JUNE 24, 2016

The Brexit Vote and Its Implications: Q&A

WHAT HAPPENED?
By a slim margin, the U.K. has voted to leave the European Union. The referendum resulted in a roughly 52-48 split. With the British vote to leave, the European Union loses one of its largest economies and staunchest free-market proponents. The United Kingdom, in turn, will be divorced from one of the wealthiest economic blocs in the world. Nothing changes overnight, however. The decision to Leave will not be legally binding until the all-important Article 50 of the EU Treaty is invoked. This will happen after a three-month handover period to a new Conservative government. The vote creates a major crack in the foundation of the European Union, and a major fissure in the transatlantic partnership. Largely spear-headed by the United Kingdom, the European Union has long been America’s number one export market and top destination for foreign direct investment.

WHY DO U.K VOTERS WANT TO LEAVE?
British voters and politicians have been ambivalent about closer integration with continental Europe ever since the U.K. initially joined the European Economic Community (EEC) in 1973. Just two years after accession, the then Labor government held a similar referendum on continuing EEC membership in 1975. And then in 1993, open rebellion by Conservative eurosceptics over implementation of the EU Treaty was held partly to blame for the party’s electoral defeat four years later.

This latest referendum decision stems from a growing discontent among U.K. citizens about the growing influence of EU institutions in Brussels — particularly in the areas of public finances, immigration and sovereignty in lawmaking. Specifically, the Leave campaign has been focused on 1) the U.K.’s net contribution to the EU budget of around EUR 10 billion per year, which could be redirected toward domestic priorities like the national health service; 2) the near 200,000 net new EU immigrants that entered the U.K. last year, most of whom can start claiming out of work benefits within three months of arrival; and 3) the numerous EU regulations and directives that must be incorporated into U.K. law. This was essentially a vote to take back greater control over domestic affairs.

WHAT IS THE LIKELY TIMELINE FROM HERE?
Under the articles of the EU Treaty, the U.K. will now enter a period of negotiated withdrawal from the European Union, and will surrender its treaty obligations and benefits as an EU member after two years unless an agreement can be reached sooner. A process of bilateral, country-by-country renegotiation of trade policy, labor movement and other key areas will then begin, and could last for several years. However, with no precedent for EU withdrawal by an individual nation state, there is a considerable amount of uncertainty over how the remaining members will approach negotiations, what type of economic and political relationship will emerge and over how long. This ambivalence will contribute to market uncertainty and volatility in the months ahead.
It could be argued that the EU will have a strong incentive to ensure that the U.K. is seen to receive unfavorable terms (e.g. on market access for service exports where the U.K. has a trade surplus with the rest of the EU) so as to deter secessionist movements elsewhere on the continent. Indeed given the widespread opposition to this result among European leaders, it remains to be seen whether challenges to the legitimacy of the referendum itself could emerge over the coming days, especially given the narrow margin of victory for the Leave camp. In short, the referendum decision raises more questions at this stage than it provides answers, and official statements made at the upcoming EU Summit on June 28th and 29th will be critical in assessing how the rest of the union intends to respond.

**WHAT ARE THE POTENTIAL MODELS THAT THE U.K. COULD FOLLOW?**

While no individual member state has left the EU until now, Switzerland and Norway (which never joined the EU in the first place) offer alternative examples to full EU participation that the U.K. might follow. As non-members, neither is subject to the full slate of EU rules; both can pursue their own foreign policy; and both can negotiate their own trade agreements while still enjoying access to the single market. However in practice, the additional freedoms that these countries gain from staying out of the EU are limited. As parties to the European Free Trade Association, both still make substantial, if reduced, contributions to the EU budget (Norway proportionally contributes more than Switzerland as a member of the European Economic Area which also grants free movement of capital and labor). Both are excluded from the single market in any area in which they choose not to adopt EU legislation. And both of course are excluded from negotiations on regional trading rules through the EU’s executive and legislative bodies. This may be a particular concern for the U.K., which carries far more weight in Europe than either Switzerland or Norway (the city of London’s population alone is greater than that of both countries) but lacks Norway’s natural advantage as a net energy exporter or Switzerland’s as a historical tax haven with a geographical location at Europe’s center. These may not therefore be particularly suitable examples for the U.K. to pursue.

