World First briefing note:

EU Referendum Special

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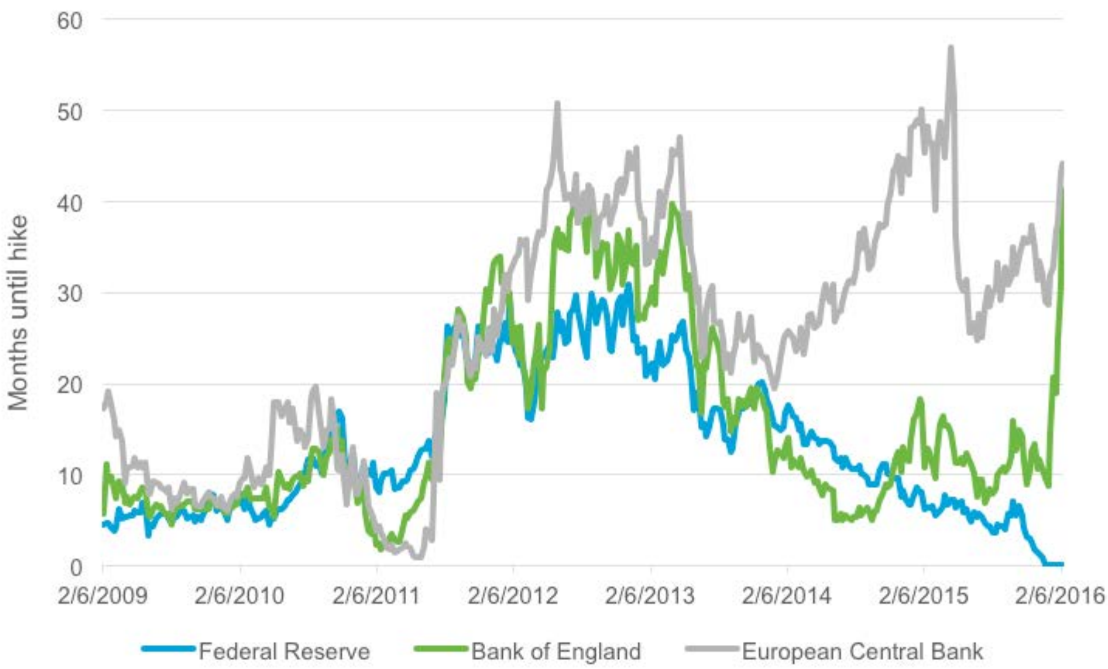
Something Wicked This Way Comes

2014 had the Scottish referendum, 2015 saw a general election and 2016 looks set to complete this hat trick of UK political risk with the hotly debated EU referendum. Of course, I am writing this at time when the details of Prime Minister Cameron's negotiations have not been made public, let alone at date set for the vote, but there is little else that is being talked about in UK financial circles at the moment.

The referendum is not the only negative impulse on sterling at the moment. Since the summer of 2015 we have seen the economic data produced by the UK start to weaken. Inflation has remained weak, wages have remained stagnant, growth has been unable to reach what we economists have come to term 'escape velocity'. As such, expectations around a Bank of England interest rate rise have withered and died.

Months until first rate hike priced in

Data: Bloomberg Finance L.P.



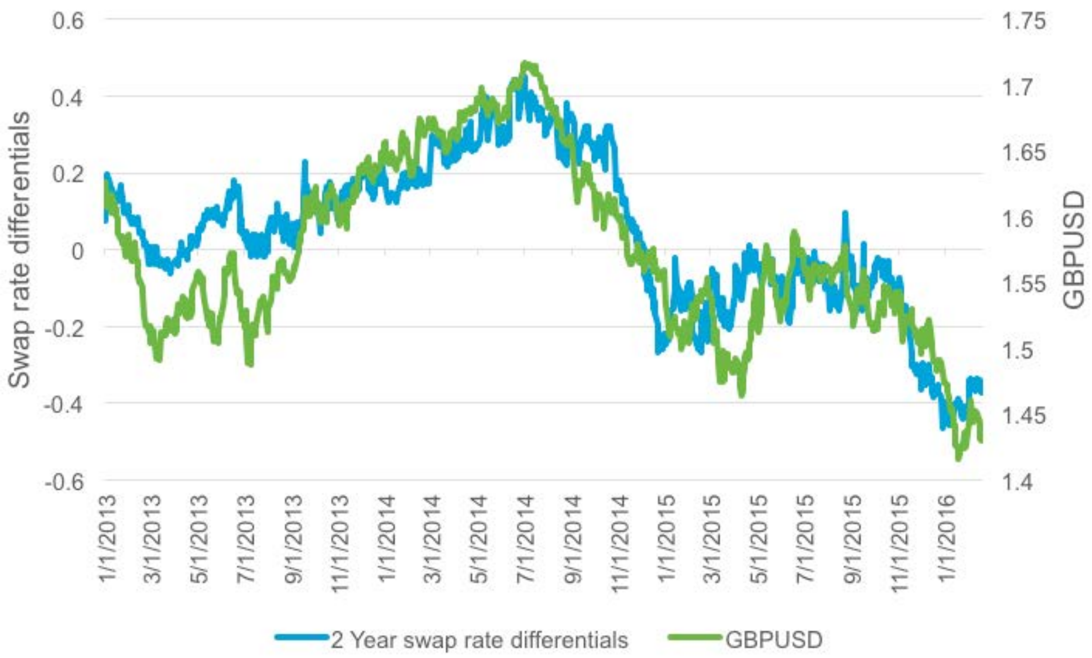
The exponential delaying of interest rate hikes has been largely due to the market sell-offs we saw midway through February as a result of fears over bank funding levels and riskier bond holdings. This sell-off, led by European banking shares, was not a world ending move.

