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Should I Stay or Should I Go?

BREXIT UK's EU Referendum

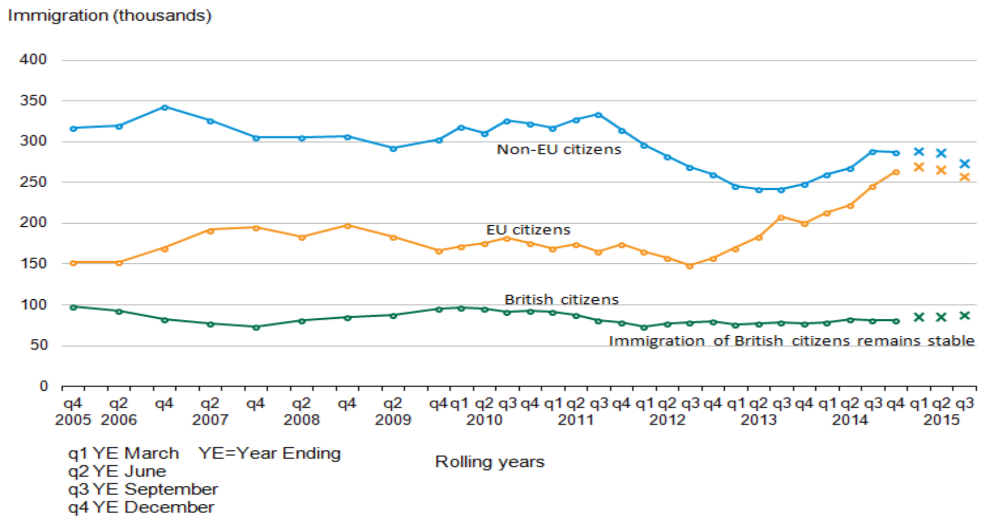
There has been no shortage of headlines over the past months championing both sides of the argument regarding the upcoming (June 23rd) referendum as to whether or not the United Kingdom will remain a member of the European Union. Attempting to wade through all the information and digesting it can quickly become a bit overwhelming, so we thought we would lay out a few key points leading up to the so-called BREXIT (British Exit) vote.

The main issues this vote is intended to address are trade, control over U.K.'s borders, and budget. Essentially, what were originally viewed as the key benefits of EU inclusion (namely the free flow of goods and services, citizens and capital) are now all being called into question.

Free flow of trade, the principal intended benefit of single market membership, has in recent years seen a waning demand of goods from EU nations. Exports to the European Union fell from $240 billion in 2014 to $201 billion in 2015, while over the same period exports to non-EU members rose (U.S. imports climbed from $54 billion to $57 billion). It appears to be a fundamental imbalance of trade that has led many in Britain to question the benefit of remaining in the EU. It is a view, however, that very well may be short-sighted. Relative to their trade ties to the rest of the world, British trade is highly dependent on the EU (EU trade partners represented more than half of both U.K. imports and exports last year). Conversely, U.K. imports and exports made up only 6.25% and 5.07% respectively of total EU trade during 2015. While the exact trade and overall economic impact of leaving the EU is uncertain, it is safe to say that the move would be disruptive and the resulting drag on the U.K. economy could potentially last for decades.

With a lingering recession resulting in a disproportionate influx of EU nationals into the U.K., a growing nationalistic sentiment has placed immigration policy at the forefront of the collective conscience and political debate. The recent terrorist attacks in Paris and Brussels have merely served to fan the flames of the anti-immigrant fervor.

