COMMENTARY

April 22, 2016

Dear clients and colleagues,

With the Brexit referendum and a potential re-election process in Spain, stock markets should remain uncertain. Once again the “Sell in May and go away” proverb could take on its full meaning. Although the real outcome of a Brexit scenario is hard to assess at this time, here are some thoughts on the subject.

The UK financial market has de-rated over the past few weeks. As of April 21, the UK small cap market (-12.8%) has been one of the worst performing markets year to date. Over this same period, only Portugal and Hong Kong have done worse.

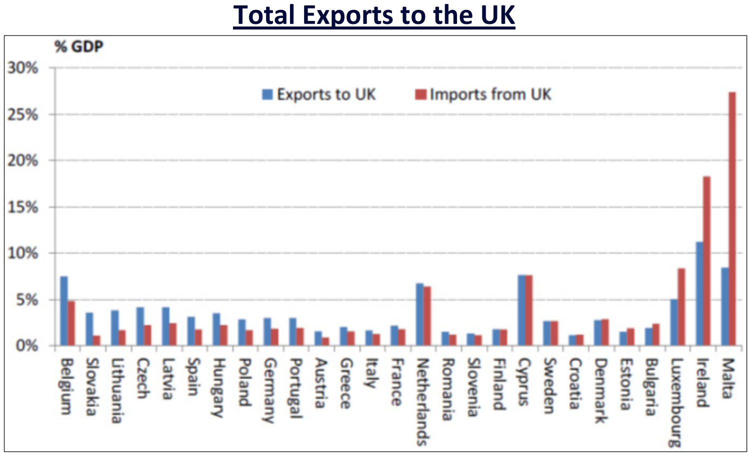
Without any surprise, the Brexit referendum has primarily impacted the British financial markets, the real estate industry and the pound sterling. As confirmed by the returns of the MSCI UK Small Cap index, the financial sector (-17.0%) has been the worst performing sector year to date. In fact, all sectors are in negative territory with the exception of energy and materials.

Potential impact on Trades and Investments

When looking at the exports between the two trading partners, we realize that the EU (European Union) is not so exposed to the UK. While 45% of UK exports go to the EU, less than 7% of EU (ex-UK) exports go to the UK. We reached the same conclusion when looking at the sales exposures of holdings within our portfolios. Our UK-domiciled companies export 12% of their sales to EU whereas our EU-domiciled companies derive 6% of their sales from the UK. Bottom line, our UK companies are more locally focused and the EU would likely be less impacted following a Brexit.

As shown below, the most exposed countries to a potential fall in exports to the UK are Ireland, the Netherlands, Belgium and Luxembourg.

Total Exports to the UK



Source: Eurostat, Deutsche Bank

A Brexit scenario would also impact investments made by foreigners. According to World Investment Report, the UK is the world's fourth largest recipient of direct foreign investment. The Netherlands, Luxembourg and France are amongst the top investors in the region and represent more than 54% of total investments made in 2014. A prolonged period of uncertainty following a Brexit would significantly reduce foreign direct investment.

Potential impact on sectors

UK Financials/Real Estate/Housebuilders:
The UK's financial sector would be the most impacted in the event of a Brexit. Similar to Switzerland, exports of services may be excluded under a free-trade agreement with the EU. Without free movement of people and capital, the UK's position as Europe's financial centre will be at risk.

A Brexit scenario would also be negative for the overall real estate space, especially for commercial real estate. In the mid-term, international buyers could take advantage of a depressed pound sterling to reallocate into the sector.

Housebuilders would be fairly immune to a Brexit situation. The sector has been supported by several government programs facilitating homeownership and good mortgage availability. Moreover, the Bank of England would most likely maintain an accommodative monetary policy in a Brexit scenario. On the other hand, in the long term, demand and confidence could be impacted.

UK Consumer / Travel:
A Brexit would further pressure the pound sterling. UK consumers would probably redirect their consumption spending to the UK. Companies such as The Restaurant Group and Greggs would probably see a positive impact. A cheaper currency would also drive international travelers to the UK, which would increase demand for hotels and restaurants. On the other hand, retailers would suffer from an increase in input cost denominated in USD or EUR.

UK Industrials:
Industrial companies (engineering firms, commercial services) that have an important part of their production base in the UK and sell predominantly outside of the UK would definitely benefit from a weaker pound.

A Brexit scenario would clearly have a meaningful impact on the UK's economy. Although we believe that a Brexit scenario is unlikely, we remain vigilant on any possible outcomes. The UK's financial market has already been under severe pressure, but we believe that a Brexit situation is creating some investment opportunities.

Have a good weekend.

The Global Alpha Team