We firmly believe that these market fears are entirely misplaced, specifically around bank debt levels and that once markets become wise to this fact then the need for a haven position, in debt, the euro or the yen will be traded away in favour of yield hunger.

We have been unable to conceal our disdain for the subsequent weakening of rate expectations and this leads us to believe that, as the risk profile of markets unwinds, that GBP has a decent amount of strength to be returned to it. As we can see from the chart below, falling rate expectations have contributed only some of the weakness in GBPUSD. There is obviously something else at play here and that is the referendum.

Something else working in GBPUSD

Data: Bloomberg Finance L.P.



Have a look a how the pound underperformed in the early part of 2015; the election worried sterling investors but the recovery following the comprehensive win for the Conservative particularly was quick. Sterling retraced the political discount that it had forced upon it in short order. I could take the chart back to the General Election in 2010; the story is similar however the 'hung parliament' result sent sterling lower.

It is our estimate that a vote to keep the UK in the EU would see GBP wipe out this political risk and see a sharp retracement of market beliefs on when interest rates would rise as well. The graph below is a prime example of this.

Markets too negative on UK rate rises

Data: Bloomberg Finance L.P.

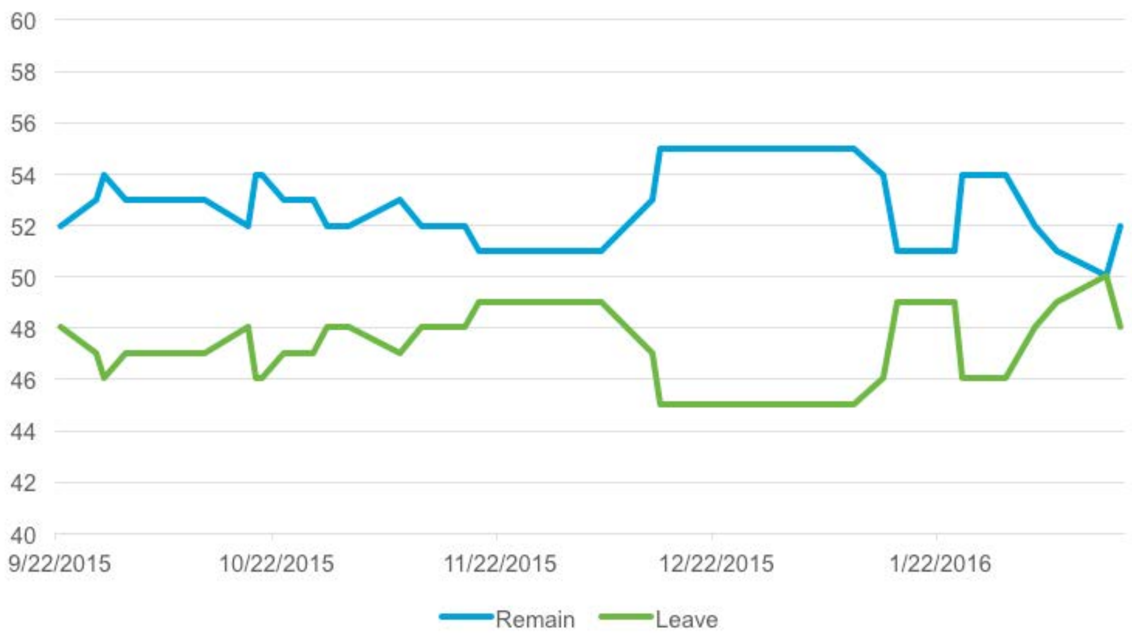
Market expectations of when the Bank of England will raise interest rates have slipped to a point where rates will not rise for 41 months. That would see the base rate remain at 0.5% until July 2019 at the time of writing. A return to more normal levels, as equity and bond markets calm, of around an 18 month wait would see a nice retracement in GBP as well.