**WHAT DOES THIS MEAN FOR THE U.K. ECONOMY?**

The referendum decision casts a great deal of uncertainty over the economic and political outlook for the U.K., both in the near- and medium-term. Prime Minister David Cameron, as expected, has resigned. In the days ahead, political fragilities across individual U.K. member countries could also be exposed. Scottish nationalists still in favor of EU membership could push for a second referendum on independence. And in Northern Ireland — where citizens have enjoyed borderless movement with the Republic of Ireland over the 20 years since the end of the conflict, and have benefited hugely from EU transfers — sectarian divisions could also be reopened by the introduction of checkpoints at the border. On top of the political risks, the economic fallout will also be difficult to gauge given the unknown duration and extent of the current market reaction, the various paths that the U.K.-EU renegotiation process could take and the lack of any historical analogues. Private forecasters are estimating potentially a roughly 1-3 percentage point dip in growth over the next few years from current levels (which could tip the U.K. economy back into recession) due to lost trade and investment. And overall, the U.K. is likely to be diminished as a gateway for foreign investment and trade into the broader EU.

**WHICH U.K EQUITY SECTORS MIGHT BENEFIT/LOSE?**

The main macroeconomic effects from the referendum decision on relative sector performance are likely to come through domestic demand and the exchange rate. With economic weakness and depreciation of the pound likely to persist given the considerable uncertainties now facing the U.K. economy, we would expect the more domestically-oriented sectors to underperform from here. These include retail, real estate, transportation and financials. The European Union system has been a key driver of the U.K.’s booming financial sector, which accounts for a whopping 40% of total EU financial services exports. Therefore, this adds additional questions on the financial sector. Defensive sectors and exporters are likely to be
outperformers over the nearer-term, though relative optimism on the latter could be offset by concerns over the potential reintroduction of trade tariffs with EU members.

WHAT DOES THIS MEAN FOR THE MAINLAND EU ECONOMY?
The referendum decision will be a near-term headwind for growth in the rest of the EU, but the direct impact from the U.K. exit is likely to be far less severe than the impact on the U.K. itself. Exports to the U.K. account for just 2.7% of EU GDP, as compared to 7.9% of U.K. GDP for exports going to the EU. However, the indirect spillovers to mainland Europe through financial markets are harder to measure. Credit spreads for riskier EU sovereigns will widen as risk premiums rise across the continent on fears of further fragmentation, and Western European equity market valuations would be set back as a result. This could mean a higher cost of capital for EU firms. And there could also be near-term operational upheaval for the EU as budget contributions are reassigned and voting thresholds for the EU legislature are reviewed. And while the euro should continue to appreciate against sterling, it is likely to weaken against the U.S. dollar. The longer-run effects on the mainland will depend on the outcome of negotiations with the U.K., and whether remaining EU members draw closer together.

WHICH INDIVIDUAL COUNTRIES COULD BE IMPACTED?
Individual EU countries with the closest trade ties to the U.K. are likely to suffer the most in the near-term given the weakness of the pound, lower domestic demand within the U.K. and the prospect of higher tariff barriers (at least until new trade agreements can be negotiated). Ireland and the Netherlands in particular stand out, with export shares of GDP to the U.K. of more than twice the EU average at 7.2% and 5.6% respectively. However, as at the broader EU level, the longer-run country implications are likely to depend on changes in capital flows that result from the U.K.’s new status. Should London cede its position as the principal location for European headquarters among global financial firms and other multinationals, many business leaders have pointed to Frankfurt, Paris and Dublin as potential alternatives.

