# JCP Investment Partners – Investing in Practice

## Brexit Research Trip: Sell London, Buy Regional Britain but Uncertainty Prevails

October 2016

### A Step Too Far

In January 2013, David Cameron, the then UK Prime Minister, committed to an In-Out referendum on the UK's membership of the EU. He made this pledge in an attempt to unite his Conservatives, see off a challenge from the rising populist UK Independence Party and put Labour (unwilling to countenance a vote on the EU), on the back foot. In September 2014 he then staved off a Scottish Independence vote before going on to win an unexpected majority in the House of Commons in May 2015 which made him the first Conservative leader to do so in 23 years. Cameron was riding a significant political wave until executing his referendum pledge on 23 June 2016. The UK people voted to leave the EU by a majority of 51.9% on a national turnout of 72%, which was the highest ever turnout for a UK-wide referendum and also the highest for any national vote since the 1992 General Election. Honouring his pledge to hold a referendum was a step too far for Cameron and one that ultimately cost him his Prime Ministership.

### Brexit Shock

The exit vote triggered a political crisis in the UK, sending shockwaves throughout global capital markets and pushing the UK economy into a nebulous period of uncertainty. To exit the EU and respect the outcome of the referendum, it will require the UK Government to trigger Article 50 of the 2009 Treaty of Lisbon. (Refer Appendix A).

### The Aftermath: A Visit to the UK

In light of these events and given our portfolio exposure to the UK and the European Union, we undertook a research trip to the UK to witness firsthand the unfolding ramifications of this decision. JCP's Head of Financials Research and Senior Portfolio Manager (Matt Wilson) visited London and Glasgow in October for 25 meetings with 37 people, across a range of sectors and expertise, including: Property (Office, Commercial, and Residential), Banking, Retail, Recruitment, Asset Management, Research, Regulation, Policy, Whiskey, and Oil, among other things. The aim of these meetings was to better understand the political, economic and real impacts of this changed course for the UK economy.

After the initial shock of the exit vote, confidence and activity appear to have bounced back sharply. However, the question is, will this be sustainable?

Questions we sought to gain insight on:

- **What drove the exit vote?**
- **What is the path to exit?**
- **Could Brexit be reversed?**
- **Near and long term economic and policy implications?**
- **Scottish Independence?**

### Key Observations

- The Brexit referendum was a **gross miscalculation by David Cameron**.
- The exit win was a **clear rejection of globalisation and QE, exacerbated by domestic policy failures and political opportunism** on immigration sensitivities.
- **The Brexit vote itself was straightforward, but the uncertainty could prevail for a long time**.
- **Base case will see the implementation of WTO rules**. However, this only covers 'goods' **not 'services'**
- **Business has returned to 'doing business' surprisingly quickly**.
- **Uncertainty will lead to slower growth but not a recession**.
- **Lower Sterling is unlikely to make much difference in trade** given the nature of UK exports.
- Bank of England rate cuts below 10bps unlikely. **Expect to see the emphasis move to fiscal policy.**
- **London is a vibrant global city with resilience and flexibility**.
- **Regional UK and its six key cities** (Glasgow, Birmingham, Manchester, Leeds, Edinburgh and Bristol) **will likely benefit from any slowdown/shrinkage in London**.
- The **fall-out in Europe could be significant.**
- **Scottish Independence looks unlikely** given Scotland's fiscal position.

### What Drove the Exit Vote?

The UK economy has performed relatively well compared to the rest of the EU post the 2008 financial crisis. UK success and EU austerity has created certain pressures for the UK. Human and financial capital within the EU moved to where job opportunities and remuneration presented itself – largely London and some of the UK's regional cities. This influx placed pressure on the three planks of community existence; housing, health, and education. Indeed, one might say, a failure to execute sound domestic policy by encouraging investment in homes, hospitals and schools played a key role in the decision made by the 'exit' voters. Feedback from a number of meetings suggested that the UK needs to build ~200k houses a year, yet is only building ~80k. Contrast this to Australia with only 38% of the UK population and building 210k!

Two apparent non-negotiables in the exit process emerged:

i) Free movement of labour within the EU; and
ii) EU supremacy of law.

The anomaly of Brexit is that there is no common strategy. Many 'exiters' seem at odds with the correct pathway forward. On the one hand, ardent right wingers that see the UK adopting a Singapore/Hong Kong globally open model; and the other, extreme protectionists wanting to close borders and restrict capital flows.

