

# BREXIT: BREWING TEMPEST, OR MUCH ADO ABOUT NOTHING?

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06/09/2016

On June 23, United Kingdom citizens will vote on whether to stay in or exit the European Union. A vote to exit started as a slim chance but has grown to become a real possibility, with recent polls indicating that a majority of UK voters now favor [Brexit](#).<sup>1</sup> As the possibility grows and the voting date nears, discussions of hypothetical outcomes begin to take on more clarity. If voters choose to stay in the EU, look for the pound sterling (GBP) and the euro to rally against the dollar, along with UK and European stocks. Should voters choose to exit, we believe the pound is likely to continue weakening, and exporters and financial stocks throughout the UK and Europe would likely see a headwind develop over the next two years, as lawmakers and regulators translate that voter mandate into policy. With the UK currently running a [current account deficit](#), it is considered a net debtor to the rest of the world. Part of what helps the UK maintain this deficit is its unimpeded access to the EU and the foreign investment or capital inflows that it provides. If the UK exits the EU, it's possible that frictional costs to attract foreign capital may increase, thus potentially making it harder for the UK to finance its deficit. A wave of reregulation would undoubtedly swoop over the financial industry as it relates to the UK and Europe, halting and complicating new and existing business. The duration and effects of this reregulation process are impossible to forecast and, more likely than not, will have negative effects on the UK financial sector in aggregate, with the potential for a residual impact on European banks as well. It is worth noting that European financials have been the worst-performing sector in Europe this year, falling 9% year-to-date in U.S. dollars<sup>2</sup>. Any decrease in demand for GBP-denominated assets could also create continued pressure on the British pound. In fact, since the possible Brexit first made headlines in May of 2015, the pound sterling has declined about 5.5% against the U.S. dollar.<sup>3</sup> Brexit creates uncertainty on all fronts: while the terms and conditions to be set on future trade agreements are unknown, it is likely that being outside the block, the UK will have less leverage to negotiate favorable trade terms in the future. At a [bilateral trade](#) level, trade agreements both with the EU and outside the EU may become more costly. Adding to the uncertainty is the prolonged timeline until the UK would be fully disentangled from the EU and new deals on trade, security and law-making are agreed to. Under [Article 50](#) of the Treaty on European Union, which stipulates the process of withdrawal from the European Union, Britain might have to wait two years to face the new terms and conditions for withdrawing from the block. Until this is clarified, it remains uncertain which trade model the UK is going to emulate. While relinquishing EU membership to reclaim control over immigration means losing access to the EU's single market, the greater long-term risk is the fracturing of the UK itself. Among Conservatives, the party is largely split, with six cabinet ministers alongside half the Conservative Members of Parliament lining up against Prime Minister Cameron's case for remaining in the EU. The euro is also at risk of succumbing to selling pressure, as fringe parties will seek to exploit Brexit by pushing their own nationalist agendas at the expense of a Europe-wide plan to tackle budget deficits, unemployment and immigration. If there is any silver lining to the specter of Brexit, it may be that the European Central Bank (ECB) continues to take spirited action in an attempt to spur private sector lending across the continent. The corporate sector purchase programme (CSPP)<sup>4</sup> and the targeted longer-term refinancing operations (TLTRO II)<sup>5</sup> should provide a major boost to [credit](#) growth. The implementation of CSPP (June 8) and of TLTRO II<sup>5</sup> (June 22) should help accelerate domestic demand-led growth as banks are expected to more enthusiastically take up interest-free ECB loans. The additional announcement of CSPP and the TLTRO programs have worked to counter any incentive to rein in credit. Small businesses have not seen tightening in the face of the turmoil in eurozone banks this year, and that means the European recovery remains on track, even in the face of dire headlines. **Investment Considerations** One way to mitigate the impact of the pound sterling, given the uncertainty of the vote, is to consider [hedging](#) the impact of the currency. WisdomTree made this possible when, in June of 2013, it launched the [WisdomTree United Kingdom Hedged Equity Fund \(DXPS\)](#). Its underlying Index, the [WisdomTree United Kingdom Hedged Equity Index](#), is significantly under-weight financials compared to traditional [market capitalization-weighted](#) benchmarks. In fact, as of June 6, 2016, the

WisdomTree Index had 8.6% less weight to financial stocks relative to the [MSCI United Kingdom Index](#). In Europe, the [WisdomTree Europe Hedged Equity Index](#) is currently more than 11 percentage points under-weight European banks relative to the [MSCI EMU 100% Hedged to USD Index](#). The largest over-weights in the WisdomTree Index come in the Consumer Staples sector, particularly to global brand names like Unilever, Heineken and L'Oréal, and in the Industrial sector, to names like Siemens, Philips and Airbus.<sup>6</sup> We believe this had made both strategies slightly better alternatives to the currency hedged cap-weighted benchmarks in 2015 and 2016, given the total returns of the WisdomTree Indexes,

Index	WT Index Inception	Average Annual Total Returns as of 5/31/2016		
		YTD as of 6/3/2016	1-Year	Since WT Inception
WisdomTree United Kingdom Hedged Equity Index	5/1/2013	3.40%	-6.44%	2.68%
MSCI United Kingdom US Dollar Hedged Index		1.68%	-7.74%	2.24%
MSCI United Kingdom Index		0.03%	-12.12%	0.15%

displayed

below.

