

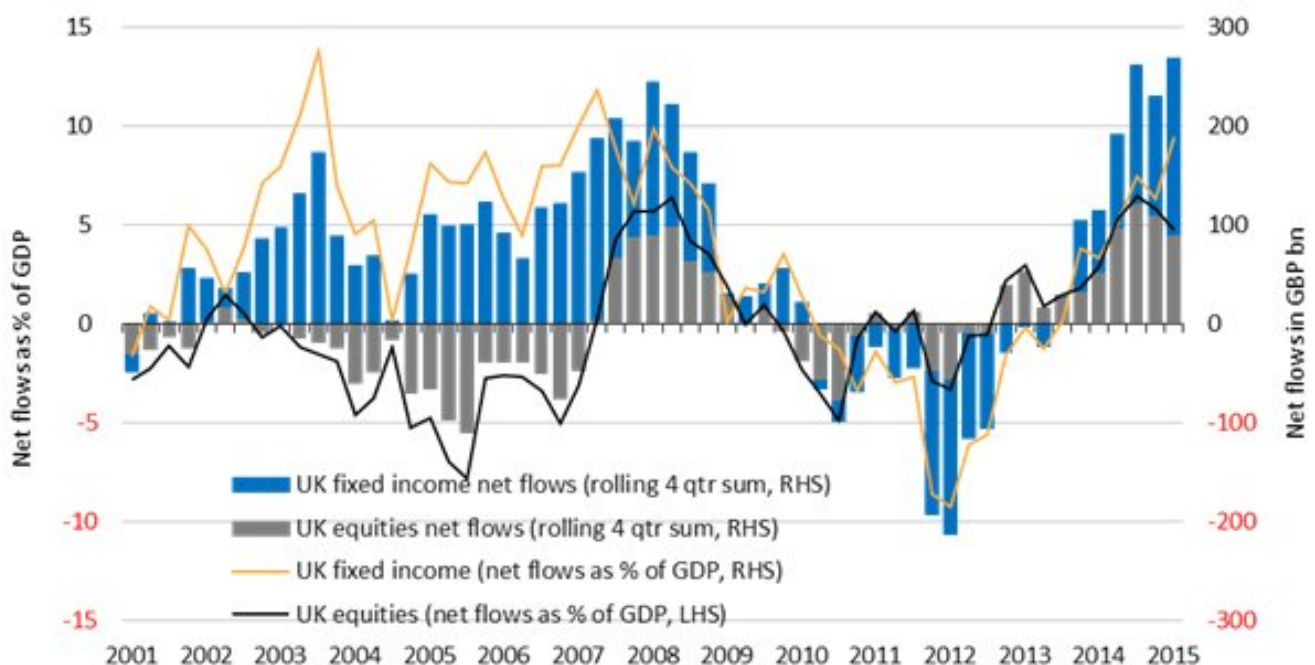
Sterling's Structural vs. Euro's Political Weakness: "Brexit" Opens Opportunities

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Jeremy Schwartz, CFA

Global Chief Investment Officer

The people of Britain have voted to leave the EU. What does this mean for the economy and asset markets in the very short to near term? Our central thesis is that the UK's structural economic imbalance is likely to grow larger as a result of Brexit. Underpinned by a large current account deficit of 7% of GDP, the UK is going to have to rely ever more on the grace of foreign investors to finance a growing trade deficit. The UK is a net exporter of services and a net importer of goods from the EU single market. While there will be difficult negotiations of trade agreements ahead, we are likely to see barriers to trade with the EU erected, which will more negatively impact the UK export of services, while the EU tries to preserve the earnings of EU members that sell goods into the UK. A devaluation of the pound, one likely fallout, may help make British goods more competitive and could offset some pressures from less favorable trade terms, while leading to price pressures for imported goods into the UK, thus hurting consumers. **Sterling Prone for Reversal: UK Portfolio Inflows Reached Relative Extremes** Rolling 4th-quarter sum of net flows



Source: WisdomTree, Europe, Bloomberg. Date to Q4 2015.