### The Path to Exit?

The consensus view was clear; there is no near-term upside from Brexit and life beyond Brexit looks to remain extremely uncertain for some time yet. While the exit agreement itself should be relatively easy to establish it will likely come with its challenges. The replacement trade agreement is expected to take some time to establish given the complexities involved. The UK will only be able to negotiate new, bi-lateral trade deals once it has formally exited the EU. Skill in negotiation will be critical in driving outcomes, with the EU likely outnumbering the UK on experienced trade negotiators. A Norway-like transition arrangement is unlikely given the risk that it could encourage additional exits from the EU.

The base case will see the UK revert to WTO Rules to enable trade access to the EU. However, this will only cover 'goods'. While the UK itself is currently not a member of the WTO (membership was previously via the EU), joining should not be a problem. Given the trading dynamic between the UK and Germany, whereby the UK imports many German goods, we would expect the outcome to be reasonably pragmatic. Leaving the customs union may present logistical inconveniences, but these should not be insurmountable. Services are not covered by WTO Rules and therefore stand to be more problematic for the UK. In particular, financial services, which represent around 40% of UK exports, employ 700k people in London (versus 70k in Frankfurt and 60k in Paris) and contribute material tax revenues.

The consensus view was that the City would shrink, with some jobs moving to Paris and Frankfurt, while other jobs/functions will likely disappear completely as US banks retreat to New York. Interestingly, a European presence tends to cost 40% more than in London. These moves would extend the secular trend of shrinkage in Institutional/Wholesale Banking. The conundrum here is that this industry is economically important but politically unpopular.

It is also worth noting, that while financial services seem large, they have only represented 6% of leasing activity in London since 2007. Technology has been much more active representing 26% of leasing deals. Indeed, technology and media appear utterly relaxed about Brexit; both Apple and Facebook have recently signed long-term leases for European headquarters in London. The general expectation is that other industries will fill any void left by a smaller financial services sector. As a result, the UK could become more diversified.

### Could Brexit be Reversed?

Throughout our journey, we met some people that hoped the Brexit decision would be reversed. "London is a European asset, and we need free movement of people", was this cohorts catchcry.

More specifically, there is a group of private citizens that have launched a High Court challenge claiming the UK Government has no right to execute Article 50 without a Parliamentary vote. The Government claims it has a '*royal prerogative*' following the referendum to do so. If Parliament voted in line with their stated public views on Brexit, then the 'remain vote' would win about 60% of the vote. However, the question remains - could Parliament ignore the referendum outcome?

Others suggested unravelling the linkages with the EU will become so difficult and cumbersome that they will abandon the process at some stage. Pragmatism may prevail to avoid Europe tearing itself apart.

### Near and Long-Term Economic and Policy Implications?

Nobody we met had a definitive answer about the near and long-term economic and policy implications of Brexit. As written above, business has returned to 'doing business' surprisingly quickly. Mortgage flows have stabilised, recruitment flows are returning to pre-Brexit levels (indeed, demand for accountants, lawyers and consultants has increased), confidence and the PMI have bounced, property cap rates have tightened to pre-Brexit levels, and construction activity continues apace, with no known delays or cancellations.

Businesses are expected to adapt to continue to 'do business'. Some will shrink as opportunities close, while others will expand into new projects. Some businesses have implemented contingency plans by opening offices on the continent, supported by comments such as "*we can deal with change, but we fear uncertainty*."

The Conservatives are likely to augment loose monetary policy with expanded fiscal policy, and Heathrow's third runway approval could be the first decision to reflect this stance (await the Chancellor's Autumn Statement 23 November). The Bank of England messaging indicates that rates are unlikely to fall below 10bps. We expect more investment outside of London into regional Britain as politicians respond to the result.

Uncertainty will lead to slower growth but no recession. Sterling will likely remain volatile, and the downside could be parity with the USD. However, a lower Sterling is unlikely to make much difference in trade given the nature of UK exports, i.e. high-value and price insensitive items with many and complex integrated EU supply chains.

