BREXIT: BIG RISK, LITTLE REWARD

THE UK REFERENDUM ON EUROPE

FEBRUARY 2016

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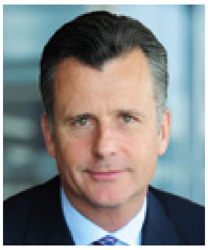


Philipp Hildebrand
BlackRock Vice Chairman

Introduction

UK voters will decide in June if the country will stay in the European Union (EU) or exit the bloc. The upcoming referendum represents a critical juncture for the UK and EU alike, and comes at a time when the global outlook is clouded by unusual uncertainty.

I am pleased to present this BlackRock Investment Institute publication on the implications of a leave vote or 'Brexit.' It draws on the views of BlackRock's investment professionals and public policy experts, and analyses the economic, policy, market, regulatory and financial industry consequences of the referendum.

While it is neither our practice nor our role to wade into political debates, we felt it was incumbent on us to help our clients think through the issues – and the choices on the table. Our bottom line is that a Brexit offers a lot of risk with little obvious reward. We see an EU exit leading to lower UK growth and investment, and potentially higher unemployment and inflation. Any offsetting benefits look more amorphous and less certain, in our view.

Joanna Cound (LEFT)
Head,
BlackRock Public Policy Europe

Joe Di Censo (RIGHT)
Portfolio Manager,
BlackRock Global Fixed Income

Rupert Harrison (LEFT)
Chief Macro Strategist,
BlackRock Multi-Asset Strategies

Ewen Cameron Watt (RIGHT)
Senior Director,
BlackRock Investment Institute

Summary

- A newly independent UK would likely have reduced leverage to fashion trade deals for the crucial services sector and less clout to negotiate regulatory standards for unimpeded EU market access. Both would be lengthy and painful processes, and we see the UK as economically worse off in the end.
- The EU, for its part, would lose a major budget contributor, a leading voice for free markets and easy access to a world-class financial centre. A Brexit could spur separatist calls and embolden populist parties across the continent, but we do not see a EU breakup as a result.
- We see volatility in UK and European assets rising ahead of the referendum. Global markets are already reeling from a deflationary scare driven by the oil price crash and a slowdown in China. An actual Brexit would hit global risk assets, we believe, whereas a vote to stay would reassure markets.
- Sterling is most vulnerable to Brexit fears as it is the most liquid UK financial asset. A Brexit could pressure the UK's budget and current account deficits, hurting the currency and potentially triggering credit downgrades. Conversely, we see depressed sterling bouncing back if the UK votes to stay.
- A leave vote would likely increase gilt yields. Portfolio inflows could falter, pressuring domestic sources of funding for the budget deficit. We could see bank funding costs rise and credit spreads widen. The Bank of England (BoE) would likely cut rates in such a scenario or revive quantitative easing, looking past any temporary rise in inflation caused by a weaker currency, we believe.
- We could see a Brexit dealing a blow to domestically focussed UK equities, and would expect large cap overseas earners to outperform as sterling falls. A leave vote also poses risks to the London property market as at least some corporate office demand is based on access to the EU's single market.
- A Brexit would cut into the financial industry's outsized contributions to the UK economy, tax revenues and trade balance, we believe, and offset apparent fiscal gains from leaving the EU. We could see the EU pushing hard to harmonise standards for financial services and capital markets – to the detriment of a UK financial industry dependent on single market access.

First words

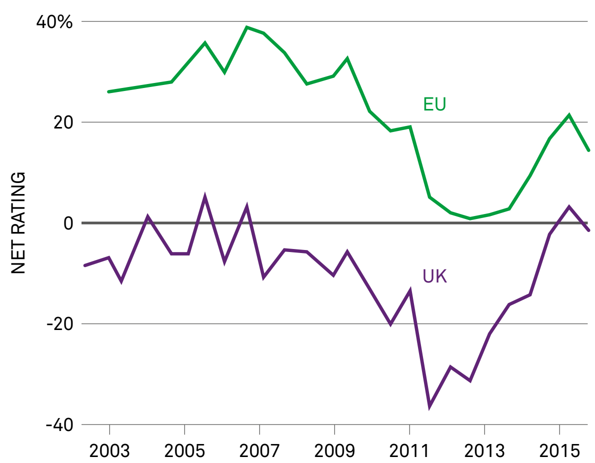
UK voters have often been reluctant Europeans. There are clear economic benefits to integration with the world's largest common market. Yet these benefits come with perceived costs. The leave camp, for example, points to burdensome regulations, large EU budget contributions and big inflows of migrants from member states.

Attitudes toward European integration tend to fluctuate with economic cycles. Euroscepticism most recently peaked during the European debt crisis of 2011. Attitudes to Europe were deeply negative in the UK then, whereas they were neutral in the EU overall. Citizens became more upbeat as debt troubles eased and economies started to eke out some growth, yet the recent refugee crisis has arrested this trend. See the chart below.

Two key issues dominate the headlines on the Brexit debate: the economy and immigration. The remain camp emphasises the economic risks of going it alone, while seeking to neutralise concerns about immigration. The leave faction seeks to capitalise on immigration concerns, while trying to assuage fears about economic risk. We focus on the economy, markets and regulations in this publication, and mostly steer away from the immigration debate and non-economic issues relating to sovereignty. As investors, we claim no particular expertise on these issues.

IMAGE BUILDING

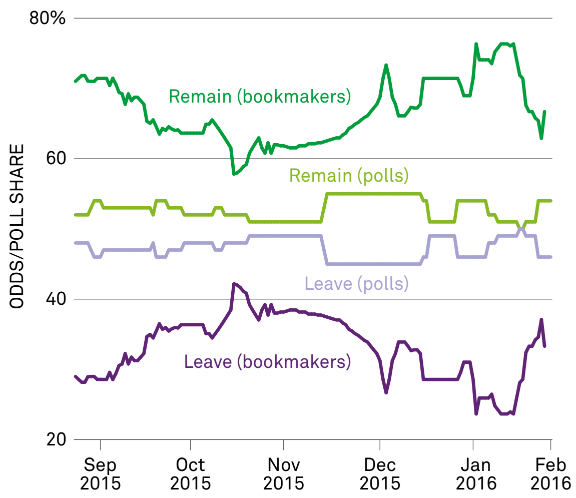
Net positive/negative ratings of EU, 2003-2015



Sources: BlackRock Investment Institute and Eurobarometer, February 2016. Note: a number above zero indicates that more citizens hold a positive view of the EU than a negative view. The most recent survey was in November 2015.

POLLS AND ODDS

Polls and betting odds on referendum outcome, 2015-2016



Sources: BlackRock Investment Institute, Morgan Stanley, Betfair and NatCen Social Research, February 2016. Note: the polls data are based on the average share of the vote for 'Leave' and 'Remain' in the six most recent polls of voting intentions in the EU referendum.

SHOULD I STAY OR ...

Should the United Kingdom remain a member of the European Union or leave the European Union? That is the question UK voters will answer on 23 June. Which way are they leaning? The remain camp has a slim majority in the polls. See the middle two lines in the chart above.

Pollsters in the UK, however, have had a poor track record in recent years. They predicted cliffhangers for both the 2014 Scotland Referendum and the 2015 UK elections, whereas the results for both were clear-cut. Betting markets have been pricing in a solid victory for the remain camp. See the outer lines of the chart above. If they are correct, the apparent enthusiasm of many voters for the UK to go it alone will wane as the referendum approaches. This would be in line with the experience of referenda worldwide, where the status quo tends to gain in the final stages of campaigning.

The result may be a close call – especially if turnout is low. The remain camp's strongest argument is the large potential hit to jobs and investment in the event of a Brexit. The leave camp's core view? Europe cannot flourish without further fiscal, monetary and political union. Yet many UK citizens, or indeed many other Europeans, do not want to be part of this. Their conclusion: it is better to quit now than face an ugly and even more complicated divorce years down the road.

