June 2016

Omnis Investment Bulletin – The EU Referendum

On 23rd June 2016, citizens of the UK will go to the polls to decide whether the UK retains its membership of the European Union, or whether it strikes out alone. The political debate thus far has been fierce, with both sides claiming social, economic and political gains for the UK should the vote go their way.

The rhetoric surrounding the referendum has clouded the outlook for UK businesses and investors. Depending on which polls are viewed, the vote appears tightly poised. Not knowing whether the UK will retain close ties with its largest trading partner, businesses have refrained from making significant expenditures and investments. This has proved a headwind for the construction and industrial sectors in particular and, ultimately, for the economy as a whole. Thus, even before a decision has been reached, the potential for the UK to leave the EU has had a perceptible impact on the nation's economic outlook.

Though a range of forecasts have been published, the consensus among economists suggests a decision to leave the EU will prove a burden on UK economic growth. Interestingly, while the currency markets have moved to price in the potential of this scenario unfolding, bond and equity markets appear to have adopted a more sanguine stance.

In recent weeks, sterling has weakened markedly against the dollar, euro and yen. In part, this reflects the notion that severing ties with the UK's largest trading partner will trigger a decline in Britain's exports and, consequently, worsen the nation's current account deficit which already stands at record levels. Estimates suggest that, in the event Britain votes to leave the EU, sterling may fall a further 10% or so. In this scenario, investors will be well served by holding assets denominated in foreign currencies. Such assets make up meaningful proportions of all Graphene Portfolios.

"If the UK were to vote to leave, we would see a great deal of uncertainty over the short term, which is rarely taken well by markets. Analysts have predicted that sterling could fall sharply, which would certainly hurt European companies with high exposure to the UK domestic economy.

We don't believe it makes sense to try to predict the longer term implications of a potential Brexit. There are just too many unknowns. Rather than attempting to make such predictions about the future state of the world, we will continue to focus on picking individual companies that we believe can outgrow the broader economy under a variety of different market conditions; where these are available at reasonable prices, we invest."

Cedric de Fonclare
Omnis European Equity Fund Manager

Should the UK vote to retain its current position in the EU, future financial historians may look back at the current preoccupation with the referendum as nothing more than a temporary diversion. Though the pound's decline in part reflects the potential for the UK to leave the EU, it is also symptomatic of the UK's record currency account deficit, as well as a slackening of the UK's economic growth irrespective of the referendum result. Even if the UK votes to remain in the EU, consensus expectations are for a bounce of only 3% or so in sterling's trade-weighted exchange rate. Sterling strength is detrimental to UK-based holders of international assets. A 3% swing in the currency is likely to be of little long-term consequence to equity investors. However, with international bond yields pinned down by low or negative interest rate policies, the returns generated by the Omnis Global Bond fund are likely to be impacted by currency movements.

"We would expect sterling to rise in value in the event of a remain vote, as some of the uncertainty premium associated with the referendum is unwound by markets. This is likely to result in negative total returns for the portfolio, as the value of non-sterling denominated assets will fall in sterling terms.

However, we would expect the extent of any bounce in the currency to be limited as the interest rate outlook in the UK has been reappraised over the last 6-12 months. The likelihood of rate increases (which would support the currency) appears low in the current environment."

Tom Sartain
Omnis Global Bond Fund Portfolio Manager

In contrast to currency market participants, investors in the UK's equity and bond markets thus far appear to have been more influenced by changes in the global economic outlook than by the prospect of the UK's withdrawal from the EU. However, it is arguable that this apparent indifference simply reflects uncertainty over the implications of Brexit. Consensus expectations point towards slowing – and even negative – economic growth should the UK leave the EU, alongside sterling weakness. Ordinarily, slowing economic growth would argue for looser monetary policy. Yet a decline in the currency effectively serves to import inflation, thus arguing for higher interest rates.

Though the Bank of England's mandate refers only to inflation, it is expected that, in such a scenario, Governor Mark Carney would prioritise economic growth. Should he do so, gilts and high quality sterling bonds would likely be among the primary beneficiaries of looser monetary policy. For investors in the Graphene Portfolios, allocations to these assets are achieved through the Omnis UK Bond fund, managed by Columbia Threadneedle.

"The BoE will undoubtedly push out the prospect of rate hikes and may even go as far as to cut rates, as long as sterling is not in free fall... With weaker sterling, it appears at long last inflation may follow suit due to higher import and oil prices. Although inflation, given the long period of 'low and slow' in the economy, would normally be welcomed, with such high uncertainty the BoE will still be forced to keep rates low so as to support businesses."

Mark Burgess
Columbia Threadneedle Chief Investment Officer EMEA

The prospect of loose monetary policy also offers support to UK equity investors. Though slowing economic growth undoubtedly creates a challenging environment in which to expand profits, low or even negative interest rates would permit companies to refinance onerous debt, invest at a low cost of capital or, as has become a feature of the post-financial crisis environment, take on debt in order to fund shareholder-friendly policies such as share buybacks.

Two additional factors offer further succour to UK equity investors. Firstly, the UK's largest companies earn approximately 70% of their revenues from international sources. Should sterling depreciate as expected, the value of these earnings to sterling-denominated investors will rise – a fact that Schroders, the managers of the Omnis UK Equity fund, are well aware of.

"Although denominated in sterling, many companies listed in UK markets receive a substantial share of their earnings from overseas markets, which means they would benefit from an expected depreciation in the currency. Not only would the sterling value of profits rise through translation effects, but overseas demand for the goods and services could also increase as the competitiveness of those companies improves."

Azad Zangana
Schroders Senior European Economist and Strategist

Secondly, following a period of protracted outperformance, the shares of UK companies more dependent on domestic earnings have retrenched in the lead up to the referendum. Consequently, these shares now trade at undemanding valuations, offering potentially attractive opportunities to stock-pickers who remain focused both on a company's ability to generate positive earnings regardless of economic conditions and the price at which the shares of such companies can be purchased

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"The portfolio strategy [delivering attractive long-term returns for investors through investment in quality companies that can deliver sustainable dividend growth] remains the same. The UK economy is important, but not the dominant factor, by any means, in terms of determining portfolio strategy."

Neil Woodford
Omnis Income & Growth Fund Manager

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Over the past few months, the uncertainty surrounding the vote has impacted the UK's economic outlook and influenced the behaviour of its financial markets and its currency. Thus, the EU referendum poses risks to UK-based investors, irrespective of the outcome. For investors in the Graphene Model Portfolios these risks are mitigated in three key ways.

Firstly, the diversification inherent in the portfolios should provide ballast in the volatile market conditions that are likely to persist up to – and shortly after – the referendum on the 23rd June. This is particularly true in respect of the international currency exposures contained within each portfolio.

Secondly, each portfolio contains an allocation to high quality fixed income securities. These allocations should be expected to provide some protection to investors in the event that a decision to leave the EU triggers a period of low or negative economic growth.

Finally, by employing active fund managers, the Omnis funds that make up the Graphene Model Portfolios can be positioned to defend against the risks – and exploit the opportunities – presented by the EU referendum.

Past performance is no guide to future performance and may not be repeated. The value of your investment, and any income derived from it, may go down as well as up and you may not get back the full amount invested.

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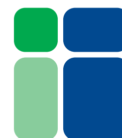

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