WHAT DOES THIS MEAN FOR FUTURE EU INTEGRATION?
Even before the U.K. referendum result, the degree of commitment to political cohesion among EU members was questionable. And the leave vote will only increase uncertainty over the future of the union. Across Western Europe, eurosceptic parties have been gaining popularity in Germany, France, the Netherlands, Italy and Spain (which holds a general election this Sunday), and many of their leaders have already called for their own referendums at home. The risk of similar campaigns being waged elsewhere on the continent will need to be watched, particularly as voters go to the polls for national elections in the Netherlands, France and Germany in 2017. The negotiation process with the U.K. will again be critical to watch in this regard over the coming months for the type of deal that can be secured, how quickly it can be achieved and the reaction of political parties in individual countries across the continent. Anti-EU voters could be emboldened by a favorable agreement. But on the other hand, a difficult and drawn out negotiation for the U.K. and a renewed push by the EU institutions toward more cohesion (e.g. through faster completion of the banking union or closer cooperation on intra-EU security policy) could draw the remaining member states closer together and shore up investor confidence. In short, the actions and statements of EU politicians, and the response of EU voters over the coming days, weeks and months will be the key data points to monitor in assessing the likely direction of the post Brexit European Union.

WHAT ARE THE IMPLICATIONS FOR THE US AND GLOBAL ECONOMY AND MARKETS?
Beyond the EU itself, we expect the U.K. exit vote to have a limited direct economic impact on the rest of the world. The U.K. accounts for just 3.9% of global GDP, and for many of the large non-EU economies (including the US, China, India, Russia and Japan), export exposure to the U.K. accounts for less than 1% of total output. The bigger risk to the global economy over the coming weeks and months will come from financial market
channels. Near-term concerns over EU cohesion could cause a widening in sovereign spreads for weaker countries and a weakening in risk appetite globally (as we saw during past bouts of eurozone credit stress in 2011 and 2012). Meanwhile, both the Bank of England and the European Central Bank have stated that they are ready to provide additional liquidity to the banking system should it be needed, while the Federal Reserve will also stay accommodative having passed on a rate hike ahead of the vote earlier this month. This should mean that any financial market fallout to economies outside the EU stays contained, in our view. We should not, however, overlook the earnings risk to U.S. firms should there be protracted weakness in the U.K. economy. Since 2000, the U.K. has accounted for nearly 9% of cumulative US foreign affiliate income (a proxy for global earnings), and 15% of total income earned in Europe. We are also now likely to see more support for the U.S. dollar against the euro, another headwind for earnings. And more broadly, we should also acknowledge that the U.K.’s exit decision could potentially divide a key pillar of Western geopolitical alignment. For decades, the EU has been a unified and stable ally for the US, with the U.K. arguably acting as the transatlantic lynchpin (most recently on the sanctions agreement against Russia). What effect the U.K.’s absence might have on similar US agreements with the EU in the future remains to be seen.

THE CHAOTIC AFTERMATH – WHAT HAPPENS NEXT AND NEAR-TERM RISKS?

Britain’s decision to exit the European Union has significantly unsettled global capital markets that were betting on a Remain vote. The unexpected outcome has triggered a risk of flight to quality, with both the yen and gold gaining in value in the immediate aftermath of the vote. The British pound, the euro, and European equities have sold off heavily, as expected, out of rising fears of a U.K. recession and weaker-than-expected EU growth. Commodity prices will remain under pressure in the near-term, as will most emerging market asset classes. The spillover effects are evident in the US markets, with the US equity market also under some pressure. Central bank easing should mitigate against risks of money markets becoming dysfunctional. Bearish sentiment and a defensive tone to the markets will stretch into the next few weeks as investors ascertain the impending risks to the global economy and capital flows. In terms of policy responses, global central banks will likely do whatever it takes to maintain healthy levels of liquidity, open dollar swap lines, and other easing measures. Watch for more talk from the G-20 about more policy coordination and fiscal reflationaly policies.

