SYZ WEALTH MANAGEMENT

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« BREXIT »

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IS IT TIME TO REACT TO A POSSIBLE BREXIT SCENARIO?

As the February 18th-19th European Council meeting has just ended, the European Equities team at SYZ Asset Management takes the opportunity to discuss their thoughts on the upcoming referendum on whether the UK should remain in or leave the EU.

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The following note gives the views of the team at the time of publication.

As the February 18th-19th European Council meeting has just ended, it is timely to discuss our thoughts on the upcoming referendum on whether the UK should remain in or leave the EU. One should clearly not gamble on the result of such unpredictable events, but it is important to monitor and analyze such disruptive events. As this type of episode provokes volatility on financial markets, it is essential to be able to anticipate potential risks that could harm the performance of portfolios in absolute and in relative terms but also to capture possible investment opportunities. Obviously measures should be taken if the positioning doesn't seem appropriate to brave such circumstances.

A lot of assumptions can be made about UK's referendum on EU membership, but what seem likely today are the following elements:

— If a deal is reached between the UK and the other member States at the EU Summit in February, it would considerably increase the chances of a "Stay" vote at the referendum.

— The referendum could be held as soon as June 2016.

— If the uncertainty around the outcome remains it is likely to generate financial volatility and negatively impact growth until the result of the vote.

— A vote to leave the EU would put the sterling at risk due to UK's large current account deficit mainly financed by direct foreign investments.

— A cloud of uncertainty surrounds what would happen if Britain leaves the EU. What kind of relationship will Britain be able to renegotiate with the EU but also with non-European countries given that that it will have less influence and negotiating power?

— A new Scottish referendum is possible in the event of a Brexit.

— A vote to stay within the EU would remove the uncertainty risk accumulated over the pre-referendum period. A rally on UK stocks is possible if investors had started to price the impact of an exit.

With all these variables in mind, the outcome is clearly unpredictable. However, the distribution curve of the potential macro-economic impacts delivers very scattered scenarios, most notably to the downside. Against this backdrop, let us monitor the risk, both at the portfolio level and at the stock level to evaluate any possible effects.

What are the main risks at the portfolio level?

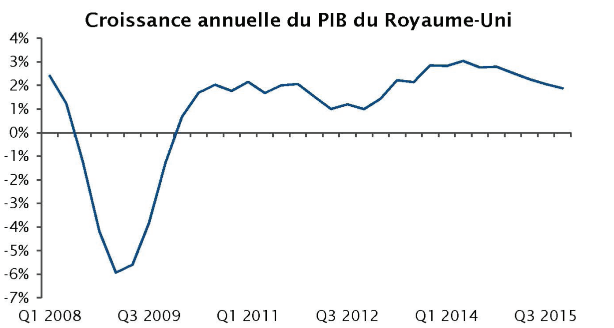
The first one is the currency risk at the portfolio level. As a pure bottom up stock picking team this element is normally not a major concern. But when a threat with substantial effect on portfolio performance arises, tracking such an element is important.

Even if the Brexit outcome remains a less-than-likely possibility, the uncertainty fueled by tight opinion polls and the magnitude of the various possible impacts that can result can make investors nervous. This uncertainty might already have influenced the BOE in its recent more "dovish" stance. Compared to 3 month ago, the yield curve has considerably flattened as a rate hike seems to have been pushed to 2017. This has caused an acceleration of the weakening of the GBP in January. Postponed or cancelled investments could further harm UK's economic growth path and further weaken the pound.

Source : FactSet

Worse, a vote to leave the EU could make investors less willing to finance the UK's large current account deficit and put at risk the UK economy's recent stability. This shock could set off a negative chain reaction with a sharp fall in sterling, a deterioration of the GDP growth path, and possible increase sovereign risk as some of the major consequences.

On the other hand, a vote to stay within the EU would release some pressure on the economic front and, if not strengthen, at least stabilize the pound. In addition, if PM Cameron succeeds in renegotiating the UK's relationship with the EU, it could improve business confidence and give lead to a continuation of the relatively strong economic growth it has recently enjoyed.



Source : Datastream

The revenue risk at the stock level is the second risk. This factor is something to follow much more frequently as it is scrutinized, like many other elements, during the stock research process. At first sight there are three type of companies held in the portfolio that would experience different fortunes depending on the result of the referendum.

The UK based company with revenues coming mainly from the UK.

In case of a Brexit this type of company will be affected by depressed business confidence from which will result a further drop in growth, weaker UK consumer's purchasing power and tighter financing conditions. For example, companies in the UK food retail business such as *J Sainsbury* and *Wm Morrison Supermarkets*, already suffering from the effects of a price war could additionally be impacted by the effects of imported inflation which will increase pressure on their margins. Housing market related companies such as *Countrywide, Berkeley Group* and *Persimmon* could in addition suffer from the potential loss of foreign house buyers. *William Hill* which generates more than 80% of its revenues within the UK could also be impacted due to the fact that it has some exposure to pro-European Scotland who would face a renewed pressure to leave a newly isolated UK.

Any UK listed GDP sensitive stock with domestic based revenues such as *Topps Tiles* may be punished by the financial markets due to deteriorating economic conditions. *Aberdeen Asset Management*, as a financial service provider, will suffer at least until the uncertainty towards UK's status outside the EU is redefined and this could take some time. As an Aberdeen based company there is also a possible risk if another Scottish referendum is held although the company recently said that it would be manageable.

There will be offsets in portfolios though. UK banks are sensitive to the business cycle and presumably could be hurt alongside the other UK cyclical stocks. The issue of higher cost of goods sold due to a weaker pound may also impact the wider UK retail sector whose supply chains are global in nature.

The UK based company with revenues coming mainly from abroad.

This type of company offers some interesting investment opportunities on most scenarios.

Initially, it is possible that such stocks will be hurt indiscriminately simply due to sentiment. However, the depreciation of the pound that can result from a Brexit would boost the converted foreign revenues of these companies and a slowdown of the economic growth would be less harmful compared to domestically focused stocks. The big downside risk would be a loss on competitiveness owing to a new unfavorable trade deal. Financial service companies represent a substantial part of the UK's exports to Europe and the uncertainty surrounding their access to the single market will be a potential burden. Schroders, Ashmore Group and Aberdeen Asset Management are among such

companies. In these cases Continental European stocks in direct competition with these penalized UK stocks could become potential winners.

On the other hand, if the UK stays within the EU, Cameron would certainly have managed to agree a deal for a better regulatory framework to do business. That would be a plus for UK-EU cross border revenues earners and that could improve the competitiveness of UK financial services stocks in particular.

The EUR based company with significant revenues coming from the UK.

In case of a Brexit, these companies might suffer from weaker GDP growth and also from the translation impact of GBP revenues converted back into Euros. If they have offices in the UK they will have cost benefits, but if the revenues coming from the UK are greater than the net result will be negative. Companies such as BAM Groep and Deutsche Boerse have for example a limited revenue exposure of respectively 30% and 25% of their total sales.