

INVESTMENT INSIGHTS

June 2016

IN BRIEF

- Most view Brexit as a binary “in-or-out” outcome. But we see three potential outcomes, and none of them looks likely to spur global growth, given the weak economic backdrop against which the referendum is taking place.
- Protracted uncertainty appears to us to be the biggest risk factor in the event of a Brexit. The task of renegotiating trade agreements with the EU and with other trading partners, as well as changes to the UK regulatory and the legal regime, would have an enormous impact on companies based in the UK.
- Brexit would be a breakthrough for populist movements, with potential implications for the US elections this autumn. It may well signal that voters are moving beyond just registering their dissatisfaction to actually doing something about it.

REMAIN OR LEAVE: IMPLICATIONS OF A POTENTIAL BREXIT

The United Kingdom faces a crucial referendum on its membership in the European Union later this month. While polls have tended to favour the Remain camp, some of the more recent polls have put Leave in the lead. While no one can confidently predict what will happen, most would agree that there will be significant reverberations in financial markets if the UK votes to withdraw from the EU.

Brexit could lead to economic turmoil

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There is no historical road map to guide us as we contemplate the potential impacts of the UK leaving the EU. Currency unions have been abandoned over the years and alliances have been made and broken, but we’ve never seen anything of this scale. With the effects of a vote to leave the EU shrouded in uncertainty, Brexit, in essence, comes down to UK voters choosing some level of turmoil in exchange for an uncertain benefit.

Most view Brexit as a binary “in-or-out” outcome. But we see three potential outcomes, and none of them looks likely to spur global growth over the medium or long term, given the weak economic backdrop against which the referendum is taking place.

An unambiguous vote to remain within the EU would merely maintain the status quo. Short-term uncertainty would be removed, which might result in some repricing of asset and currency markets. And although there would be no real added catalyst for growth, there could be a modest, short-term rebound in UK growth, which has slackened in the run-up to the referendum.

A second potential outcome is a narrow victory for the Remain camp. Such a result might not entirely put the Brexit issue to rest. Prime Minister David Cameron might not survive a close vote, as the referendum has revived old splits in his Conservative Party. Furthermore, opponents of the EU might not go quietly, and could be emboldened to wage another campaign at some point in the not-too-distant future.

Finally, a vote to leave the EU would likely lead to a sustained period of uncertainty. Even in the best case scenario — a smooth negotiation between the EU and the UK on their future relationship — there would likely be at least a two-year period of gridlock while the exit negotiations unfolded. Much of the political bandwidth in the UK and EU would be consumed by these negotiations, pushing other priorities further back. In addition, the European electoral calendar would likely play a role, with national elections in both

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Germany and France in 2017. It's hard to see a promising investment environment for businesses while trade and economic relations between the EU and UK remained unresolved. Reduced investments would likely put a drag on an already sluggish economy. In the worst case scenario, a Brexit vote could prove to be the tipping point for another serious market disruption — not unlike the serial European sovereign debt crises of the past several years, the US Federal Reserve's 'taper tantrum' in 2013 and China's meltdown last summer.

In the event that the UK votes to leave the EU, there will likely be far-reaching market impacts. The British pound sterling would probably weaken materially on a trade-weighted basis, and the UK yield curve could steepen. Rates on the short end of the curve would likely remain depressed on expectations of accommodative policies from the Bank of England, while uncertainty over the UK's relative creditworthiness in a lower-growth, post-Brexit environment could push yields higher on the long end. Countries on the periphery of Europe might also see their yields rise with risk aversion setting in amid fears that more countries might look to leave the EU. In such an environment, the euro could weaken materially, and the continued viability of the EU could be called into question. Finally, global inflation dynamics would likely be further restrained by Brexit, which could renew downward pressure on commodity prices, resulting in possible spillovers into emerging markets.

Potential Brexit impacts on UK equities

Victoria Higley, ASIP, Institutional Portfolio Manager

Protracted uncertainty, at least in the near to medium term, appears to us to be the biggest risk factor for UK companies in the event of a Brexit. The task of renegotiating trade agreements with the EU and other trading partners, as well as changes to the UK regulatory and legal regime, would have an enormous impact on companies based in the UK.

The companies most obviously at risk are domestically focused cyclicals: financials, construction, services, leisure and retail. The banking system would likely be impacted the most. While the UK banks' capital position is far stronger than it was prior to the financial crisis, banks remain tied to the fortunes of the economies in which they operate. Commercial banking operations would be particularly vulnerable. Further, real estate would likely be affected by both lower investment and weaker economic sentiment. UK consumer-facing companies would likely be hurt by falling consumer confidence and lower household expenditures owing to an uncertain post-Brexit environment, as well as the risk of higher labour costs because of some low-wage EU workers returning to the continent.