What is inside

Politics

The UK has faced a referendum on Europe before: a two-thirds majority in 1975 voted to stay in the EU's predecessor, the European Economic Community. Yet the increased influence of today's EU on economic activity means the potential economic impact of the result is far greater than it was four decades ago.

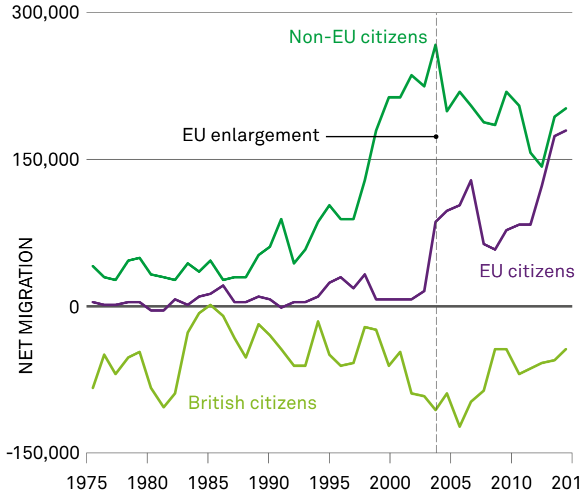
Economics alone, however, will not settle the Brexit debate. The emotive issue of sovereignty and border control could be a swing factor. Immigration and terrorism leapt to top of the list of issues troubling UK citizens in 2015, replacing concerns over unemployment and the economy, as the chart below shows.

Immigration is a central issue. Net migration into the UK has surged in recent years, especially after the EU enlarged in 2004 to admit countries such as Poland and the Baltic states. See the chart at the top right.

One-eighth of the UK population was born abroad, according to 2014 Eurostat data. This places the UK in the middle of the EU pack, between Spain (12.8%) and Germany (12.2%). Yet the UK has been largely spared from the recent European refugee crisis, helped by 22 miles of grey water. The country declined to join an EU-wide plan to spread the burden of resettling 120,000 new migrants.

WELCOME TO THE UK

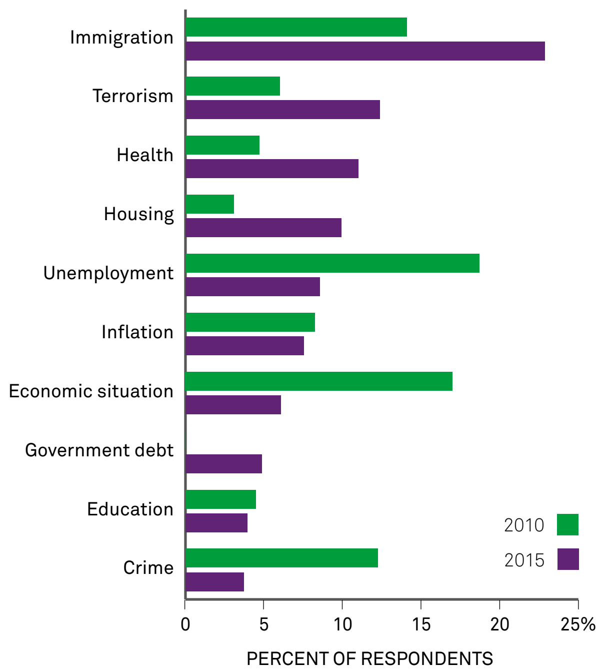
UK net migration, 1975-2015



Sources: BlackRock Investment Institute, Office for National Statistics and Eurostat, February 2015.

HOT TOPICS

Perceived issues faced by UK citizens, 2010 vs. 2015



Sources: BlackRock Investment Institute and Eurobarometer, February 2016.
Note: responses are based on the survey question: "What do you think are the two most important issues facing the UK at the moment?" The chart shows November 2010 and November 2015 surveys.

Prime Minister David Cameron conducted lengthy negotiations to reset Britain's EU membership on more favourable terms, in an attempt to pave the way for a vote to remain. The outcome, Cameron's core message holds, constitutes something like associate membership of the EU, with an exemption from 'ever-closer union' or further political integration. The leave camp argues the agreement still fails to protect UK sovereignty.

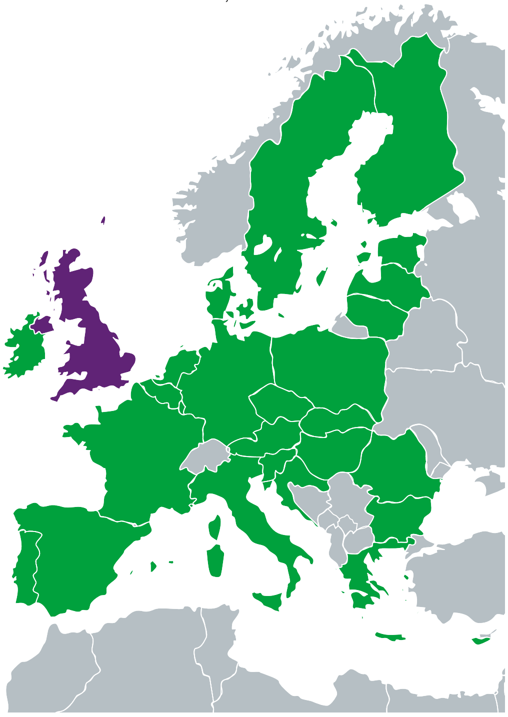
Both sides have moved to focus on the bigger picture: the stark choice between staying and leaving. After a leave vote, the government would be duty-bound to activate the exit process (we cannot see a House of Commons majority to overturn the result). Similarly, a remain vote would likely settle the issue of the UK's EU membership for at least a decade.

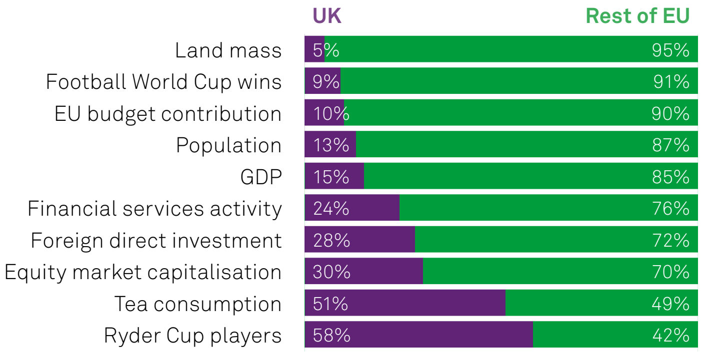
The domestic political consequences of the different outcomes are profound. A remain vote would represent an arguably enhanced status quo. Yet a tight result or a feeling by leave campaigners that it had not been a 'fair fight' might see Cameron's small parliamentary majority and authority over his divided party come under pressure. This spells trouble for post-referendum unity regardless of the vote's outcome, we believe, and would make it harder to pass controversial legislation.

A leave vote could cause political turmoil. At the very least, senior figures from the leave campaign would likely demand leading roles in the exit negotiations. This could make the exit process unpredictable and destabilising. A Brexit may also give the Scottish National Party (SNP) cause to call for another independence referendum – although the oil price collapse has undermined claims about the fiscal viability of an independent Scotland.

RELATIVE STRENGTH

Selected UK and EU metrics, 2013-2016





	UK	Total EU
Unemployment rate	5.1%	9%
GDP per capita (euros)	33,842	26,604
Population growth (five-year annual average)	0.7%	0.2%
Median age	40.5	42.5
Population density (people per sq km)	267	120
Government fiscal balance (share of GDP)	-2.8%	-2.0%
Gross government debt (share of GDP)	88%	87%
Defence spending (share of GDP)	2%	1.5%
Internet users (per 100 people)	92	78
Time to start a business (days)	4.5	10.2
Clean energy (share of energy use)	11.3%	17.7%

Sources: BlackRock Investment Institute, Confederation of British Industry, Bank of England, European Commission, MSCI, UK Trade and Investment, IMF and World Bank, February 2016. Notes: GDP, fiscal balance and government debt data are based on IMF forecasts for 2016. Equity market data are based on weights at the end of January 2016. Tea consumption data are for 2013. All other data are for 2014. The financial services share of EU activity is based on gross value added.

