Illumination: Equity strategy and market outlook

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Global perspectives: Brexit – ultimately unlikely

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- **We believe the risk of an actual Brexit is modest**. Polling indicates that the "Remain" campaign is still on target to win the vote. In the event of a narrow victory, there is nothing to prevent a renewed attempt to renegotiate the UK's position from within the EU, even though this has been ruled out for now.
- **Could the uncertainty surrounding Brexit be opening up a (relative) valuation opportunity?** The combination of the decline in sterling and the underperformance of the UK market leaves export-led UK industrials at a significant discount to US peers. With growth expectations similar for both US and UK industrials, there does seem an increased prospect of inbound M&A, after a very slow start in 2016 to date.
- **We remain of the view that the global relief rally is largely behind us.** Oil prices have risen to levels more consistent with long-run marginal supply from US producers and commodity prices look to have run ahead of improvements in global economic data. With the reduction in financial market volatility, we also believe the US Fed is on course for an interest rate increase in June.

Brexit: Ultimately unlikely

Edison has not taken any formal position on the desirability or otherwise of the UK leaving the EU. However, we provide the following summary of what we believe are the key issues.

Any discussion on Brexit should be placed in the proper context. Based on current polling data it is significantly more likely than not that the UK will remain in the EU in the two years following the referendum on 23 June. Online polls may indicate a nation split nearly 50:50 on the issue, but online polls also proved significantly less accurate than telephone surveys in the UK's most recent election.

We would lend greater weight towards telephone polls which continue to point to a victory for "Remain" by a margin of 50% to 39%, with 11% undecided. Furthermore, recent bookmakers' odds indicate only a 33% chance of a vote for Brexit. Academic research at University College London on the behaviour of voters in referenda also suggests that undecided voters tend to migrate to the status quo as a referendum approaches. On this basis polls are likely to swing further towards the "Remain" camp in coming weeks. In our view, based on the polls, bookmakers' odds and likely shifts in voting intentions up to the date, we think there is about a one in three chance of a Brexit.

The key uncertainty would appear to be in the turnout; Brexit is favoured by older voters who, if the UK's last general election is a guide, are significantly more likely to vote than the young, who favour remaining in the EU. However, on balance (and we emphasise again we have taken no position on the outcome) the data continues to point to a victory for "Remain".

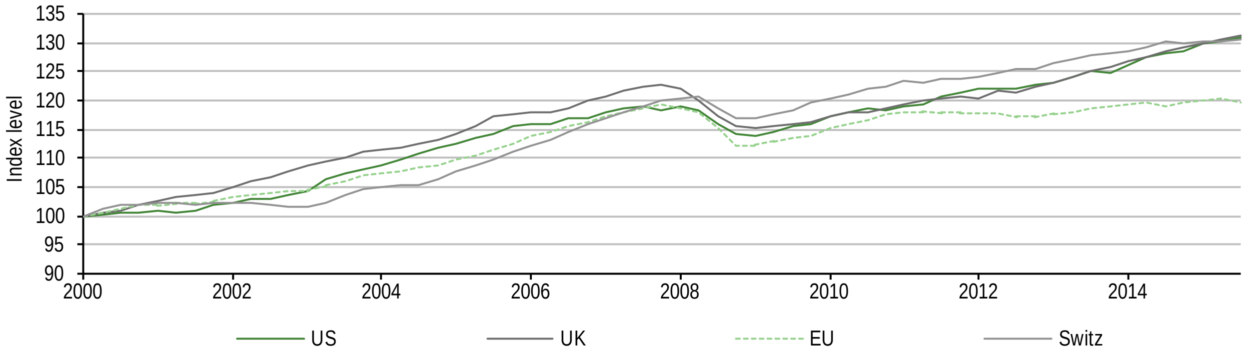
Further, should the electorate vote for Brexit in the referendum, although Prime Minister Cameron has indicated that Article 50 (to leave the EU) would be invoked immediately, he would be under no legal obligation to do so. The UK's EU Referendum Act 2015 only obliges the holding of a referendum and makes no legal obligation to take any action following the result.

