CAZENOVE
CAPITAL MANAGEMENT

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When trying to analyse the potential consequences of Brexit, it is necessary to make a number of assumptions. Our principal long-term assumption is that the main implications for the UK will be political and not economic. This is based on the view that the linkages between the UK and other EU economies are so deep, complex and multilateral that it would be in no country's interests to ostracise the UK. Put bluntly, the EU has too much to lose: European companies have significant investments in the UK, and the eurozone has an appreciable trade surplus with the UK (in goods, although not in services).

Hence we believe that the UK, were it to vote for Brexit in a referendum, would be able to negotiate an agreement with the EU that left its access to the single market substantially intact. Were that not to be the case, and were the UK to find itself on the wrong side of measures that inhibited free trade and the free flow of capital, then the consequences would be considerably more severe than those outlined later, particularly in the medium term (on at least a three-year view). In the longer term, the impact would depend on the UK's ability to forge links with other countries and economic areas.

The picture could be further complicated by the possibility that Brexit could (or would) trigger another Scottish referendum, with the Scots, on this occasion, more likely to vote to leave the union.

Bearing this in mind, the next page outlines our assessment of the key ways in which Brexit could have a short-term impact on the UK. That impact could well start to emerge in the run up to a referendum as well as immediately after. The key influence on the economy would be uncertainty, both in terms of the result of a referendum and then, should it result in Brexit, over the terms that the UK could negotiate relating to its withdrawal and the post-Brexit landscape. The concern in this context is that negotiations could last for two years, resulting in a protracted period of uncertainty and anxiety.

While there have been a number of attempts by economic forecasting groups to quantify in GDP terms the various scenarios, we believe this is not a particularly helpful approach, given the nature of the uncertainty that will prevail.

Near-term consequences of Brexit

Economics

TRADE VOLUMES
Modest reduction in imports and, probably, exports

We do not envisage that Brexit will have a significant impact on UK household demand or government spending. However, uncertainty could cause investment to fall and also trigger a reduction in inventories, both of which would reduce imports modestly. Little impact on EU growth would be likely, but there could be a backlash against some UK exports.

TRADE DEFICIT
Widen – potentially significantly

Sterling weakness could result in an appreciable 'J' curve effect on the trade deficit. That is, higher import costs would impact before any improvement in competitiveness boosted exports.

INVESTMENT
Significant reduction

Uncertainty could hit investment spending from two directions: domestic companies could be expected to suspend investment programmes, and there would almost certainly be a significant drop in inwards foreign direct investment (FDI). The latter could leave sterling looking more vulnerable.

THE UK BUSINESS MODEL
Partially on hold

A key feature of the UK economic model is its ability to attract FDI, nurture new businesses and sell those businesses to overseas companies. Activity in these areas would be significantly curtailed.

CURRENCY
Weaker

It is likely that uncertainty over the Brexit period would induce negative sentiment towards sterling. In addition, there would probably be some negative capital flows that would cause it to fall. Also, sterling's residual status as a reserve currency would be undermined. Movements in sterling will act as a barometer of how Brexit is perceived internationally and could also induce some of the economic consequences.

INFLATION
Higher

Sterling weakness would increase import costs and that would be likely to raise imported inflation. Reduced immigration could put upwards pressure on domestic wages, although employers would certainly try to withstand this.

INTEREST RATES
Upwards pressure

While the Monetary Policy Committee could decide to ignore short-term developments attributable to Brexit uncertainty, sterling weakness and an increase in inflation could test that resolve and force a monetary tightening.

GOVERNMENT BORROWING
Upwards pressure

If there is a significant deceleration in economic activity, this will increase government borrowing – at least in the short term. This would be partially, but probably not wholly, offset by the removal of the UK's contribution to the EU budget were Brexit to become a reality.

Financial markets

RISING VOLATILITY The inevitable consequence of increased uncertainty.

GILTS Rising yields
Overseas selling, an increase in uncertainty, potentially higher inflation and interest rates, and a possible downgrading of the UK by ratings agencies, suggest that gilt yields could rise appreciably. In all likelihood, this would provide a buying opportunity. In relative terms, index-linked gilts would be likely to perform better than conventionals.

CREDIT Wider spreads
Again the consequence of uncertainty, rising spreads could also result from selling (particularly by overseas holders) into a very illiquid market – beware!

EQUITIES Weaker
While a depreciation in sterling could result in positive translation effects on company profits, the stronger initial influence on the equity market would be from uncertainty. There might be some switch towards companies with lower exposure to the EU. For investors, returns could be further undermined by companies keeping dividends on hold. Again, this could present a medium-term buying opportunity.

FINANCIAL SERVICES AND THE CITY
Prior to a referendum, uncertainty could lead to a short-term drop in international capital raising and other activity in London. Were Brexit to happen, this could eventually enhance London's position as an international financial centre, particularly if the EU were to continue to tighten the regulatory regime surrounding its financial institutions, and also introduce a tax on financial transactions.