Can the UK avoid Brexit?

Of course it can and our base case remains that the UK remains part of the EU. Opinion polls at the moment are showing that the Remain camp are still leading with the blended 'poll of polls' showing that, after a convergence to 50/50 the Brexit campaign is once again losing ground.

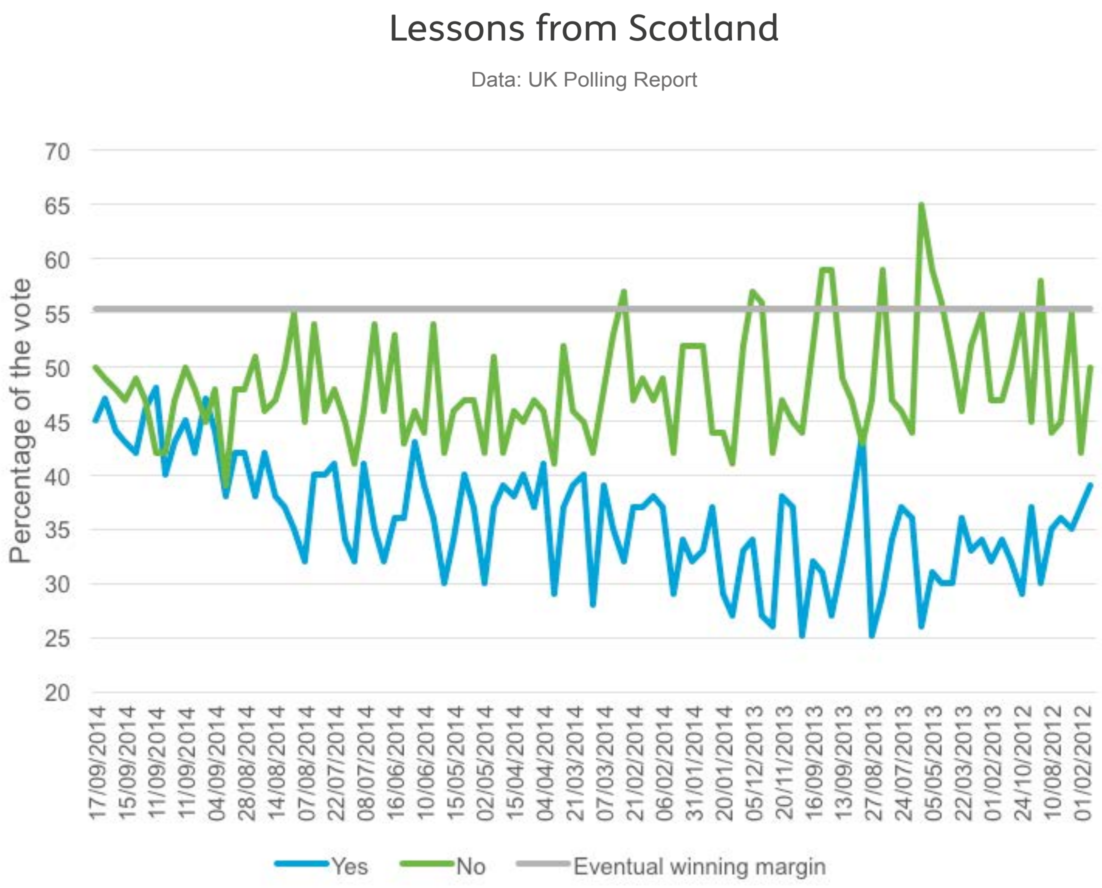
EU Referendum poll of polls

Data: UK Polling Report



Polls have been wrong in the past of course. The 2015 General Election had the Conservatives consistently polling at 33-35% of the vote and they came through with 37% and a large lead in the First Past the Post system.

More pertinently in the case of referenda falls the Scottish Independence Referendum in 2014. The 'No' campaign won out in the end, keeping Scotland as part of the union however the graph of opinion polls below shows that the majority of the time opinion polls undersold the support for Scotland to remain. Indeed of the 101 polls we have sampled in the lead up to the Scottish Referendum only 13 gave us a result that showed the No campaign winning by its eventual margin and more.