Index	WT Index Inception	Average Annual Total Returns as of 5/31/2016			
		YTD as of 6/3/2016	1-Year	3-Year	Since WT Inception
WisdomTree Europe Hedged Equity Index	7/2/2012	-2.05%	-9.01%	7.45%	13.30%
MSCI EMU 100% Hedged to USD Index		-4.44%	-9.40%	8.00%	12.65%
MSCI EMU Index		-0.98%	-8.40%	2.52%	8.71%

Source: Bloomberg, as of 5/31/2016. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

Should the Brexit referendum

pass on June 23, it remains to be seen which stocks and which sectors bear more of the relative pain that is expected to coincide with a major disruption in how the UK manages its economic relations with the rest of Europe. Although the referendum expresses the will of the people, investors should be mindful that the British parliament has two years in which to disengage from the EU, so a break would not happen overnight. Moreover, given sentiment among some British elites that they gain more from integration with Europe than they do from separation, British lawmakers may look for a compromise: a way to honor the vote of the people while keeping the UK tethered to the common market, without being obligated to follow all the rules that apply to European Union members. Similar to the confusion that accompanied the fear of a Greek exit from the euro (Grexit), wherein the ultimate solution hinged on details that needed to be resolved well into the future, a cataclysmic market impact may not develop even in the aftermath of a British vote to leave the EU. Although Prime Minister Cameron has equated Brexit with a "bomb" being detonated on the British economy, the actual impact over the months that follow may be more muted than people now expect. Should UK voters decide to stay in the European Union, we expect UK and European stocks to rally, given that some of the discounting has already occurred.

<sup>1</sup>Source: Greame Wearden and Nick Fletcher, "Pound Slides as Polls Show Brexit Support...", The Guardian, 6/6/16. <sup>2</sup>Source: Bloomberg as of 6/6/2016. Returns measured using the MSCI Europe Financials Index in U.S. Dollars. <sup>3</sup>Source: Bloomberg, from 5/28/15 through 6/6/16. <sup>4</sup>According to the ECB, the "CSPP aims to further strengthen the pass-through of the Eurosystem's asset purchases to the financing conditions of the real economy. Purchases will start in June 2016. The CSPP will be carried out by six national central banks acting on behalf of the Eurosystem, coordinated by the ECB. In combination with other non-standard measures, the programme will provide further monetary policy accommodation and help inflation rates return to levels below, but close to, 2% in the medium term." (Source: [www.ecb.europa.eu](http://www.ecb.europa.eu)) <sup>5</sup>According to the ECB, TLTRO II "will offer attractive long-term funding conditions to banks to further ease private sector credit conditions and to stimulate credit creation. TLTRO II is intended to reinforce the ECB's accommodative monetary policy stance and to strengthen the transmission of monetary policy by further incentivizing bank lending to the real economy. In conjunction with the other non-standard measures in place, TLTRO II will contribute to a return of inflation rates to levels below, but close to, 2% over the medium term." (Source: [www.ecb.europa.eu](http://www.ecb.europa.eu)) <sup>6</sup>Visit the [WisdomTree Europe Hedged Equity Index](#) page, the [WisdomTree United Kingdom Hedged Equity Index](#) page and the [WisdomTree United Kingdom Hedged Equity Fund](#) page for current holdings.

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## DEFINITIONS

**Brexit** : an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Union.

**Current account deficit** : Situation where a country has a greater level of imports than exports.

**Bilateral Trade** : Exchange of goods between two countries.

**Article 50** : States the rules and procedures regarding a member of the EU intending to withdraw from the EU.

**Credit** : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

**Hedge** : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

**MSCI United Kingdom Index** : A market capitalization-weighted index designed to measure the performance of the United Kingdom equity market.

**MSCI EMU 100% Hedged to USD Index** : represents a close estimation of the performance that can be achieved by hedging the currency exposure of its parent index, the MSCI EMU Index, to USD, the "home" currency for the hedged index. The index is 100% hedged to USD by selling the EUR forward at the one-month forward rate. The parent index is composed of large and mid-cap stocks across 10 Developed Market countries.