Given the magnitude of any decision to leave the EU, the temptation for the UK's incumbent political leaders to re-frame a marginal victory for "Leave" into another attempt at re-negotiating the UK's relationship with the EU cannot be completely excluded, in our view. A second referendum is entirely possible in this scenario, even if campaigners for "Remain" have emphatically ruled this out at the present time. Prior experience in Europe shows that referendum results which go against the wishes of EU policymakers are often not definitive. Academic studies also demonstrate that European governments have proved adept at winning a second referendum in these circumstances.

Therefore, taking into account that even after a vote to leave there is a significant likelihood of remaining in the EU, the actual probability of Brexit is even lower than the referendum polls suggest. In addition, there is certainly merit in the argument that it is better to negotiate for better terms from within the EU rather than outside. For investment purposes we would suggest the Brexit probability in the next five years is currently 10-15% (c 33% chance of vote to leave and a 30-50% probability of Brexit if so). For comparison, we would put similar odds of the EU breaking apart for another reason over the same period.

While we may be relatively relaxed about the outcome of the UK's referendum, we would caution against underestimating the medium-term risks arising from the EU's low-growth economic trajectory, Exhibit 1. This low-growth trajectory is in our view the primary cause of the EU's financial instability and voter disaffection. The 'reformed EU' scenario presented by the UK's Treasury is perhaps not an optional extra but an absolute necessity over the medium term. Otherwise electorates will continue to question the cost of centralising political power to achieve the benefit of only modest improvements in welfare.

Exhibit 1: US, UK, Switzerland and EU GDP growth



Source: Thomson Reuters Datastream

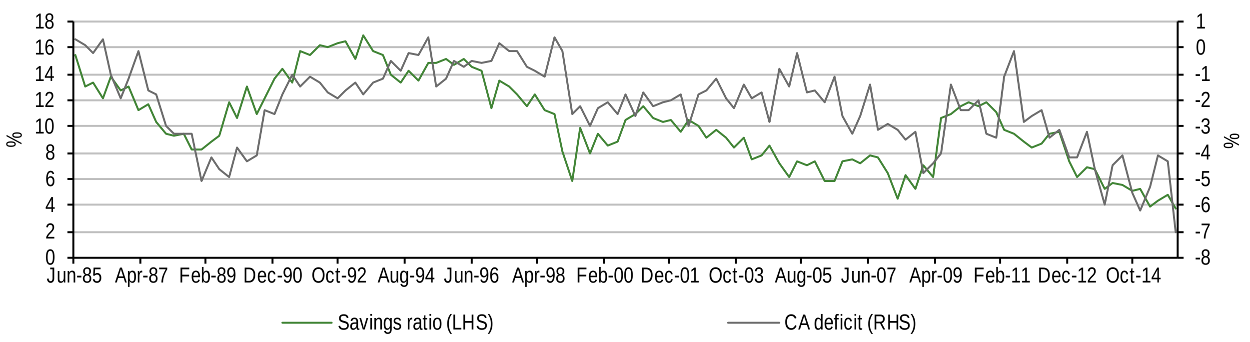
Global markets may therefore be over focused on the Brexit vote, which is at risk of demonstrating in real-time Kahneman and Tversky's availability heuristic. It seems every soft data point for the UK's economy can now be attributed to the Brexit vote by executives and the media. This deflects from the underlying issues of low global growth.

Brexit: But what if it does happen?

Even if Brexit has in our view only a modest probability, we should consider the potential impact for investors. Here we have changed our views somewhat from February, as on closer examination an exit would in itself give rise to significant uncertainties in the timing and terms. Uncertainty is the enemy of investment and as the recipient of a 20% share of European foreign direct investment (FDI), the UK would quickly suffer, even if the reported slowdown in City hiring looks a little premature.

Importantly, the Brexit vote is also highlighting the UK's current account deficit, which reached over 7% of GDP in Q415, the widest deficit in 30 years as shown in Exhibit 2. This, in our view, is the crucial issue. We understand that changes in net foreign income have exacerbated the situation in recent years but the correlation between the deficit and the declining savings rate is striking, Exhibit 2. BOE Governor Mark Carney has highlighted that the UK is reliant on the kindness of strangers; but such financing can prove fickle in the event of a shock. Both the savings rate and the current account deficit are uncomfortably close to the levels of 2008.

