Punter Southall
INVESTMENT CONSULTING

NewsAlert
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Forthcoming events

Maturing Gracefully: End Game Planning for Pension Schemes

- 12 July
  London

Annual Pensions Conference 2016

- 29 September
  London

Getting Ready for your Next Pension Scheme Valuation

- 24 November
  London

Reserve your place

Result of the EU referendum

So, after weeks of seemingly endless press coverage, rallies, debates and counter-debates, history has been made and the United Kingdom has voted to become the first major country ever to leave the European Union (EU) after yesterday's referendum.

What happens next?

To begin the process of dis-integration from the EU officially, the UK will need to trigger Article 50 of the Treaty on European Union by notifying the European Council of its intention to leave, after which the negotiations between the UK and the rest of the EU on the arrangements of its withdrawal can begin. Activation of Article 50 sets a two-year deadline for exit talks to agree the terms of departure and only unanimous agreement of all the other 27 member states can extend this deadline.

Short-term impact on markets

Uncertainty will prevail in the short term and we expect the initial market reaction to be negative. Arguably, some of the reaction has already been priced in to markets as the possibility of a Brexit increased over recent weeks. Nevertheless, aside from a sustained period of volatility, we believe that the reaction in certain parts of the market is reasonably predictable. Firstly, we believe that sterling will depreciate against both the dollar and the euro, with any sharp currency depreciation giving rise to a temporary spike in inflation. Secondly, risk assets across the UK and the world are likely to struggle, with UK equities in particular affected by a potential slow-down in headline growth and a decline in the exchange rate. Thirdly, corporate bond spreads may be expected to widen as the UK's perceived credit worthiness may be deemed to have deteriorated. The effect on government bond yields is harder to predict, with the possibility that initial increases are subsequently countered as a result of the potential for further monetary policy stimulus; initial clues as to the Bank of England's intentions in this respect may become apparent at the Monetary Policy Committee's next meeting on 14th July.

Longer-term considerations

During the two-year period of exit negotiations, it is highly likely that discussions will also take place over the UK's post-Brexit relationship with the EU, particularly with respect to trading arrangements. To understand the possibilities at a high level, it is useful to consider the models currently adopted by other non-EU participants such as Norway and Switzerland. In the case of the former, membership of the European Economic Area (EEA) ensures full access to the single market (barring a couple of exceptions), in return for a requirement to contribute to the EU budget and to adhere to the EU's 'Four Freedoms', which include allowing free movement of labour. In the case of the latter, complex bilateral trade agreements have been negotiated ensuring access to the single market, but with exclusions on financial services and similar requirements to pay into the EU budget and (as things stand, currently) to accept free movement of people.

In the UK's case, certain considerations will be more relevant to these negotiations than may be the case with other countries. One such consideration will be an attempt to ensure that the UK can protect the high levels of Foreign Direct Investment (FDI) it currently receives. With an estimated FDI stock of over £1 trillion, currently only the United States and China receive more FDI than the UK and many non-EU countries will be looking to see whether they can continue to access the single market through the UK in the way that they currently do. London, in particular, has become a favoured location for US and international financial services firms to base their headquarters with the UK being seen as key entry point into the EU. However, without the ability to 'passport' their services throughout the single market, firms may look to other countries within the EU to base their headquarters. The UK will also look to protect the future of its services sector more generally; in 2015 the sector as a whole accounted for around 80% of UK gross domestic product (GDP) and exports of UK services accounted for 12.1% of GDP*. And consideration will need to be given to the possibility that skills shortages and a loss of productivity begin to materialise if we do indeed see an end to the free movement of labour into the UK.

But the UK's relationship with the EU will not just determine how it interacts with its remaining members going forwards. The UK will also look to strike trade deals with major economies such as the US, China and India. In the absence of a deal between the UK and the EU, the UK would be required to follow World Trade Organisation rules on tariffs and negotiation of such deals is likely to take considerable time too. Barack Obama has previously said that a trade deal with the UK could take up to 10 years to negotiate as the US looks to prioritise key regional agreements, such as the Transatlantic Trade and Investment Partnership currently being discussed with the EU, over bilateral deals with other countries. Given that the UK is the world's fifth largest economy, it may be in the US's interests to settle a new trade deal in quicker time.

It is clear, then, that these negotiations will be far from straightforward and – along with the potential political fall-out that may now ensue – will go a long way to shaping the longer-term economic outlook following the UK's vote for Brexit. We will keep a close eye on how events unfold as the negotiations progress and the possible implications for pension schemes and will refine our Asset Class Views accordingly over the next few months.

*Source: FT.com

Where can I get further information?

For specific advice, please get in touch with **Guy Plater**.

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Alternatively, please speak to your usual Punter Southall contact.

Punter Southall Investment Consulting has offices across the UK.
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