

The Implications of a Leave Vote in the European Referendum on Treasury & Pensions Activities

Introduction

This note considers the implications of “Leave” vote following the June referendum on LBHF treasury and pension activities and possible actions in anticipation of the vote.

Current Portfolios

Treasury

The LBHF debt portfolio is £232 million. All debt is sterling fixed rate from the PWLB. 71% of debt matures in more than ten years, with only 5% (£12 million) within 12 months.

The investment portfolio is currently £299 million and invested with a relatively small number of counterparties, being UK Government and controlled entities, investment funds and UK and overseas banks. All balances are sterling, relatively short term (maturing within 12 months).

Pension Fund

The pension fund holds assets of £844 million (December 2015). 58% of the assets are equities (equally split UK and Overseas), with 26% in global bonds and credit (majority hedged into sterling), 6% UK ILG, 8% UK real property and 2% cash. Approximately 30-40% of the portfolio is unhedged non sterling currency exposures.

Potential Impact of Leave Vote

The implications of a Leave vote or the belief that the vote is moving towards the leave campaign are hotly contested. It has to be remembered that the UK’s relationship with the EU will not alter immediately after a vote. It will take at least two years and possibly more to negotiate the terms of the UK’s new relationship with the EU. However, markets will react any try and anticipate the outcome of exit negotiations.

Capital Economics have commented “Although we think that the UK will do well in the long run whether inside or outside of the EU, there is clearly potential for a disruptive short term impact from uncertainty that would be seen immediately after a “leave” vote. But we doubt that this would be as bad as many fear”.

The short term implications are perhaps clearer than the long term impact. Both are considered below:

Short Term

The general consensus is that in the short term financial market impact leading up and after a no vote will be:

Sterling depreciation

Falls in the value of sterling denominated assets e.g. equities, bonds and property.

Greater volatility in financial markets

The Bank of England attempting to stabilise financial markets through monetary policy; easing liquidity and changes in interest rates.

Possible downgrading of the Government's credit rating and widening of credit spreads.

Morgan Stanley has predicted a 5% fall in sterling in the immediate aftermath of a vote for Brexit, with weakness persisting into the indefinite future. Citigroup and Goldman Sachs both forecast a 15% to 20% fall. Much of that will be priced in if expectations are of a leave vote.

Shares in UK companies whose fortunes are most linked to the UK economy will suffer the most as markets take stock of the longer term implication on UK growth.

Larger companies in the FTSE 100 are tipped to cope better with the uncertainty generated by the referendum because 70pc of their earnings come from overseas. Exporters should benefit and possibly also UK based businesses with imports being less competitive, although the cost of production will increase.

Long Term

As mentioned above, there is much less certainty of the longer term implications. Much will depend on the agreement the UK strikes with the EU and its trading relationships with the RoW. Differing opinion include:

Will the UK economy grow faster or slower – No agreement. Most converge on the implications being marginal and perhaps limited to the financial services sector.

Although [Brexit] could have a small impact on growth and job creation, it's more likely to have a small overall beneficial effect because of lower regulation, more freedom to make trade deals and savings for the government.

Will overseas banks relocate out of the UK – Some have indicated that they will, but others see London as remaining at the heart of the European financial service sector.

Leave:

Talk of capital flight is nonsense. London will remain a leading financial centre outside the EU and banks will still want to be headquartered in Britain due to low tax rates.

Stay:

Banks will flee the UK and the City of London collapse if Britain votes for exit, because the trading advantages of being inside the EU help boost banks' profits.

Trade in general:

“If Britain withdraws, but follows Norway and remains within the European Economic Area (EEA), the free trade area and the Single Market, there won't be any real change to the way the economy works and interacts with our main trading partner. Changes may take place longer-term as the UK no longer adopts new legislation, but the effects of this cannot yet be

determined.”[Fidelity]

Will interest rates be higher or lower – a lower sterling may boost inflation requiring rates to increase, however slower growth or market stabilisation may require rates to fall.

The IMF has commented if the referendum were to decide in favour of leaving the EU the IMF would expect negotiations on post-exit arrangements to be protracted, which it warned "could weigh heavily on confidence and investment, all the while increasing financial market volatility".

It also believes a UK exit from the EU would "disrupt and reduce mutual trade and financial flows" and restrict benefits from economic co-operation and integration, such as those resulting from economies of scale. The emphasis is on global implications.

However, the Fund said that UK domestic demand, boosted by lower energy prices and a buoyant property market, would help to offset the impact on UK growth ahead of the EU referendum.

Implications for LBHF Treasury and Pension's Portfolios

Treasury

There will be no significant short term impact on the debt portfolio, which is all fixed rate and with minimal short term maturities. The investment portfolio will cover redemptions for many years to come. Should the UK Government credit rating fall, the cost of Government and hence local authority borrowing may eventually increase.

When considering investment returns, whenever there is uncertainty markets seek safety. Yields on short term UK government debt may fall while banks and corporates may have to offer higher returns. Depending on which way interest rates move, expected returns could increase or decrease. No potential counterparties will leave the market and if overseas investors seek less exposure to sterling, the returns from sterling investing could increase.

Proposed Actions

The safety course is to invest with the most secure counterparties, including UK government, high quality overseas banks and diversified money market funds until clarity returns. The portfolio will continue to emphasis security. Should attractive yields emerge for longer term maturities, these should be considered. This is very much in line with current policy.

Pensions

Investments

As noted above, the pension fund investments include global equities and bonds and UK real estate. The most obvious impact is that those assets invested outside of the UK will benefit from sterling's continued depreciation. However, sterling has fallen recently and a remain vote could see a sterling recovery. Similarly, larger UK companies with significant non UK operations or net exporters will also benefit from a fall in sterling.

The schemes fund managers will already be considering the outcome of the vote and positioning their portfolio accordingly.

The assets that might suffer include credit, where uncertainty will impact on spreads and real estate, where overseas buyers have recently been one of the factors behind the property recovery, representing 50% of commercial property purchases [Capital Economics]. The fund's bond mandates are global and the managers are not required to hold UK securities.

Potential Actions

The LBHF fund is a long term investor and therefore short term volatility has little impact, in fact it can represent a buying opportunity.

With the longer term impact of Brexit so unclear, any action is as likely to lose value as gain. Fund managers will already be positioning their portfolio to take advantage / protect against market moves. Any negative impact on UK stock or property markets is likely to be offset by gains on non-sterling denominated assets. Trying to sell illiquid assets such as property in the short term will incur substantial transaction costs. Thus no immediate action is recommended.

Conclusion

The consensus from economists is that "the UK's long term prospects do not hinge on the Brexit question. Admittedly, the short-term impact would certainly be negative." [Capital Economics]. Markets will react as they anticipate the vote and sterling has already suffered. With negotiation on new agreements with the EU likely to take years, change will be gradual.

As always a focus on high quality and diversification is critical. Treasury investments need to emphasize security of capital, while pension investments can look through short term volatility and focus on the relatively unchanged long term prospects.