Our hope and our belief is that the UK electorate will respond in a similar manner in this referendum; the desire to avoid abandoning the status quo and bringing economic uncertainty will trump any feeling of change. Chalk another win for ‘Project Fear’.

That being said the economic arguments of the 2014 Independence Referendum were drastically different to the decision that is going to be made about Europe. The rest of the UK would have had felt very little longer-term damage from an independent Scotland. The same cannot be said now.

What if?

What if we wake up, or if you’re anything like me see the results come in through the night, and Leave campaign have triumphed? What would it mean for the pound and the UK economy as a whole?

In attempting to answer this unanswerable question we think that it is easiest to view this through the prism of the UK’s current account deficit.

The UK’s current account position – the level of our trade accounts with the rest of the world – is pretty poor. We are in a deficit of around 3.7% of GDP – close to the worst on record – having not been in a surplus since 1986. Why does this matter?

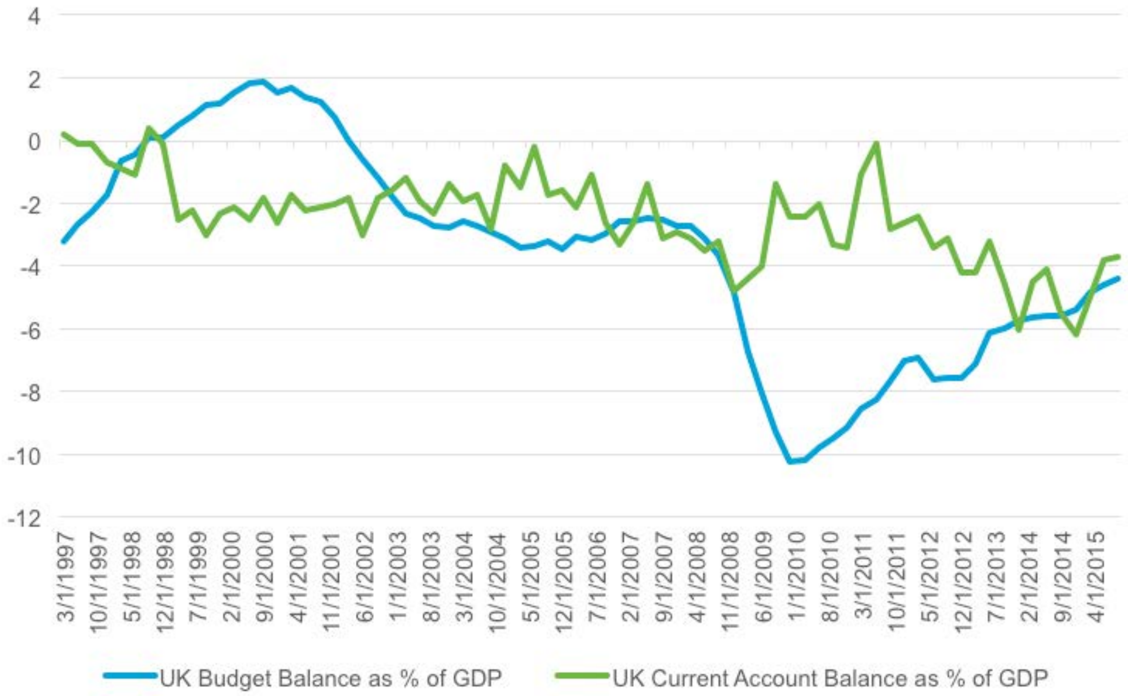
Simply put if a great deal of your financing and investment is coming from abroad and you import more than you export then you are much more at the whim of foreign economic headwinds. Those could be headwinds from China, Europe, commodities or political instability.

And while a current account deficit in itself is not dangerous, currency market participants will always take it in to account, especially when the proverbial hits the fan. You only have to look at the currencies benefiting from this period of market peril – the euro, Swiss franc and the Japanese yen – to see who are in a current account surplus.

Likewise, the UK's fiscal deficit – the difference between government spending and receipts – remains in a poor state and currently sits at -4.4%.

The Twin Pressure Points

Data: Bloomberg Finance L.P.



A vote to leave the EU would see both of these deficits increase drammatically as funding from abroad dries up.

And what would that do to the pound?

With apologies to John Kenneth Galbraith "The only function of currency forecasting is to make astrology look respectable." Bearing that in mind we can make some educated assumptions about the state of a post-Brexit based on the current account. Some opinion pieces that are calling for a 20% decline in the value of trade-weighted sterling are basing their thoughts on the closing of the current account deficit. A similar decline is not impossible and, as we have seen in the past 6 months or so, market sentiment can drastically over-run fundamentals faster than you can say Farage.