NOT THE SAME WITHOUT YOU

The EU would be poorer without the UK, a large, reform-minded member with considerable diplomatic heft globally. We see five main implications:

Competitiveness: the EU would lose a global financial centre and easy access to world markets. It is hard to see any mainland European city rising to the same financial league as London in the near future.

Defence of the realm: the UK is an important contributor to European security, spending an above-average 2% of GDP on defence. See the table above. The UK would still back up its neighbours in the case of any threats via NATO and other alliances. Yet its absence would undermine Europe's aspirations to mount a credible and self-determined 'hard power' response to other security issues.

Budget: the UK, along with Germany and France, is a pillar of the EU's budget, with a £9 billion annual net contribution (10% of the total) in 2015. Remaining EU members would have to make up for resulting shortfalls or forego subsidies.

Free market voice: the UK has always been one of the strongest open-market advocates in the EU. The UK's departure would likely tilt the balance of power toward less market-friendly policy makers. Germany has acted as the swing voter between reformers and countries wanting to preserve the status quo in the EU's Council of Ministers. With Germany, the reformer camp can theoretically drum up enough votes for a 35% blocking minority. We could see Germany and France becoming entangled in more direct confrontations on economic issues in the UK's absence – to the detriment of EU unity.

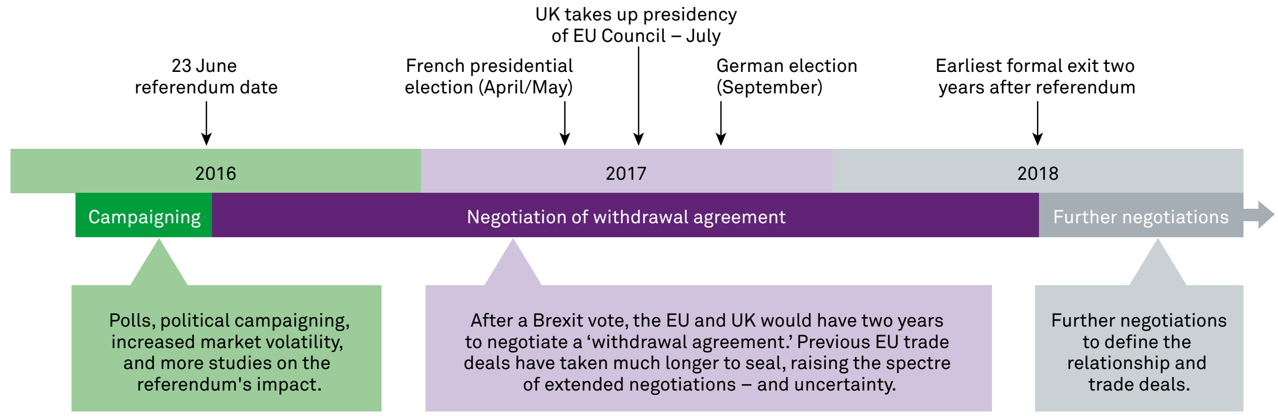
Cohesion: the UK has been the most vocal opponent to the vision of 'ever-closer union' – and its departure could pave the way for closer European integration. Yet the UK is not the only country debating the costs and benefits of more integration. And the appetite for such reforms has been lowered by the refugee crisis. Populist or separatist parties would likely cheer a Brexit as Germany, France and others gear up for 2017 elections. Would the EU break up? Our view: a Brexit would not be the beginning of the end for the European project (the core remains committed).

"Brexit wouldn't be a sudden shock to the EU, but it would corrode its cohesion and competitiveness notably over time because of the UK's position as a highly efficient financial services hub."

– **Isabelle Mateos y Lago**
Senior Advisor,
BlackRock Investment Institute

BRACING FOR BREXIT

Timeline if the UK votes to leave the EU, 2016-2018



Source: BlackRock Investment Institute, February 2016.

BREXIT TIMELINE

A leave vote would immediately usher in a period of acute political and economic uncertainty for the UK – and to a lesser extent for the rest of the EU. No country has ever left the EU. This means the formal rules can provide only a rough guide for how events would unfold.

The Treaty on European Union stipulates in Article 50 that a member state must notify the European Commission (EC) of its intention to leave. This would trigger a negotiation between the rest of the EU and the UK on the arrangements for withdrawal. A majority of EU member states and the European Parliament would have to agree on the details.

Separation would likely take effect either on the date a new agreement enters into force, or, failing that, two years after the initial notification. Only unanimous agreement of the UK and the EC could extend this deadline. The earliest UK exit: June 2018. See the graphic above.

In practice, we see talks dragging on for several years. The UK could delay triggering Article 50 because it arguably would reduce its bargaining power by placing a deadline on negotiations. Any political instability in the UK following a leave vote would slow down negotiations. And the talks' complexity could have both sides call for an extension.

We see a risk of economically damaging brinkmanship in the process. A recent simulation exercise by Open Europe found UK-EU relations would break down quickly after a Brexit vote. Potential reasons: domestic political jockeying in the UK and other EU member states, fears in the rest of the EU about setting secessionist precedents, and mercantilist desires to redirect investment in key sectors away from the UK. Also, negotiations are unlikely to take place in a collaborative spirit if the UK delegation were led by politicians hostile to the EU. It takes two to tango.

What would the UK's relations with the EU look like in a post-Brexit world? We see four key options:

Norwegian deal (non-starter): this would involve full access to the European Economic Area (EEA) as enjoyed by Norway and others under the European Free Trade Association (EFTA). In return, EFTA members contribute to the EU budget and are bound by its 'Four Freedoms,' including free movement of people and regulations on working hours, banking and climate change. We cannot see a post-Brexit UK accepting these terms. Plus, EU members would likely veto the UK candidacy to avoid setting a secessionist precedent.

Swiss style (unacceptable): Switzerland has bilateral accords that grant it access to parts of the single market but exclude financial services. We see this an unacceptable option for both the UK and EU because of the financial services exclusion and the effort needed to negotiate complex bilateral agreements. The UK also would have to contribute to the EU budget.

Turkish trade (unattractive): this would be a customs union, where access to the EU internal market is allowed for goods on a tariff-free basis, but services and agriculture are excluded. We doubt the EU would be keen on including services, given the UK runs a large surplus in that area. We see this as an unattractive option.

UK-tailored deal (difficult): this would involve free trade agreements with the EU and others. Promoters of this solution point to the EU's goods surplus with the UK as an incentive for it to grant UK financial services 'equivalence' (translation: have the same rights and duties as EU rivals). One problem: the UK already has trouble extracting concessions from the EU. So why would Europe yield to the UK if it were no longer contributing to the EU budget?

Conclusion: none of these options are attractive, in our view, and all would entail years of negotiations and uncertainty.

Economics

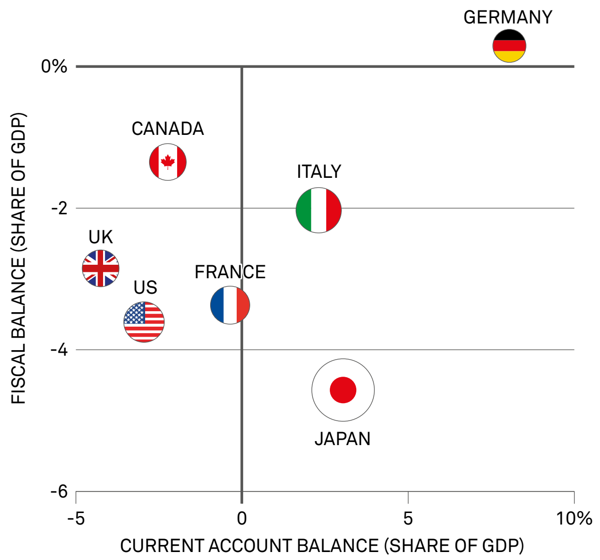
We see a Brexit vote having a large and negative economic impact in the near term – and meaningful implications in the long run. Our overarching view from an investor's perspective: the likely negative impact on the UK economy is more concrete than any speculative long-term positives.