With a high weighting of multinational companies, including mining and energy stocks, the UK equity market has not fared much worse than many other developed markets as of 1 June, but within the UK market one can point to 'referendum pricing'. A basket of UK-based, domestically focused names have underperformed the broader market, with financials the worst performing sector of the FTSE All-Share Index. A vote to leave the EU would not help this situation. Interestingly, the more domestically exposed stocks have recently appeared to follow the opinion polls more closely, recovering since the end of April as the lead in the polls for the Remain camp has increased, and again giving back some performance at the end of May.

In the event of an exit, the transition process out of the EU will likely determine whether the UK will be materially better or worse off over the long term. Although we wouldn't dismiss the impact of Brexit on the competitive positioning and prospects of UK-based companies, over our investment horizon, it is more likely that the fortunes of the companies we invest in will be determined by their strategic direction, investment choices and, ultimately, the strength and sustainability of their products.

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Brexit: Likely reactions from major trading partners EU, US, China

Camille Humphries, CFA, Institutional Portfolio Manager

If the UK leaves the EU, the British government will face the critical task of negotiating trade deals with the EU and at least 60 individual countries. International trade is a major component of the UK's economy, with exports accounting for 28% and imports accounting for 30% of GDP. The willingness of the UK's major trading partners to negotiate advantageous trade agreements would largely determine the economic impact of a Brexit over the next few years, which will likely weigh on the UK in the short term. From a longer-term perspective, however, we believe that the UK government would eventually secure favourable trade accords with its major trading partners.

The EU accounts for about half of the UK's international trade. While minimising tariffs and regulatory hurdles is in the best interest of both parties over the long term, the UK may find negotiations difficult after a messy divorce. The EU leadership would be eager to discourage other member countries from following a similar path. Regardless of the trade agreements, UK companies that want to sell their products in the single market will be required to comply with EU product and safety standards.

The UK could choose to join the European Economic Area, an agreement that covers three European countries that are outside the bloc — Norway, Iceland and Liechtenstein. The UK would have access to the single market while avoiding regulations in a number of areas. This option would cause the least disruption to the UK economy but would require the UK to contribute to the EU budget and accept the free movement of EU workers, two conditions opposed by those favouring Brexit. A better example for the UK might be Switzerland, which has negotiated a set of bilateral accords with the EU governing selective access to the single market and participation in some policies, such as the Schengen passport-free zone. Switzerland has also agreed to several package deals with the EU, in some cases accepting elements it originally opposed.

Renegotiated trade agreements with the United States and China would also be important. The US accounts for 15% of UK exports and 7% of imports, compared with 6% and 8%, respectively, for China. In light of the traditional 'special relationship' between the US and UK, the two countries would likely fashion a favourable trade agreement in time, but it probably wouldn't happen quickly. Because of the UK's relatively small size and China's emphasis on multinational trade agreements, the UK might not be able to negotiate trade terms as constructive as those in place between China and the EU.

Political repercussions of a Leave vote on the UK and abroad

Ben Kottler, CFA, Institutional Portfolio Manager

A Brexit scenario could very well set off a series of political tremors, both within the UK and abroad. The Brexit question is not just a straightforward economic matter, as many in the markets view it, but an opportunity for the electorate to give the establishment a bloody nose. And the entire establishment — the UK government and the opposition, the president of the United States, the International Monetary Fund and NATO — has all lined up behind the Remain camp. For voters who want to show how they see themselves in the UK and in the world, this is an opportunity to do just that.

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Within the UK, it is likely that Prime Minister Cameron will be forced to resign if the Leave campaign wins the referendum. Chancellor of the Exchequer George Osborne might be forced out as well. It is not clear who would succeed Cameron, but there is the possibility that voluble former London mayor Boris Johnson could be swept into Downing Street after leading the Leave campaign. The leader of the Scottish National Party has called for a fresh independence referendum in the case of Brexit, which could reopen a recently healed wound and would be likely to lead to a vote for Scottish independence so that Scotland might rejoin the EU.

A successful effort by the Leave camp would no doubt energise the growing populist and anti-EU parties within Europe, which could begin their own campaigns to leave the EU. In recent times we've seen populist and right-wing parties in Europe do well in the first round of voting, only to have voters reject them in the second round. It happened not long ago in France, with the National Front leading after the first round of balloting in regional elections in December, only to lose in the second round. The same pattern occurred recently in Austria, where the Freedom Party presidential candidate won the first round of voting but was narrowly defeated by a Green Party candidate in the second round. Brexit would be a breakthrough for populist movements, with potential implications for the US elections this autumn. It may well signal that voters are moving beyond just registering their dissatisfaction to actually doing something about it. ■

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