As shown in the chart, portfolio investment flows into UK fixed income and equities in 2015 accumulated to GBP 270 billion (or 14% of GDP) levels, which is extremely high even compared to years of relative stability during the period post-dotcom bubble and pre-2008 financial crisis. It is unlikely that foreign investors will be as enthusiastic about allocating into gilts and FTSE All-Share companies to that degree. By invoking Article 50 of the Lisbon Treaty—the only legal way to leave the EU—the UK must now negotiate a new trade agreement with the EU over the coming two years. There is no alternative trade model to fall back on, so Brexit means *guaranteed* uncertainty for a considerable amount of time. Until the dust settles, many asset allocators—at least in the short term—are likely to consider reducing their UK exposure. The pressure point in financial markets will gravitate around the pound sterling, which, while trading more or less range bound, has succumbed to significant intraday volatility. From an asset allocation perspective, our stance on various asset classes over the short to mid-term is as follows: **Equities** UK financial services are most at risk of trade barriers being erected in an attempt by the EU to reduce its trade deficit with the UK. Outside the services industry, in sectors such as cars, chemicals, clothing and footwear, and food, beverage and tobacco, where the UK has struggled to gain preferential trade agreements, a high-tariff regime against UK firms is likely to remain or become more punitive. In negotiations over coming agreements, the France-led protectionist-biased block of EU members are more empowered, while the more liberal, free-trade-leaning block of Benelux, Scandinavia and Germany are weakened. • **Unfavorable for UK-Oriented European Small Caps.** Most susceptible to such downside risks are smaller-capitalization stocks whose business models are more focused in the UK or whose trade profile is more concentrated in Europe. Our broad Index of European small-cap dividend payers (the WisdomTree Europe SmallCap Dividend Index), which includes UK stocks, derives roughly 21% of its revenue from the UK. But the eurozone-specific [WisdomTree Europe Hedged SmallCap Equity Index](#), by only focusing on stocks trading in the eurozone, has less than 4% revenue exposure from the UK and 60% from the eurozone. At close to 10%, revenue exposure to the United States for this index is about 2.5 times the revenue exposure to the UK. Given that this Index also hedges the euro, this may be a good place to focus European allocations. • **Eurozone Exporters, Hedged.** The UK's exit from the EU could instigate further political instability and may potentially lead to the euro weakening (given that the euro had remained relatively immune from Brexit fears). Ahead of general elections in France (May 2017) and Germany (Sep 2017) where fringe parties' euro-skepticism could fuel souring sentiment on the euro, the currency-hedged overlay may have longer-term strategic significance. Note that European exporters only generate 5% of their revenue from the UK, so the fallout in decreased revenue from the UK should be minimal to these stocks. • **Positioning in UK Large Caps, GBP Hedged.** Least susceptible to unfavorable trade agreements may be UK large caps. UK multinationals with a strong global footprint may benefit from improved exports and revenues if the pound weakens and investors hedge that currency exposure. Approximately 20% of revenue for the [WisdomTree United Kingdom Hedged Equity Index](#) comes from the UK, and approximately 80% comes from outside the UK. The eurozone, in aggregate, only represents 15% of the revenue exposure. More important revenue drivers are the United States, which represents over 20%, and emerging markets, which also represent over 20%. This may be one area of the European exposure that could stand to benefit on relative basis from Brexit. **Fixed Income and Currencies • Gilts: Short-term gain, long-term pain.** A risk-off sentiment will potentially boost gilts in the short term, with a strong incentive by the Bank of England (BOE) to delay monetary tightening to soften

the blow to business confidence and potential weakening economic ramifications. The already record-low interest rates in longer-dated UK government debt could fall further in the immediate aftermath of the vote. Further out, the UK's large macro imbalance will be laid bare in anticipation of a volatile and debased currency—the pound sterling's safe-haven status is undermined, and with it will be foreign investors' gilt purchases. • **Bunds: Unassailable Haven for Safety.** An already heavily crowded trade in German bunds may intensify if sentiment in risk assets, particularly within eurozone banks, sours decisively. A negative yielding bund may not be a big enough deterrent any longer, as almost a quarter of outstanding eurozone government debt is in sub-zero yield territory anyway. For as long as the European Central Bank's (ECB) QE program lasts, bunds are unlikely to succumb to major downside risks. • **Euro–Dollar: Bearish Euro, Bullish Dollar.** The dollar is expected to benefit from bullish sentiment relative to the euro, as U.S. domestic fundamentals are stronger. Banks have stronger balance sheets, the labor market remains resilient and business confidence is proving stable. A relative wide U.S. interest-rate differential over the eurozone means the euro is structurally weak.

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Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations.

Hedging can help returns when a foreign currency depreciates against the U.S. dollar, but it can hurt when the foreign currency appreciates against the U.S. dollar.