The economic impact of Brexit would come through many channels, but we think the effects on trade and investment inflows are the most important. This is because the UK relies on the kindness of strangers to finance its twin deficits. The country's current account shortfall is the largest in the G7, and its fiscal deficit lies in the middle of the pack. See the chart below.

The current account balance is made up of three parts: net trade, net income (the gap between what UK investors earn on their overseas investments and what foreigners earn on investments in the UK) and net transfers (such as money sent home by migrant workers). A persistent trade deficit is the main drag. Yet a net income drain is responsible for much of the UK deficit's recent increase. Foreigners' investments in Britain have paid off better than UK investments in ailing Europe and other areas.

WRONG NEIGHBOURHOOD

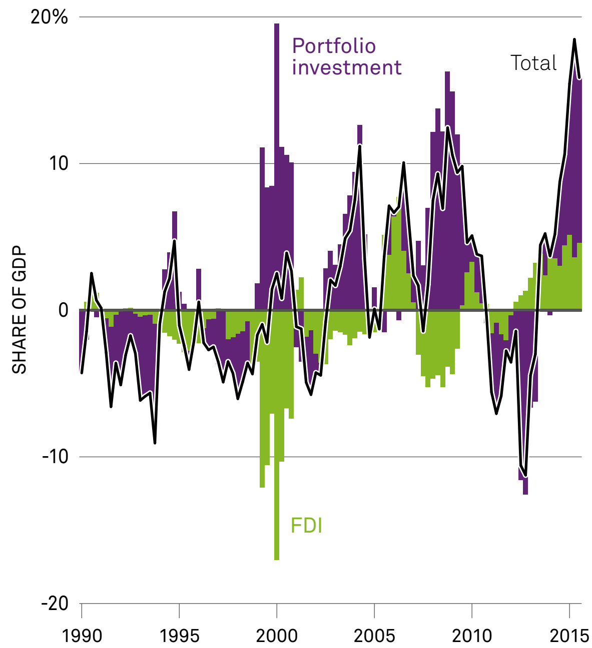
G7 current account and fiscal balances, 2016



Sources: BlackRock Investment Institute and IMF World Economic Outlook, February 2016. Notes: the values are based on IMF forecasts for 2016. The dots are sized by the ratio of gross government debt to GDP.

FAVOURED DESTINATION

UK net capital inflows as share of GDP, 1990-2015



Sources: BlackRock Investment Institute and UK Office for National Statistics, February 2016.

PORTFOLIO FLOWS PARAMOUNT

Net capital flows into the UK rose to multi-decade highs as a share of GDP in late 2015. See the chart above. These include foreign direct investment (FDI) and portfolio inflows – foreign purchases of UK assets such as equities, bonds and property.

Would a newly independent, smallish archipelago off the northwest coast of Europe attract such big inflows? This is unlikely. We see other EU countries gaining at the UK's expense. Financing the current account deficit might become harder under this scenario. A big fall in sterling could be needed to restore balance.

We do not expect an exodus of capital in the case of a Brexit. Many of the UK's attractions – strong institutions and flexible markets – would remain intact.

Yet the lure of unimpeded access to the EU's single market would no longer be there, likely reducing future investment flows. The loss of financial services tax revenues and the fiscal impact of any induced economic slowdown would likely spur action from rating agencies, we believe. See page 11 for details.

"The UK has a significant twin deficit financed by record capital inflows. That's a strong display of global confidence – a scarce and perhaps fleeting commodity in an environment where a lot is shaking."

– **Jean Boivin**
Head of Research, BlackRock Investment Institute

DEPENDENCIES

UK exports, imports and FDI in billions of sterling, 2014

	UK exports	UK imports	FDI stock in the UK
Germany	£43	£71	£50
Netherlands	£34	£36	£176
France	£31	£37	£76
Ireland	£28	£17	£14
Italy	£16	£22	£4
Spain	£15	£26	£46
Belgium	£16	£24	£26
Luxembourg	£3	£2	£79
Other EU	£43	£56	£25
EU total	**£229**	**£291**	**£496**
EU share	**44%**	**53%**	**48%**
Other Europe	£56	£57	£113
US	£88	£52	£253
Japan	£10	£10	£38
China	£19	£38	£1
Rest of the world	£113	£103	£133
Total	**£515**	**£550**	**£1,034**

Sources: BlackRock Investment Institute and Office for National Statistics, February 2016. Notes: all figures are in billions of pounds. The two left columns show the UK's exports and imports of goods and services in 2014. FDI (third column) stands for foreign direct investment. The EU countries shown make the top five EU partners for imports, exports and FDI. 'Other Europe' for FDI consists mainly of the UK offshore islands.

TRADING PLACES

Economic estimates of the benefits of the UK's EU membership vary wildly, ranging from a 20% boost (a 2014 academic study by Campos, Coricelli and Moretti) to a drag of 5% (a 2010 analysis by the populist UK Independence Party). The estimates are imprecise at best. The main positive impact of EU membership comes through reduced barriers to trade and investment, we believe.

The UK has much to lose in a Brexit scenario, in our view. The EU accounts for around half of its trade activity and owns about half of its FDI stock. See the table above. Access to the single market would likely get harder for a newly independent UK, hitting the financial industry particularly hard (see page 14).

The Brexit camp holds out the promise of increased exports for UK industries and services to the rest of the world. We are sceptical. Areas where the UK leads (think aerospace parts, financial services and Scottish whiskey) already are showing steady or strong growth. This means at least part of the export-boom argument amounts to a double counting of existing opportunities, we believe.

ILLUSORY GAINS

How about the UK's new-found freedom to strike trade deals on its own? The potential gains may prove to be illusory, in our view. The realpolitik of trade deals is that the larger you are, the harder you punch. A lone UK would have less clout to negotiate favourable deals.

Also, services make up around half of UK trade. The new world of services trade is not just about tariffs and quotas; it involves complex 'behind the border' issues such as regulation, standards and enforcement. There are no examples anywhere in the world of services trade agreements with the potential scope of the EU single market. And trade agreements including services are complex and difficult to negotiate. They are not just one-off agreements, but require high levels of ongoing engagement to seal and maintain. Witness the troubles the EU and US have had in inking the Transatlantic Trade and Investment Partnership (TTIP) – even with its modest ambitions. TTIP may not see light of day before the end of the decade.

Bottom line: the UK would be condemning its largest economic sector to higher trade and regulatory barriers. Trade and FDI are drivers of innovation. Any impediments to them could worsen already poor UK productivity. See *Productivity Slowdown Puzzle* of January 2016 for details.

STICKY RED TAPE

Optimistic Brexit scenarios also assume the UK abolishes swathes of EU regulations – and emerges as a Hong Kong-style provider of valued-added goods and services to the rest of the world. Again, we are sceptical. The UK already ranks among the world's least regulated economies. And its overall export growth to China and India lags that of supposedly overregulated Germany.

To be sure, UK businesses would welcome the scrapping of EU rules such as the Working Time Directive on maximum weekly working hours. Yet we do not see UK policy makers easily tearing up thousands of pages of EU social, employment and environmental rules. Many EU rules would need to be replaced with UK equivalents – a particular problem in financial services (see page 14). And the UK parliament has already chosen to go beyond EU minimum standards in many of these areas.

Overall, we find it hard to believe an independent UK would be better off economically, barring a big rise in productivity or a much lower exchange rate. Neither are guaranteed. The UK would likely become a follower – not a shaper – of EU regulatory affairs, its access to the single market would be hampered, and lower migration levels would likely slow its economic growth prospects.

Currency and bonds

Sterling is the most liquid UK financial asset – and the most logical short-term victim from a leave vote.