Exhibit 2: UK current account and savings ratio



Source: Thomson Reuters Datastream

Apart from the obvious threat to sterling, the Brexit process becomes lost in a fog of media campaigns in respect of the longer-term position of a UK outside the EU. There are many different precedents - such as Switzerland, Norway or New Zealand. Even the Albanian model has been suggested. In our view it is illogical to expect that withdrawing from a free trade area with 450m inhabitants is likely to benefit trade, except possibly over the extremely long term if structural changes bring increased competitiveness. In our view, the biggest risk is to the UK's financial services industry which represents the crown jewels of the UK's services sector.

Unsurprisingly, many financial firms have already come out in support of the "Remain" campaign. While larger firms can establish subsidiaries within the EU as a short-term solution to the absence of "passporting", Brexit could represent a renewed threat to London's pre-eminence as the financial centre of Europe. The remaining members of the EU would naturally look towards the development of a new EU financial centre within the eurozone, although reaching a decision over its location would likely hamper progress.

Furthermore, while a significant draw, we are not convinced the benefits of the English language and English law are sufficient to attract international corporate and individual investors to the UK, in the absence of full access to the EU. Therefore, in the (unlikely) event of Brexit, the risk to London's role as the financial centre for Europe appears real over the medium term. It is also not at all clear whether the political appetite for UK tax incentives to keep London pre-eminent would exist in the circumstances.

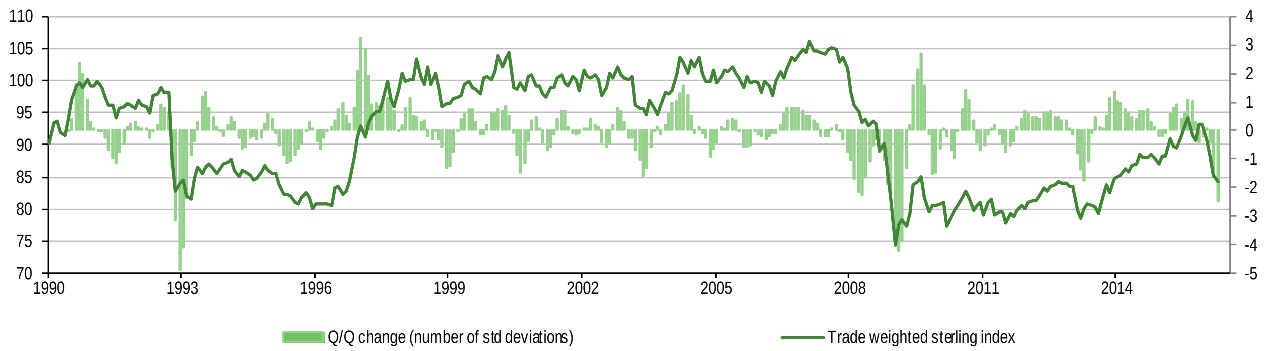
Therefore, investors who wish to steer clear of Brexit risk would underweight the banks sector and the until recently very strongly performing London property market.

However, investors should also remember the UK's stock market is only loosely linked to the fortunes of the UK itself, given the relatively high international exposure of UK listed companies. In recent months there has also been a widening discrepancy between US and UK industrial valuations, partly due to pressure on sterling, which may present an opportunity for investors. If sterling remains under pressure this would also be a strong tailwind for exporters who are focused on global rather than EU markets.

Brexit vote: Opening up a (relative) valuation opportunity?

Whether down to the potential for Brexit or a widening current account deficit the decline in sterling over the last six months has been substantial. Although not as pronounced as earlier in April, on a quarter-on-quarter basis the trade-weighted value of sterling had fallen by as much as 7%, representing a move of more than 2 standard deviations away from the mean. Only during the financial crisis and the exit from the ERM has sterling fallen faster, Exhibit 3.

