BREXIT

June 2016

The Citizens of the United Kingdom(UK) voted to exit the European Union(EU) much to the surprise of the financial markets. We had been listening to the discussions on various forums leading up to the vote and were convinced that it was too close to call. Therefore, even though polls were showing that the remain campaign would win, we decided to take some precautions well in advance of the vote.

As the clients who allow us to hold gold in their portfolios know, we had added to gold positions in the last quarter of 2015 when gold was trading at USD1'050 - USD1'100. We also started to position portfolios more defensively, increasing exposure to equities with more predictable cash flows. Whenever markets rallied strongly, we took the opportunity to hedge a part of the equity exposure as well. All of this was done not only with BREXIT in mind but other issues regarding less resilient growth in major economies of the world. As the BREXIT vote drew nearer, we used rallies to increase hedges and gold dips to add to positions. The market presented us with the possibility to do this again in Q2/2016 as can be seen below (Fig.1). Our currency exposure was also more conservative. As a result, our client portfolios have seen very little impact from the 10% drops in European stock markets since the vote, as all our positions were more conservative and gold compensated for the drop in equities as can be seen from the figure below. However, the question on everyone's mind is what happens now?

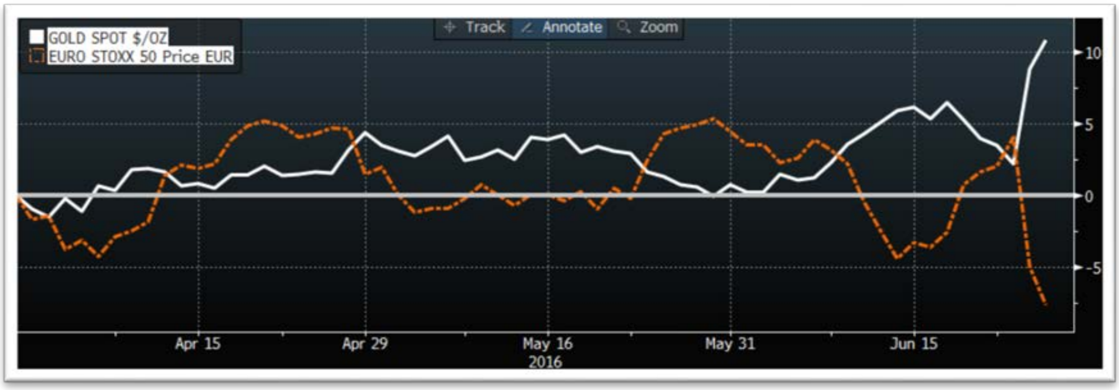

Fig. 1: Euro Stoxx 50 (orange), Gold (white) Q2/2016 Source: Bloomberg

On the political front uncertainties abound, as the remaining 27 members of the EU would like Britain to move forward quickly, while the UK would like to officially submit their petition to exit only when a new Prime Minister is in place. Political volatility amongst the various parties in the UK is rising, and some are calling for a re-run of the vote. Scotland has clearly indicated that they would like to stay in the EU, and this brings up the possibility of an EXIT UK referendum in Scotland. On the economic front, it was widely expected that the remaining EU members would make exit negotiations very tough in order to deter any other members who might be considering an EXIT referendum. There have been calls in France, Italy and the Netherlands for an Exit vote and this trend is of great concern to the EU. Recently, Chancellor Merkel has tried to put forward a picture of co-operation between the UK and the EU and a willingness to give the UK some time but not too long to put forward the formal exit request (Article 50) and start negotiations. Once Article 50 has been triggered, the UK has two years to negotiate a withdraw agreement. If such an agreement is not reached within the two year period, the UK will be under considerable pressure as all EU Treaties would seize to apply, unless there is a unanimous agreement to continue the negotiations.

Our opinion is that market volatility will remain elevated as the political negotiations begin. The UK imports more from the EU than it exports to them, so there is some incentive for the EU to co-operate rather than obstruct when it comes to negotiations. However, the EU cannot be seen to be giving in too much as this would encourage other countries to propose EXIT votes. While Germany is the biggest contributor to the EU budget, the UK is the second biggest, followed by France, Italy and the Netherlands. This is why it is crucial that the negotiations are tough enough to deter those calling for EXIT votes in the other three large contributors to the EU budget. With several elections scheduled over the next two years, there is a danger that pro-EXIT parties take over power if the negotiations are not handled correctly. The British economy itself will have major adjustments in store. The fall of the British pound to 30 year lows is discounting some of the worries in this

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regard. A lower pound does make British exports more attractive but there are several concerns that would overshadow this competitive advantage. It is expected that many large international Banks will move major parts of their operations to Germany or Spain and that the British parliament is ill prepared to deal with the fall out from BREXIT as they were against it and it appears that a contingency plan is missing. Recently, the Prime Minister of the UK, the Governor of the Bank of England and the Chancellor of the Exchequer, all tried to re-assure financial markets and the people of the UK that they are well prepared to handle the current situation. However, though it appears that markets are calmer after their speeches, this may not last long as the political wrangling starts. As David Cameron has decided to step down from the post of Prime Minister, the path to replacing him could cause political in-fighting and, hence raise doubts about the success of negotiations with the EU.

It is important to step back for a minute and think about what is at the root of all this public dissatisfaction with the system. After the European crisis, in 2011 an austerity program was implemented to bring down budget deficits. These fiscal cut backs were accompanied with monetary policy largesse with the aim to support growth and avoid deflation. The money provided to the banks by the ECB has not resulted in an increase in investment in the real economy but has mostly stayed on the books of the banks. It has been used by speculators and financial market investors and has driven assets prices higher. The result for the median income family in the EU has been that their rents have gone up and their salaries stagnated or even shrunk while the “elite” have benefited from higher asset prices brought on by loose monetary policies. The “common” people are expected to work longer and receive less pension benefits, while EU administrators in Brussels receive large monetary benefits as exemplified in the film “Brexit: The Movie”, broadcasted shortly before the vote on BREXIT. Hence, it became a vote of the people against the political elite. Additionally, the Syrian refugee crisis prompted Ms. Merkel to publicly announce that all refugees are welcome in Germany, without coordinating with EU member states at the entry points of the EU. This in turn increased the refugee streams into the EU without providing the required infrastructure. At the same time the EU then tried to impose refugee quotas on member states, which nurtured existential fears amongst a large part of the British public. Hence, the vote also became a vote to defend personal interests and national sovereignty.

We believe that the EU has finally got the message. BREXIT was a wake up call to all those who did not want to implement any fiscal stimulus and were happy to rely on monetary policy to do the job of supporting economic growth. In our opinion, if calls for EXIT votes are to be avoided in other countries, being tough in negotiations with the UK will not suffice, additionally government spending should increase with infrastructure projects implemented across the EU. This move would be difficult at a time when budgets are tight and debts high. However, we think that it is preferable to increase debt for fiscal stimulus than just pursue Quantitative Easing. Fiscal spending will inject money directly into the economy and incentivise investment by companies. This in turn should improve consumer confidence and spending and result in a more favourable view of the EU for those members whose citizens are disgruntled at the moment. We have heard a lot of support for fiscal measures recently and many economists as well as the IMF believe that this is the way forward. If fiscal stimulus is implemented, European growth should respond and deflation should be avoided. It will then be time for the European stock markets to catch up with the performance of their US counterparts. The main risk to this relatively positive scenario is that politicians drag their feet for too long and some other as yet unconsidered problem arises that could bring on recession and deflation before fiscal stimulus is implemented.

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