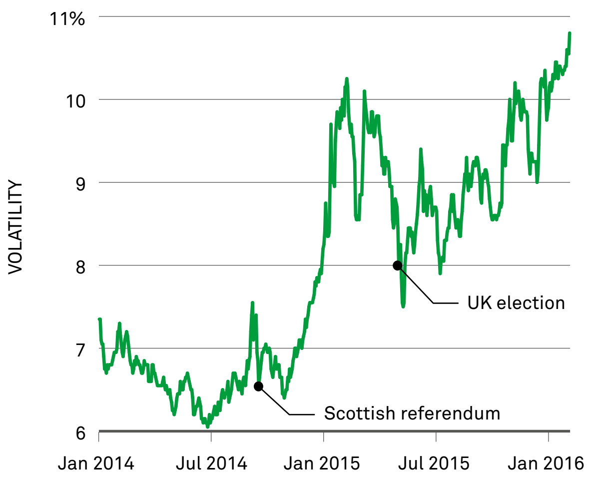
The UK has become a favoured destination of foreign investors, but this means it is subject to the whims of those investors' views on the safety and return potential of UK assets.

Brexit fears were reflected in both a downward move in sterling and a sharp rise in implied volatility in early 2016. We see more to come; volatility also rose in the months ahead of the 2014 Scottish referendum and 2015 UK elections. See the chart below. Long-dated sterling volatility looks most susceptible to spikes, given the protracted uncertainty associated with the UK leaving the EU's trade and regulatory umbrella.

The UK rates market, by contrast, has been on a one-way bull run. Yields have fallen in line with global fixed income markets, dragged down by plunging oil prices and inflation expectations. Adding to the downward momentum in gilt yields in 2016 have been fears of a global deflationary spiral and signs that an acceleration in earnings growth in the UK may have stalled.

CURRENCY JITTERS

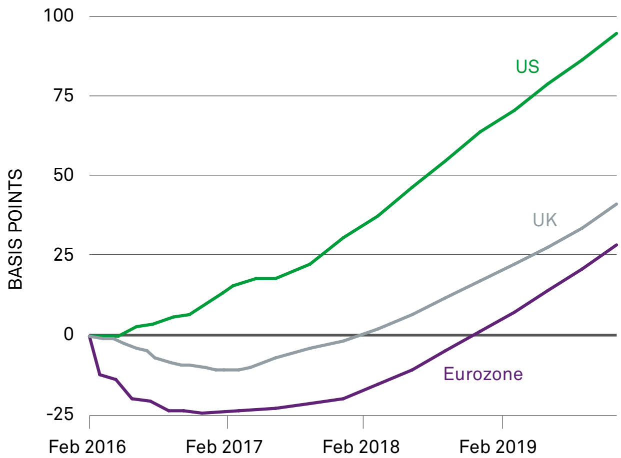
Sterling-euro one-year implied volatility, 2014-2016



Sources: BlackRock Investment Institute and Bloomberg, February 2016.

LOW EXPECTATIONS

Market-implied policy rate path, 2016-2019



Sources: BlackRock Investment Institute and Bloomberg, February 2016. Notes: the chart shows the implied change in future benchmark interest rates based on overnight index swaps. The change is given in basis points from the rate on 10 February, 2016.

PRE-REFERENDUM: JITTERS

Expectations of BoE rate increases from a record low of 0.5% have been pushed out to as far as 2019. In fact, markets in February priced in a small cut in the UK benchmark rate in the coming year, albeit not by as much as expectations for further eurozone cuts into negative territory. See the chart above. This is a far cry from a year ago, when the BoE was seen as just behind the US Federal Reserve in the tightening camp.

Heightened uncertainty and concerns about increased fiscal risk in the event of Brexit would likely lead to a steepening of the yield curve, we believe, with underperformance of long-dated bonds versus short-term gilts. We also see swaps outperforming government bonds. Corporate credit spreads would likely widen, especially for businesses that derive a high proportion of revenues from domestic and EU markets.

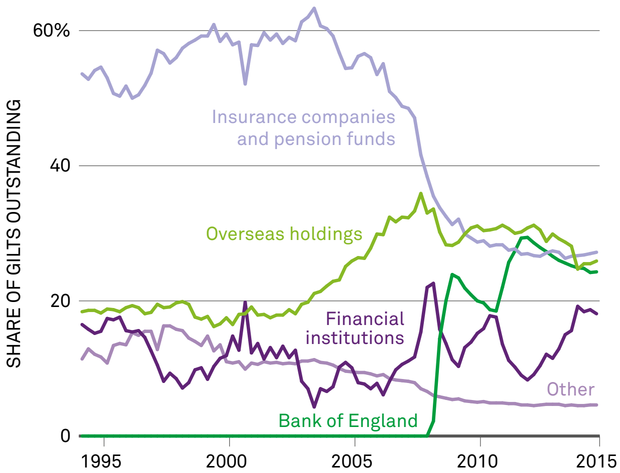
How will the BoE act ahead of the vote? We expect the central bank's public pronouncements to reflect the current status quo (similar to its communications before the Scottish referendum). Yet in practice, we see the BoE being alert to the potential impact of a Brexit. The referendum provides a reason for the central bank not to raise expectations for rate rises ahead of June, we believe. The possibility of a June rate rise would be on the table were it not for the Brexit debate, in our view.

"As we near the referendum date, the risks of a Brexit will become more clear: smaller capital inflows and potential easing. Those are negatives for sterling."

– **David Curtin**
Portfolio Manager,
BlackRock Sterling Fixed Income

OWNING BRITANNIA

UK gilt ownership, 1995-2015



Sources: BlackRock Institute and UK Debt Management Office, February 2016. Note: financial institutions include banks, building societies and other financial institutions.

REMAIN: BUSINESS AS USUAL

Nonresidents, including reserve managers, hold about a quarter of outstanding gilts, as the chart above shows. This makes the market susceptible to abrupt portfolio outflows in case of sentiment shifts. The foreign ownership share is second only to insurers and pension funds – although it has declined from a peak of 36% in 2008 in the wake of the BoE's asset purchases.

What happens next? A remain vote provides the simplest outcome for the BoE – but the central bank will still need to navigate the potential impact on the currency and financial conditions.

We could see a remain vote resulting in a one-off rise in a sterling weighed down by Brexit fears. For example, options markets have already been pricing in the risk of a sterling depreciation. See the chart below right. The pound's upside potential would be augmented by its modestly undervalued starting point, we believe.

A remain vote likely would also remove any Brexit risk premium in long-dated gilts. The effect would add up to a mix of deflationary forces on the one hand (currency appreciation adding to global deflationary pressures) and positive economic impulses on the other (from lower interest rates and a sharp reduction in uncertainty).

We see the positive effects winning out. The outlook for UK interest rates would likely return to familiar dynamics – a tug of war between robust domestic economic conditions and deteriorating global growth expectations. A BoE rate hike could come sooner than the market is currently pricing, in our view.

LEAVE: SERIOUS CHALLENGES

A leave vote would likely result in a sharp sterling depreciation and a rise in 10-year gilt yields. Portfolio flows into the UK could falter, pressuring domestic sources of funding for the budget deficit and raising UK bank funding costs. Corporate credit spreads would likely widen, especially for businesses that derive a high share of revenues from UK and EU markets. We could see risk assets across the world struggle, particularly in Europe.

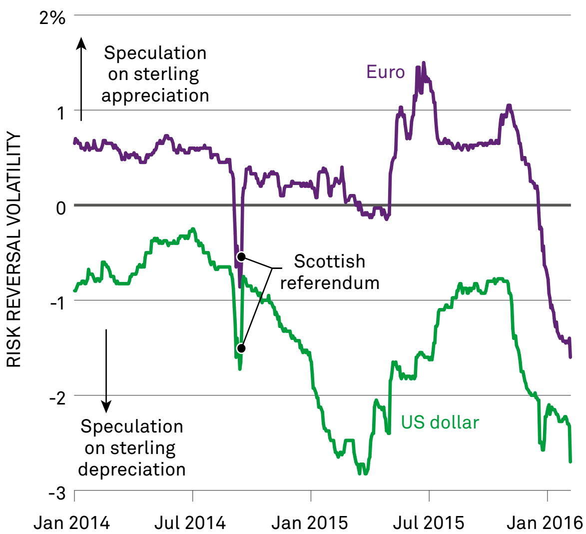
A worst-case scenario could be a vicious cycle of currency weakness, an abrupt stop to capital inflows and a sharp deterioration in market confidence. The economic impact on GDP, investment and job creation would be severe. The good news: just 5% of the UK's debt is foreign currency denominated, according to Thomson Reuters data. Nevertheless, the BoE might raise rates to prevent an overshoot in the exchange rate in such a scenario.

