

‘Britin’ or ‘Brexit’?: ”Brexit” is a confidence killer for UK gilts and broad European risk assets (Part 4)

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This week we look at the impacts of ‘Brexit’ in our in-depth focus on ‘Britin’ or ‘Brexit’. See what you missed last week when we examined the **‘Britin’ argument: “A confidence boost for European risk assets”**

A “Brexit” would potentially undermine trading and investment decisions and the fiscal outlook for the UK. These are obviously important considerations for the markets, not least because UK’s large trade deficit of 3.7% with the EU creates imbalances in UK’s balance of payment, which may give the UK less leverage to restore it without undermining the sterling. With the EU accounting for nearly 50% of UK’s total merchandise trade while the UK accounts for only 5% of EU’s total (see Chart 4), it is the UK, that depends on the EU, rather than the other way around. And while the UK is a net exporter of (financial) services to the EU, the drive towards strengthening the Fiscal Compact by the EU, such as establishing a single framework for regulation and supervision on banking, would likely strengthen financial services amongst French, German and Italian banks longer term while eating into UK’s market share.

The growing trade deficit is increasingly sustained by foreign investors who, without their capital support, would otherwise add pressure on the sterling to devalue and the yield on gilts to rise. For instance, FDI into the UK in 2014 was a £52bn according to the OECD October 2015 FDI statistics, and when extrapolating the 2013 breakdown by country of origin, then about half is estimated to have come from EU countries. The ability of the UK to continue to attract EU capital to that degree looks unrealistic against the uncertainties Brexit creates.

The risk of sterling assets weakening is also underpinned by relative large portfolio investment inflows in recent years. Faced with a global economic slowdown, the timing of Brexit is unfortunate. Debased commodity prices, high private sector indebtedness, industrial overcapacity and rising fiscal deficits of foreign trading partners will likely reduce the trade and capital flow imbalances between them and the UK and continental Europe. However, given that the Eurozone, Switzerland, Sweden and Denmark are net exporters of goods and services and by implication, of capital, the adjustment to financial markets should be relatively muted. However, as a net importer of goods, services and capital, Britain looks vulnerable. Unless foreign investors’ waning enthusiasm for sterling assets is countered by portfolio inflows from domestic investors, the pressure will be on sterling to devalue to restore that imbalance.

There is evidence of this already happening: Foreign investors’ holdings in UK gilts, worth GBP427 billion in Q3 2015, have barely increased from 12 months ago and its share of 26% of all holdings in gilts combined is down by 5% over the same period. As Chart 4 also shows, the portfolio inflows into the UK – mainly debt securities – have recently come off from historic peak levels when compared to GDP, suggesting that

the uncertainty caused by Brexit – including a potential downgrade on the longer term outlook on UK’s sovereign debt by credit rating agencies –could reinforce the slowdown of the inflows into sterling assets, if not altogether compel foreign investors to cut their exposure.

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