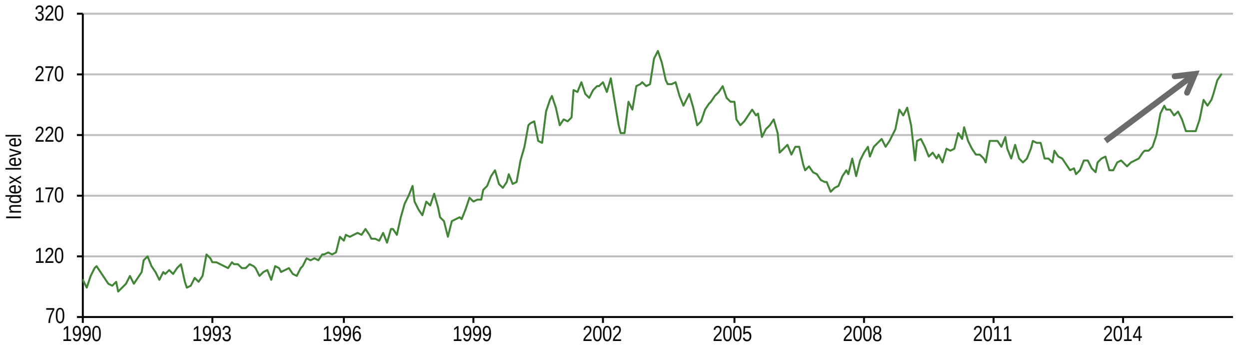
Exhibit 3: 2 standard deviation q-o-q decline in trade-weighted sterling



Source: Thomson Reuters Datastream

At the same time, the weak sterling-denominated share price performance of the UK's industrial goods and services sector - which has a large proportion of sales overseas - is becoming notable. Relative to US industrials, UK industrials have underperformed by close to 25%, Exhibit 4. This period of relative weakness is only matched by the late 1990s.

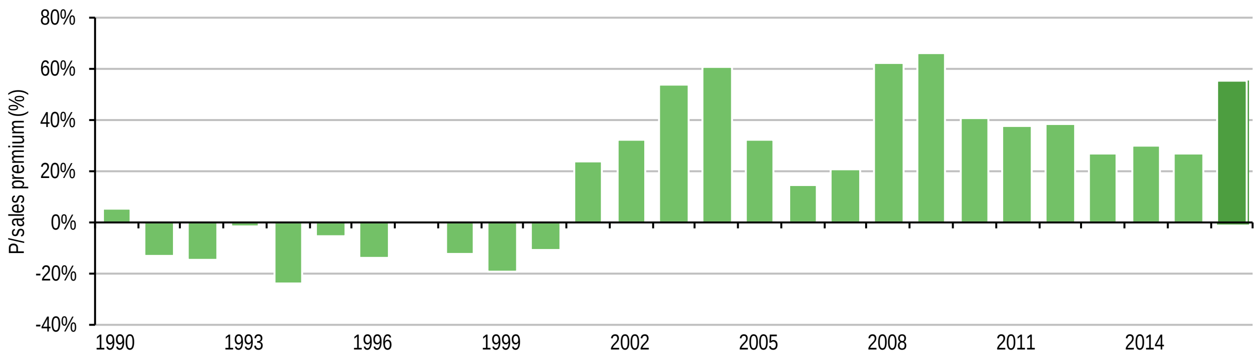
Exhibit 4: US industrials have outperformed UK peers by 25% since 2014



Source: Thomson Reuters Datastream

Leaving aside the odds on the outcome of Brexit debate, we believe that valuations of UK industrials are becoming significantly more attractive for overseas buyers, notably those based in the US. We have therefore screened the UK industrials sector for companies with more than 50% of sales overseas to see just how discounted the UK has become. To avoid the results being dominated by the largest companies in the index, in the following charts we use the median rather than the weighted average measure and estimate that for the selected universe of UK companies, US peers are on a price/sales premium of 50%, close to the highs of the last 25 years, Exhibit 5. Furthermore, US industrial EV/EBITDA multiples are currently at a 20% premium to the UK, following a decade where EV/EBITDA multiples traded in-line.