This dire scenario is not our central case, due to the UK's institutional credibility, independent monetary policy and diversified economy – but we cannot rule it out.

If monetary policy were not constrained by the need to defend sterling, the BoE's main goal would be to support the banking system and boost demand, we believe. Its Funding for Lending Scheme – to encourage lending to households and businesses – and enhanced liquidity facilities should help prevent a funding squeeze.

STERLING SHORTS

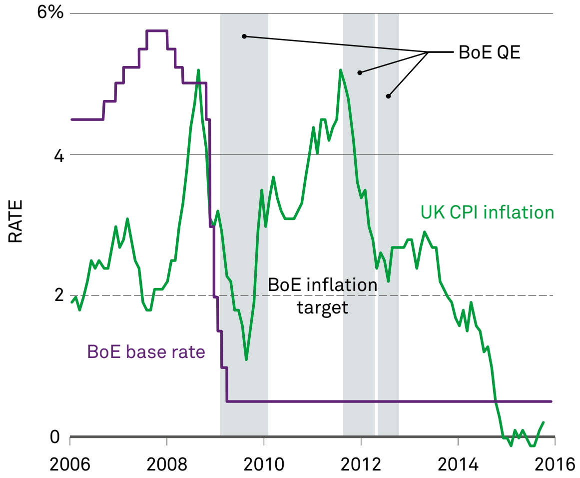
Sterling option trading trends, 2014-2016



Sources: BlackRock Investment Institute and Bloomberg, February 2016. Notes: the chart shows risk reversal for sterling versus euro and US dollar, based on trading of one-year, out-of-the-money options (with the euro lines inverted). A positive risk reversal means the volatility of calls is greater than the volatility of similar puts. This implies that more market participants are betting on a rise in the currency than on a drop, and vice versa if the risk reversal is negative.

NO INFLATION HAWKS HERE

UK inflation, interest rates and QE, 2006-2016



Sources: BlackRock Investment Institute, Office for National Statistics and Bank of England, February 2016. Notes: the shaded bars show periods of asset purchases under the BoE's quantitative easing programme (QE).

NOT SCARED OF INFLATION

A sharp currency depreciation would cause another potential problem: a temporary spike in inflation. Would this dissuade the BoE from cutting interest rates? We do not think so. The central bank has a history of looking through the short-term inflationary or deflationary effect of currency or commodity price swings.

The BoE, for example, kept interest rates at 0.5% in 2009-2012 and undertook repeated rounds of quantitative easing (QE) – even though consumer price inflation overshot its 2% target on numerous occasions. See the chart above.

We do not see the BoE starting to use the controversial monetary policy tool of negative interest rates. First, this would squeeze the margins of deposit-dependent UK building societies and potentially undermine their financial stability. Second, with an already sharply falling sterling, negative interest rates would be unlikely to push the currency much lower (an apparent motivation of some of the BoE's global counterparts), we believe.

Yet we would not rule out another round of QE focussed as before on gilt purchases if the outlook for employment and final demand were bleak enough. BoE Governor Mark Carney has stated the central bank has 'considerable room' for more stimulus if needed. It faces less operational – and political – constraints on the scale of asset purchases than some of its global peers, in our view.

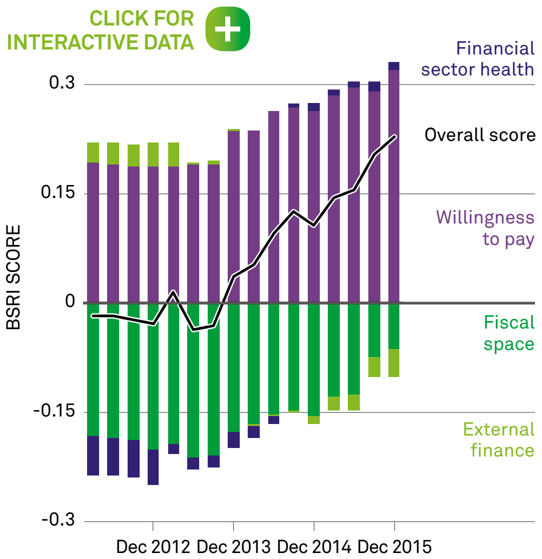
GOING DOWN IN RATINGS

Improving fiscal dynamics underpin the UK's strong credit ratings. The country ranks in the second quintile of our 50-country ***BlackRock Sovereign Risk Index*** (BSRI). The main reason is its strong rule of law and government cohesion, reflected in the BSRI's *Willingness to Pay* component. See the chart below.

The strength of the country's financial sector also is a modest positive, reflecting a gradual return to health since the 2008 financial crisis. *Fiscal Space* is a much smaller drag on the country's score than it was a few years ago, thanks to a narrowing budget deficit. *External Finance* is an increasing burden, however, reflecting the UK's hefty current account deficit.

STEADY RECOVERY

UK BlackRock Sovereign Risk Index breakdown, 2012-2015



Source: BlackRock Investment Institute, January 2016.

Rating agencies have signalled concerns about a Brexit. All would eventually downgrade the UK by at least one notch, we believe. The key factor will be to what extent the UK can keep current economic benefits in a post-Brexit world.

Double-notch downgrades are possible if the agreed arrangement with the EU ends up being harmful (with poorer market access for UK companies). Yet we see AA- as the likely floor to the UK's rating. Many of the country's credit metrics should remain robust, while exports could benefit from a weaker currency.

"The impact of Brexit on the UK's credit ratings depends on the type of deal with the EU. But we don't see downgrades of more than two notches in the long run because of the UK's strong fundamentals."

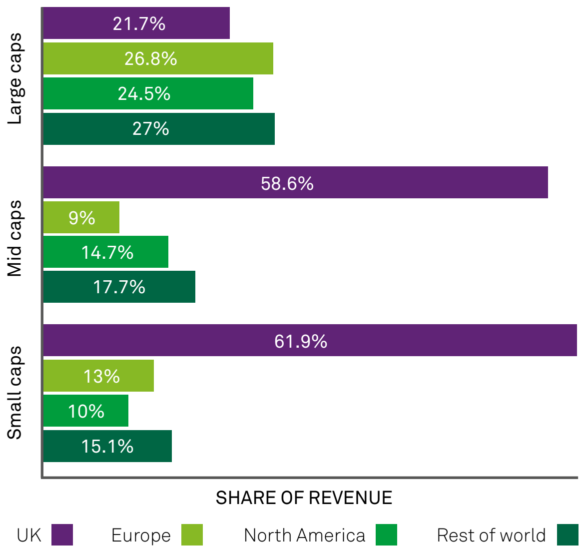
– **Tanja Boskovic**
Sovereign Credit Analyst, BlackRock Global Fixed Income

Equities

UK equities have already been on the ropes amid the global sell-off in early 2016. Volatility is likely to rise as the referendum approaches. Yet it is important to put Brexit fears in context. The UK market is well diversified and globally oriented, with around three-quarters of large cap company revenues generated outside of the UK. Small and mid caps are more domestically focussed, as the chart below shows.

