→	Bank of England expected to keep rates low or possibly cut them to support economy; quantitative easing possible; liquidity provision possible to counter Brexit shock; currency depreciation could help ease monetary conditions	↘
Bonds	Relief rally possible, but may not be large	↑	Relief rally possible but may not be large - and may be short-lived	↗	10-year gilt sells-off	↓
Equities	Rally in the U.K. and Europe as uncertainty and risk premium is removed from markets	↑	Modest rally, as risk premium is removed; gap between export and domestically-oriented UK companies, which had opened in the run up to the referendum is likely to get tighter	↗	Broad based risk-off trades are initially likely to drive equity markets lower; the gap between UK exporters and domestics likely to widen further on the weaker GBP prospects	↘

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CIO insights
NOTE

June 8, 2016

Asset class responses in summary

3+ month horizon	Clear "remain"		Narrow "remain"		"Leave"	
FX	Sterling remains strong; end-March forecast 1.50 against USD and 1.43 against EUR	↑	Sterling strength likely, but will remain vulnerable to domestic political developments	↗	Tendency to weakness, with upswings and down swings as "leave" negotiations continue.	↘
Interest rates	Bank of England rate rise expectations still pushed back into 2017	↑	Bank of England could be even more cautious on raising rates if political uncertainty impacts economy	↗	Bank of England likely to keep rates low while "leave" negotiations continue; could also encourage ECB to keep monetary policy very loose. But if inflation picks up due to weak GBP, BoE could be forced into a rate rise.	→
Bonds	UK 10-year yields to rise, but only modestly - end-March 2017 forecast 1.90%. Core Eurozone yields to remain low.	↑	Slight rise in U.K. 10-year yields still possible.	↗	Yields need to rise to a level where risk premium sufficiently compensates investors: may imply offering additional yield compared to U.S.	→
Equities	Attention refocuses on UK and European corporates' fundamentals and the economy; substantial further gains unlikely over next 12 months	→	Focus on corporate fundamentals; risk that uncertainty impacts UK domestic market; FTSE 250 could be a relative underperformer	→	Weaker GBP would support UK exporters, but uncertainty likely to weigh on UK equities, unless we have clarity on the post-EU trade regime	→

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7. Conclusion

While the referendum will have a binary outcome – “remain” or “leave” – the implications for the UK and other economies and markets will be much more complex.

When Mr. Cameron committed himself to a “Brexit” referendum, he may have believed that it would deal with the long-existing divisions in the Conservative party about Europe. Judging from the tone of the referendum campaign so far, this looks very unlikely. Unless Mr. Cameron wins a clear “remain” majority, Britain’s ruling party will remain in a very fractious state. Even if he does achieve a clear “remain” majority, he may not remain prime minister. Likewise, the conclusion of the Brexit referendum – even in the event of a “clear remain” or “remain” vote – will not fix underlying political divisions with the European Union; a “leave” vote would lead to increased questioning of the whole “European project”.

The referendum result – whatever it is – is unlikely to deal with the UK’s economic problems either. Continued political uncertainty could cast doubt over the government’s ability to achieve budget deficit targets. It could reduce business and consumer confidence, with an impact on GDP growth, and discourage foreign direct investment – an important consideration in relation to the UK’s large current account deficit.

The markets’ response to a “remain” (clear or narrow) will be positive, but may be less than anticipated: markets will quickly start to focus on other matters. A “narrow remain” would keep volatility high for a time, but this would reduce. Our overall global macroeconomic and market forecasts, as initially published in March 2016, were based on an assumption of a “remain” vote. They see scope for only limited further equity market gains by March 2017, two Fed rate hikes over this period but low rates elsewhere in the developed world and a gentle uptick in global growth next year. In other words, a moderately positive outlook.

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Glossary

The **Bank of England (BoE)** is the central bank of England.
Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom of the European Union.
The **Conservative Party (Conservatives)** party is a centre-right political party in the United Kingdom.
The **Corn Laws** refers to a pivotal policy change to remove tariffs from imported wheat in 1846, benefiting the manufacturing sector at the expense of agricultural interests.
Derivatives are contracts that derive their value from changes in the value of the underlying asset.
EUR is the currency code for the euro, the currency of the Eurozone.
The **European Council** is a council of European Union Ministers, whose membership varies according to the topic under discussion.
The **European Union (EU)** is a political and economic union of 28 member states located primarily in Europe.
The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.
The **Eurozone periphery** is usually understood as comprising Italy, Spain, Portugal, Greece and Ireland.
An **exit poll** is a poll of voters taken after they have voted.
Foreign direct investment is investment made into a firm or other entity in another country.
Foreign portfolio investment is the purchase of financial securities or other financial assets in another country.
The **FTSE100** includes the largest 100 stocks by market capitalization listed on the London Stock exchange; the **FTSE250** index includes from the 10st to the 350th largest companies listed.
GBP is the currency code for the pound sterling (see below).
Gilts are bonds that are issued by the British Government.
HM Treasury is the UK government's economic and finance ministry.
The **House of Commons** is the lower house of the parliament of Britain. It includes representatives from England, Northern Ireland, Scotland, and Wales.
The **IMF** is the International Monetary Fund.
Imperial Preference was a proposed tariff system intended to boost trade between parts of the British Empire.
JPY is the currency code for the Japanese yen, the Japanese currency.
The **Labour Party** is the main opposition party in the UK House of Commons.
The **Markets in Financial Instruments Directive, MiFID**, in force since 1997, governs the provision of financial services in the European Union.
Options give investors the option but not the obligation to buy or sell a security at specific price at a specific date.
Passporting, in a financial services context, refers to an agreement to allow financial services to be offered in other markets.
The **Schengen Agreement** refers to a 1985 agreement, subsequently added to, proposing the abolition of internal border controls.
Risk-reversal is a type of option position that is designed to limit losses but also constrains upward price movements.
Short positions are investment positions based on the belief that the underlying asset will fall in value.
Sterling refers to the pound sterling, the official currency of the UK.
USD is the currency code for the U.S. dollar.
The WTO (World Trade Organization) establishes an international system of tariffs designed to keep international trade running smoothly.

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