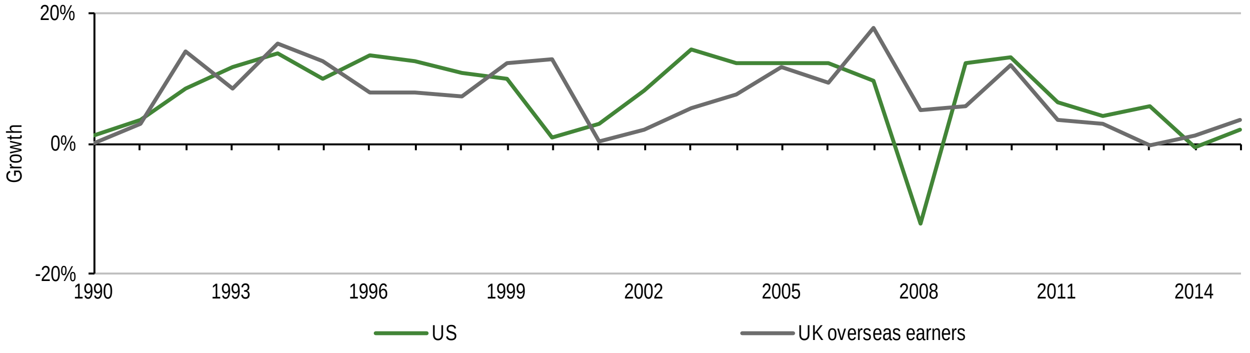
Exhibit 5: Median US industrials price/sales median close to record premium over UK



Source: Thomson Reuters Datastream, Edison calculations

The premiums for US peers do not seem to be justified by diverging sales growth prospects, as shown in Exhibit 6. US companies would appear to face the same headwinds in generating growth as UK companies with international sales. To some extent at least, the valuation gap therefore appears to be an artificial domicile effect, as both groups of companies operate in the same global markets.

Exhibit 6: Median sales growth outlook for US and UK international industrials is similar



Source: Thomson Reuters Datastream, Edison calculations

There is, however a widening gap in terms of EBITDA margins in this cycle; current margin forecasts for the US are close to 20% vs 15% for the UK. This is notable as before 2011, US and UK industrial margins fluctuated with the economic cycle but otherwise tracked each other closely.

Without wishing to suggest that a US-led M&A boom is imminent, the decline in sterling and relative price underperformance of the UK's export-focused industrial sector has opened a significant valuation gap which, if sustained, could have US investment bankers dusting off pitch books for UK targets. Even if a number of high profile but tax-led US/UK transactions have fallen by the wayside, there is no reason why traditional M&A based on earnings accretion, growth and synergies from closing the gap in EBITDA margins will not attract the attention of growth-starved US executives.

Conclusion

In terms of the Brexit vote, based on recent polls and analysis of polling trends in referenda, like the bookmakers we think there is about a one in three chance of a vote for Brexit. However, the UK government is not obliged to act following the vote and we would estimate the current likelihood of an actual Brexit at only 10-15%. In this context, we believe markets may be paying more attention to the issue than is warranted.

In this 10-15% scenario, if we examine the ramifications should Brexit occur despite the low odds, during the process leading to Brexit we now believe there would be a significant degree of uncertainty until the new UK/EU relationship is established. The key risk is the UK’s current reliance on foreign inflows of capital and as a result the likely pressure on sterling in the circumstances.

With a question mark over UK/EU trade in services, we conclude that larger financial services firms would also be likely to suffer, in addition to London real estate and related sectors. The decline in sterling would however benefit exporters focused on international markets outside the EU. The uncertainty has perhaps already led to a valuation gap in this segment of the stock market and investors should stay aware of the potential for M&A, despite relatively low levels of M&A activity recently.

In terms of global markets, we remain of the view the relief rally which started in February is largely behind us. Oil prices have risen to levels more consistent with long-run marginal supply and commodity prices look to have run ahead of improvements in the economic data. With the reduction in financial market volatility, we also believe the US Fed is on course for an interest rate increase in June.

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