DOMESTIC EXPOSURE

UK company revenues by region, 2015



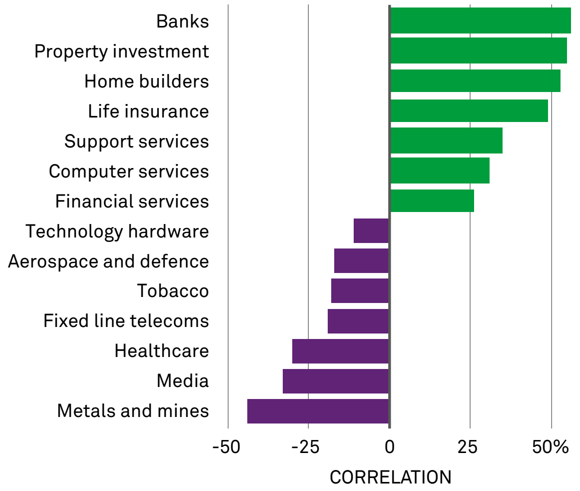
Sources: BlackRock Investment Institute and Thomson Reuters Worldscope, February 2016. Note: large caps are represented by the FTSE 100 Index, mid caps by the FTSE 250 Index and small caps by the FTSE Small Cap Index.

Pre-referendum uncertainty is likely to result in at least some companies deferring investment, hiring and expansion decisions. Domestically exposed stocks, particularly cyclical companies such as staffing businesses, retailers and property companies look particularly vulnerable. Consumer confidence could weaken, hurting general and food retailers.

The hit to the equity market should be only temporary – provided the UK decides to stay. What if it leaves? Lower employment levels would hurt the economy. And lower immigration could make labour scarcer in the long run, pushing up wage costs and eating into corporate profits.

SECTOR SELECTIVITY

UK earnings correlation with domestic demand, 1998-2015



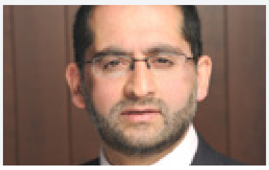
Sources: BlackRock Investment Institute, Thomson Reuters and Goldman Sachs, February 2016. Notes: the chart shows the correlation in annual sterling earnings growth with domestic demand growth lagged two quarters since 1998.

REALITY CHECK

Small- and medium-sized companies could underperform large caps due to their domestic exposure if a Brexit were to take place. This would mark a reversal of mid cap outperformance in six of the past seven years. Banks, property and homebuilders lead the table of domestically focussed industries – and have the highest correlation of profit growth to domestic demand. See the chart above. Global companies may relocate their European headquarters, reducing demand for office space in the City. See page 13 for details. Financials would face rising funding costs, we believe, due to rising yields.

An industry such as media (among our favourite picks) is more international, and could outperform. In addition, sterling weakness would increase the competitiveness of companies with substantial overseas operations. This would boost earnings for the market as a whole, given that 78% of large cap revenues come from outside the UK, as the chart to the left shows. Note: this assumes the UK is not disadvantaged in any post-Brexit trade negotiations.

Earnings growth is scarce in the UK and elsewhere, so we are focussed on three key themes: companies with a sustainable competitive advantage; companies with structural growth opportunities on the frontier of new technologies and services; and firms with 'self-help' opportunities to restructure, cut costs or sell assets.



"If Brexit actually happens, there would be a negative impact on the UK equity market. But let's put it into context: this is a well-diversified, global market, not a domestically oriented market."

– **Imran Sattar**
Portfolio Manager, UK Equity Team

Property

Investors in London's commercial property market are understandably nervous about the Brexit vote. London has a lot to lose. It accounts for 23% of European cross-border commercial property investment – and a whopping 58% of Asian investors' transactions over the past five years, according to Real Capital Analytics. Two-fifths of the world's top companies had London as their European headquarters in 2014, while London's nearest European rival, Paris, had just an 8% share, according to Deloitte.

Property markets are not known for effective pricing of political risk. The value of commercial property transactions more than doubled between the passing of the Scottish Independence Referendum Act in late 2013 and the vote itself less than a year later, according to Real Capital Analytics. This included a spurt of transactions that had been conditional on a 'no' vote to independence.

A similar trend appears to be playing out in the central London office market. Transactions volume was roughly unchanged from the prior year at a robust £18.5 billion in 2015, a February 2016 *Jones Lang LaSalle report* shows. We would expect investors to defer some transactions, and could see a rise in activity in case of a remain vote.

BUILDING TOWARD A PEAK

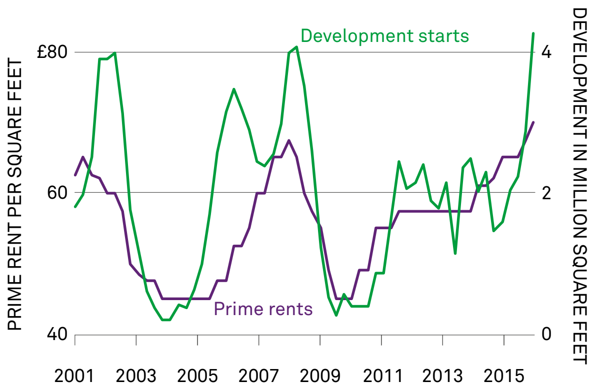
This would be good for office investments in the short term, but could spur even more development. The London office market is highly cyclical. Demand for office space grows fast in upturns, driving up rents and valuations. This prompts new development. The new buildings are completed two to three years later, often coinciding with weaker demand. Result: a downturn. The City office market appears near a cyclical peak today. See the chart above. We could see the next downturn hitting after 2017.

For now, demand remains strong, with vacancies low in central London and selected markets in south east England. We believe any short-term impact due to Brexit uncertainty would be confined to a slowing in the pace of rising rents.

If a Brexit actually were to happen, we could see occupiers deferring leasing decisions. The longer the subsequent period of political uncertainty would drag on, the more damaging it could be.

CAUTION: DOWNTURN AHEAD

London City prime rents and development activity, 2001-2015



Sources: BlackRock Investment Institute and Property Market Analysis, February 2016.

LONDON CALLING

Any new barriers to EU access for financial services would be key risks. The financial sector has come to the rescue whenever the London office market has wrestled with excess capacity.

A financial exodus could cause a structural rise in London vacancies. Financial institutions' share of the leasing market in 2015 was large at 25%, yet it has fallen from a long-term average of 48% before the global financial crisis, according to PMA.

A Brexit would also have knock-on effects for retail and residential demand. Yet London's attraction to international capital and tourists, particularly from Asia, is unlikely to be diminished, we believe. This means the impact on the luxury, retail and residential sectors should be limited. Outside of London, we see the performance of properties mirroring that of the domestic economy.

What about the investment market? It is heavily dominated by foreign players. The bad news is that foreign investors are a fickle bunch – and it stands to reason at least some of them have predicated their UK investments on access to the single market.

The good news: a number of Asian pension funds have stated they wish to boost their property exposure. London's appeal – such as the rule of law, highly educated work force and cultural attractions – mean such demand is likely here to stay for the long term.

"Strong demand for office space is currently masking the potential impact of the referendum. However, a vote for Brexit would worsen a cyclical downturn that we already are expecting as early as 2017."

– **Mark Long**
Researcher,
BlackRock Real Estate Team

Financial industry

A Brexit would be challenging to the financial services industry – and hurt its outsized contribution to the UK's economy and trade balance, we believe. The country runs a deep deficit with the EU in goods trade, partially offset by a services surplus that is led by the financial sector. See the charts below. The £18.5 billion surplus in financial, insurance and pension services would likely shrink.

The industry also is a key source of the UK's tax revenues. Financial services paid £66.5 billion in taxes, or 11% of government tax receipts, in fiscal 2015, according to a December 2015 *PwC report*. Employment taxes (£30 billion) for the industry's 1.1 million workers (3.4% of the UK's workforce) made up the biggest chunk.

This adds up to some £27,300 per person. Suppose 10% of these workers lost their jobs after a Brexit? This could cost the government up to £3 billion in annual employment taxes alone – especially if higher-paid workers bore the brunt, we calculate. This is yet another reason that the much-cited £9 billion in fiscal savings from the UK's net contribution to the EU budget is a red herring, in our view. We see Brexit's impact on the financial industry, along with higher tariffs and borrowing costs, quickly eroding such 'savings.'