WHERE WE STAND

We recently moved to a risk neutral position across all asset classes and maintain these positions in the current environment. We continue to emphasize diversification, high quality assets, and strong cash flow positions. Defensive sectors will continue to outperform. It is in times of maximum uncertainty that we again reiterate our “get paid to wait” strategy, which translates into owning higher quality assets and dividend paying/growing equities and assets. With global bond yields now at or near record lows, higher quality US companies with a dividend yield twice that of US Treasuries are even more attractive, in our opinion, despite premium valuations. A low-yielding world just became even more low-yielding — which means cash flows are even more important across asset classes, fortifying our “get paid to wait” strategy and emphasis on dividend growth ideas.

Source:
1 Bank of England
2 Central Statistics Office of Ireland, Statistics Netherlands, CEIC
3 International Monetary Fund, CEIC
4 Bureau of Economic Analysis

Joseph P. Quinlan
Head of Market & Thematic Strategy

Ehiwario Efeyini
Senior Research Analyst,
Market & Thematic Strategy Team
This report is provided for informational purposes only and was not issued in connection with any proposed offering of securities. It was issued without regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not contain investment recommendations. Bank of America and its affiliates do not accept any liability for any direct, indirect or consequential damages or losses arising from any use of this report or its contents. The information in this report was obtained from sources believed to be accurate, but we do not guarantee that it is accurate or complete. The opinions herein are those of U.S. Trust, Bank of America Private Wealth Management, are made as of the date of this material, and are subject to change without notice. There is no guarantee the views and opinions expressed in this communication will come to pass. Other affiliates may have opinions that are different from and/or inconsistent with the opinions expressed herein. All exhibits are based on historical data for the time period indicated and are intended for illustrative purposes only.

This publication is designed to provide general information about economics, asset classes and strategies. It is for discussion purposes only, since the availability and effectiveness of any strategy are dependent upon each individual’s facts and circumstances. Always consult with your independent attorney, tax advisor and investment manager for final recommendations and before changing or implementing any financial strategy.

Other Important Information

Investing involves risk, including the possible loss of principal. The views and opinions expressed are subject to change without notice at any time, and may differ from views expressed by U.S. Trust, Merrill Lynch or any of their affiliates. These views are provided for informational purposes only and should not be used or construed as a recommendation of any service, security or sector.

This material was prepared by the Merrill Lynch Chief Investment Office and is not a publication of BofA Merrill Lynch Global Research. The views expressed are those of the Merrill Lynch Chief Investment Office only and are subject to change. This information should not be construed as investment advice. It is presented for information purposes only and is not intended to be either a specific offer by any Merrill Lynch entity to sell or provide, or a specific invitation for a consumer to apply for, any particular retail financial product or service that may be available.

This report provides general information only. Neither the information nor any views expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other investment or any options, futures or derivatives related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed in this report and should understand that statements regarding future prospects may not be realized. Investors should note that income from securities or other investments, if any, may fluctuate and that price or value of such securities and investments may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not necessarily a guide to future performance. Neither Merrill Lynch nor any of its affiliates or financial advisors provide legal, tax or accounting advice. You should consult your legal and/or tax advisors before making any financial decisions.

Investments have varying degrees of risk. Some of the risks involved with equities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Bonds are subject to interest rate, inflation and credit risks. Investments in high-yield bonds may be subject to greater market fluctuations and risk of loss of income and principal than securities in higher rated categories.

Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration.

Trading in commodities is speculative and can be extremely volatile. Market prices of the commodities may fluctuate rapidly based on numerous factors, including changes in supply and demand relationships; weather; agriculture; precious metals; trade; fiscal, monetary and exchange control programs; domestic and foreign political and economic events and policies; disease; technological developments; and changes in interest rates.

Bank of America, N.A., Member FDIC.
This report may not be reproduced or distributed without prior written consent.
© 2016 Bank of America Corporation. All rights reserved. | ARR VV8W | 6/2016