Figure 1:



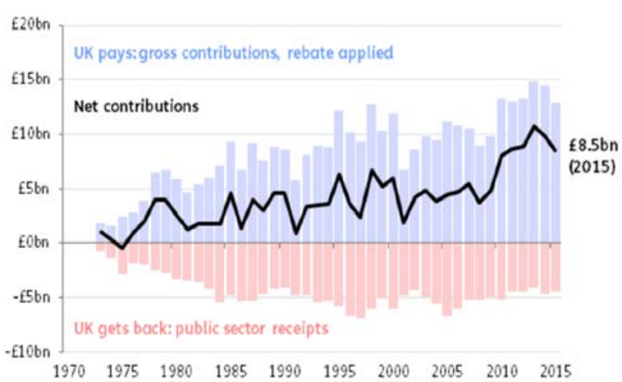
From 2005 to the end of Q3 2015, the UK has seen net immigration of British citizens drop 11%, Non-EU citizens drop 14%, and EU Citizens rise 69%.

Source: Office for National Statistics (Data is through YE September 2015)

From an economic perspective, the concern is that the immigration imbalance will lead to diminishing average wages, while also forcing a larger percentage of the nation's budget to be directed towards migrant welfare payments. However, these concerns overlook the significant economic benefits that come with an open immigration policy. Higher immigration leads to a larger workforce, which ultimately results in faster GDP growth. And while migrant welfare payments may be a justifiable concern, they comprise just a small fraction of total U.K. welfare claims. Data from the Department of Work and Pension and HMRC show that in 2014, 4.9 Million (92.6%) of working age benefit claimants were British, while only 131,000 (2.5%) were EU nationals.

There is no question that EU membership comes at a hefty cost. In 2015, the U.K. government paid £13 billion to the EU budget while the EU spent about £4.5 billion on Great Britain (a net U.K. contribution of £8.5 billion).

Figure 2:



UK contributions to the EU budget have varied from year to year, but as seen here, the net contributions have been on the rise in the most recent decade.

Source: HM Treasury European Union Finances 2015, House of Commons Library analysis and HM Treasury GDP Deflators (8 January 2016)

Although the actual economic impact of Britain's membership is difficult to quantify, some groups have attempted to model out such benefits. John Springford and his colleagues at the Center for European Reform (a London-based think-tank) recently carried out a modelling exercise which concluded that Britain's trade with the rest of the EU was 55% greater than it would have been if it existed outside of the EU.

The Impact of a leave or stay vote

Leave: Britain would gain the benefit of exerting greater trade control as a sovereign state in the long run. However, a significant number of major trade obstacles would also arise. The U.K. (as part of the 28 country EU) currently has preferential trade agreements in place with 53 non-EU countries, each of which would need to be renegotiated. Uncertainty surrounding the status of current trade agreements and the lack of direction for which regulations businesses should follow, could adversely impact trade flows and further economic weakness.

Citizenship status of EU workers in the U.K. (and vice versa) would be called into question. In addition, existing EU regulations on sector-specific business practices (e.g. automotive safety standards, pharmaceutical testing protocols, etc.) would need to be replaced in the U.K. Businesses domiciled in the U.K. would most certainly be disrupted. Considering that full access to the EU single market has made it cheaper for U.K. financial services firms (employing over 1 million people) to sell their products to other EU countries, a vote to leave would certainly lead to a major financial services shake-up.

Stay: A vote to retain EU membership would remove significant concerns for markets (and we know how markets feel about uncertainty). Although the U.K. equity market has already discounted a vote to leave, there could be a meaningful rebound in companies with high U.K. exposure, which include travel related companies, airline and retail companies. Continued membership could also bode well for U.K. banks, which have underperformed both their U.S. and European counterparts. Lastly, without having to worry about new regulations and trade restrictions, companies that do business within the U.K. would most likely continue to expand operations.

Should I stay or should I go?

Recent polls (5/17/16) show 40.5% of British voters in favor of leaving the EU and 47.5% in favor of remaining, with 11.5% undecided. Bloomberg assesses the probability for "BREXIT" to be at 18.85% and "BREMAIN" to be at 81.15%. Assuming the status quo holds steady up until the June 23rd vote, it appears as though we are on track for a continued U.K. presence in the EU.

If there are any questions, please do not hesitate to contact your advisor or visit us online at www.seia.com.

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