The European response will be rightly hard, as they fight to keep the Euro together. Accordingly, the UK should not expect any concessions. The fall-out in Europe could be significant with French, Dutch and German elections in 2017; and an Italian referendum on 4 December 2016 (with Renzi hoping to reduce the size and power of the Senate). In France, Le Pen's National Front party only need 25% of the parliament's seats to raise a referendum on EU membership. In Italy, a Senate reform referendum failure will likely topple Renzi and lead to an election and potentially a leader who promises to guide Italy out of the Euro. Polls and contacts we met with suggested that across Europe there is 40% support in most countries for a Euro exit.

### Scottish Independence?

It was hard to find support in Scotland for another referendum on Independence; perhaps this was a Glaswegian centric view.

Sentiment amongst those we met was broadly consistent: the Scottish people had their vote, spoke clearly and it had been touted as a "*once in a generation opportunity*" at the time. While the Scots are notoriously emotionally nationalistic, they aren't foolhardy. It is well understood in the UK that Scotland's fiscal position is challenged. Indeed, the drop in the oil price drove negative tax revenue growth this year.

The Scottish National Party leader, Nicola Sturgeon, is an effective politician doing a good job at leveraging the Brexit process to further the interests of Scotland. The Independence vote has fallen to 40%, and Sturgeon has stated it needs to be at 60% for a period to warrant requesting another referendum. Fail again, and her political career is over, and Scotland goes the way of Quebec.

### Other Pertinent Data Points:

- Buy to let ("BTL") prudential rules (a pointer to where Australia could head) state that these rates are 100bps above owner occupied. Also, affordability rules are very strict with 145% interest cover ratio, +2% stressed interest with reducing tax deductions (40% to 20% over five years) and 3% more stamp duty.
- Refinances have replaced the slowdown in BTL with five year fixed rates currently at 1.79%!
- High-end London homes down ~10%, while the rest of the UK is still growing modestly. However sales turnover has dropped to a very low 7%.
- London Office vacancy is 4% (versus a long-term average of 7%) but is expected to rise to 5% with near term completions.
- Mortgage Brokers are 75% of the system and only earn a 40bp procurement fee.
- London Office is priced 100bps wider than Frankfurt and Paris reflecting the occupational risk Brexit may invoke.
- Westfield Stratford shoots the lights out: 1.9m square feet of space generates annual footfall of 45m (growing at 10%) and sales of GBP1bn in the poorest Borough of London (Newham). Westfield has created two world-class assets which are hard to replicate in London, strategically located and well served by all forms of transport.
- After the 2008 Financial Crisis and in line with most UK core cities, Glasgow lost 87k jobs, of which only 40% will be recovered by 2038. Regional UK has not enjoyed a period of exuberance like London.

### Conclusion:

We return to Australia with a view that the UK can avoid a deep recession, but currency volatility will remain a challenge for investors. Having processed our learnings from this visit, we believe that the base case economic outcome will be more like a struggle rather than a complete collapse.

From a portfolio perspective, it looks like a reset between London and the regional UK, which is supportive of our Clydesdale Bank (CYB) position. Therefore, we remain comfortable with our portfolio exposure to this stock. Henderson Group PLC (HGG) should be able to navigate the Brexit process by developing their European footprint. However, the company's appetite for risk assets is likely to be volatile. We currently maintain some exposure to HGG in our portfolio but are reassessing the positioning in the context of the recent Janus merger. We have a come away with a more positive view on Westfield (WFD) UK assets and the company's ability to create some unique and well-protected retail and residential assets in the UK.

As written above, we are mindful of the elevated uncertainty facing the UK for the foreseeable future, and as such, we continue to monitor portfolio positions that are exposed to the UK closely. We will continue to have ongoing dialogue with our proprietary contacts in the UK to support our research efforts and to keep abreast of the Brexit aftermath as it unfolds, along with the risks they pose to client portfolios.


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### Appendix A: Article 50 Treaty on the European Union

1. *Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.*
2. *A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.*
3. *The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.*
4. *For the purposes of paragraphs 2 and 3, the member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in decisions concerning it.*
    - *i) A qualified majority shall be defined in accordance with Article 238(3)(b) of the Treaty on the Functioning of the European Union.*
5. *If a State which has withdrawn from the Union asks to re-join, its request shall be subject to the procedure referred to in Article 49*

For more information on the Treaty of Lisbon, please follow the link below:

http://www.lisbon-treaty.org/wcm/the-lisbon-treaty/treaty-on-European-union-and-comments/title-6-final-provisions/137-article-50.html



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