PASSPORT REQUIRED

The sector's influence goes beyond fiscal policy and the balance of payments. Financial and related services made up 11.8% of GDP in 2013, according to a March 2015 *TheCityUK report*. Much of the industry's surplus with the EU is dependent on unfettered access to the single market. This is known as 'passporting,' the right of a company registered in the European Economic Area (EEA) to do business in another EEA state. Leaving the EU would curtail the industry's market access – and reduce the surplus on the UK's capital account.

REGULATORY HOLE

A Brexit would pose severe regulatory challenges:

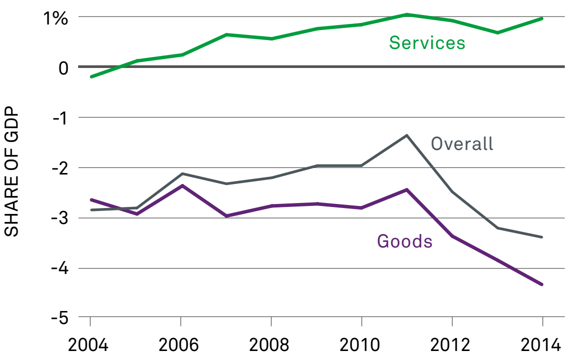
1. A huge body of 40 years of EU regulations has not been implemented into UK law. These rules apply directly to member states (unlike directives), and would cease to have effect if the UK seceded. Replicating them would be no simple cut-and-paste job.
2. A future UK government could stop replicating new EU legislation, either out of political pressure or frustration. The UK would have to negotiate equivalence each time the EU updates its legislation – and we could see standards starting to diverge from current requirements. Equivalence does not always equal access, by the way. For example, even if the UK were to be deemed equivalent under the AIFMD, national authorities could block access by refusing to sign the necessary information-sharing agreements.
3. The EC could try to discourage other member states from going it alone by raiding the UK's honey pot, the financial industry. One way to do this would be to refuse to issue the industry a Markets in Financial Instruments Directive (MiFID) passport, in our view. This regulatory framework is crucial for UK capital markets and investment firms selling or advising funds in the EU.

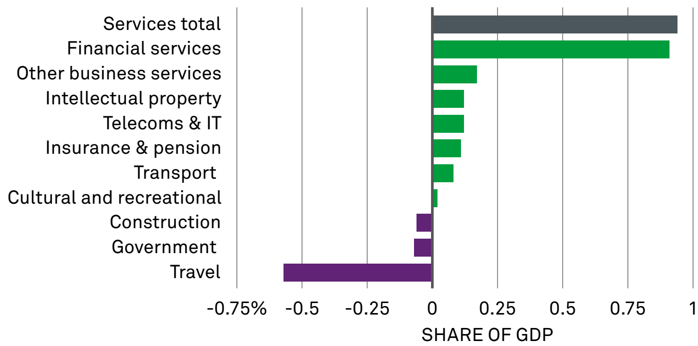
This would hurt both UK and EU-wide capital markets activity and fund management, we believe. Imagine, for example, that the UK regulatory regime for trading venues were not deemed equivalent to MiFID. This would mean EU investors accessing global markets through the UK would have to take their business elsewhere.

Dublin, Paris and Frankfurt could benefit to some extent, but we also see some business trickling to centres in the US and Asia. This would rob both the UK and EU of important economic activity.

FINANCIAL BOON

UK trade balance with EU and services breakdown, 2004-2014

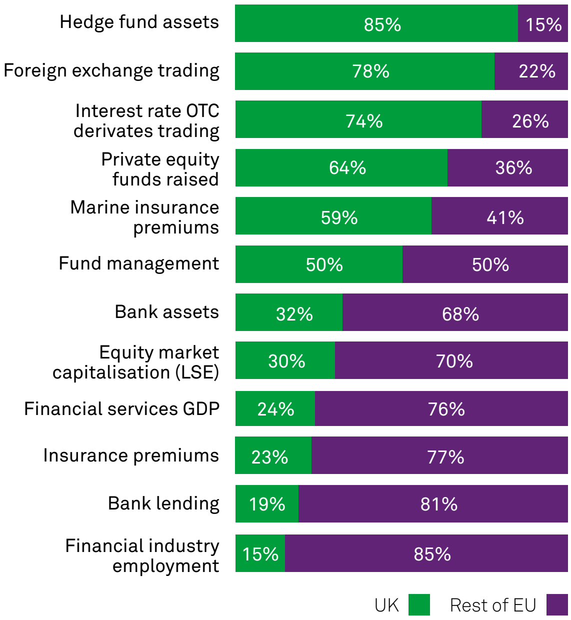




Sources: BlackRock Investment Institute and Office for National Statistics, February 2016. Note: the bar chart shows the breakdown of the services trade balance in 2014.

FINANCIAL JUGGERNAUT

UK share of EU financial markets, 2013



Sources: BlackRock Investment Institute, BoE, MSCI and TheCityUK, February 2016. Notes: market shares are based on 2013 data, except for equity market capitalisation (2016) and financial services GDP (2014). Hedge funds, private equity and bank assets show the share of the European total.

CAPITAL MARKETS UNION

The UK leads Europe in capital markets and other financial services. See the chart above. This makes the industry a prime potential beneficiary of the Capital Markets Union (CMU), an EU flagship political project. CMU aims to bolster economic growth by removing barriers to a cross-border market in financial services and by encouraging market-based finance to reduce an over-reliance on bank lending.

CMU so far has dodged tough questions on full-scale integration of national markets because of different cultural, legal and political approaches to market structure and regulation among EU states. Instead, it has focused on easing the process of cross-border investing. Without the UK's voice in shaping the debate, we believe the project's strategic direction would shift toward fundamental integration. We could see a post-Brexit CMU develop the following traits:

- Deprioritise third-country access to the EU's financial services market. It would be harder for non-EU countries to interact with the single market.
- Centralise regulatory powers, particularly in the area of conduct and supervision (the UK has led opposition to stripping power away from national authorities).
- Advocate market infrastructure be located in the EU as a requirement for participation. We see this capability transfer focussing on areas previously targeted by EU states, such as euro-denominated business.

ASSET MANAGERS

The UK is the behemoth of fund management in Europe, yet this dominance is contingent on the ability to do business across the continent. Regulation matters – a lot. Aside from MiFID, two other key pieces of European legislation apply to the industry:

1. Undertakings for Collective Investment in Transferable Securities (UCITS) Directive: this regulates marketing of funds to both retail and professional investors on authorisation by one EEA state. Both the fund and management company (manco) must be registered in an EEA country, but portfolio management can take place elsewhere.
2. Alternative Investment Fund Managers Directive (AIFMD). This covers investor protection and investment risk requirements. The directive applies to asset managers managing non-UCITS funds or marketing them to professional investors within the EEA.

If the UK were to remain in the MiFID framework, a Brexit would be business as usual for:

- UK firms managing funds under MiFID: the UK would follow any future EU legislation in this case – but would have no say in the trend of regulation.
- Funds domiciled in EEA jurisdictions such as Luxembourg that manage portfolios from the UK: the UK would likely be considered an equivalent jurisdiction for day-to-day portfolio management, similar to the US now. Funds domiciled outside the UK but run by a UK management company would need to restructure and retain an EEA manco. Their numbers are smallish, however, and they could still offer EEA funds to UK investors.
- UK-based funds distributed to UK investors in UCITS: the Financial Conduct Authority (FCA) would just need to re-authorise them.

UK-domiciled UCITS distributed to other EEA members (a sizable minority), however, would automatically be treated as alternative investment funds (AIFs). This means they could only be sold to professional investors in the limited number of EEA states that permit private placements.

To maintain their UCITS or AIF status, UK-based funds might have to move to an EEA jurisdiction. This would likely be a taxable event for investors – a high price to pay. Yet the UCITS and AIFMD regimes are important because they are recognised in other jurisdictions, particularly in Asia and Latin America. So global distribution could be affected, too.

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