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UNIT TRUST CORPORATION

ADVISORY SERVICES DEPARTMENT

Newsletter

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Q1 2019 | Issue 17

BREXIT AND YOUR INVESTMENTS

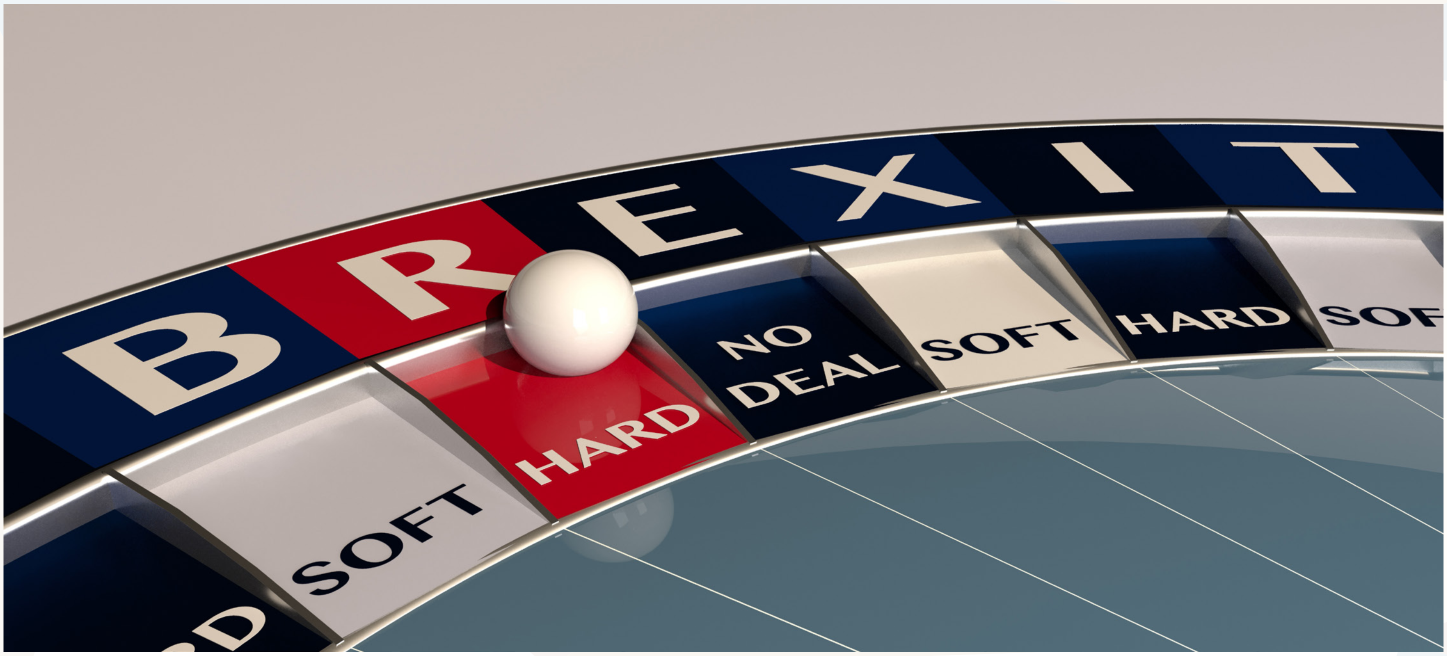
On June 23, 2016, the United Kingdom (UK) held a referendum to decide whether the UK should leave or remain in the European Union (EU) – the economic and political partnership amongst 28 European countries. The EU was established after the second World War to foster economic co-operation and has since evolved into a "single market" allowing goods and people to move around, basically as if the member states were one country.

More than 30 million people, 71.8% of the UK's eligible population, voted in the referendum: 51.9% voted in favour of leaving versus 48.1% who voted to remain. The results showed that the residents believed that the benefits of belonging to the unified monetary body no longer outweighed the costs of free movement of immigration. As a result of the vote, the term Brexit was coined, by merging the words Britain and exit, as shorthand for the UK's decision to leave the EU.

On March 29, 2017, the UK invoked Article 50 of the Treaty on European Union (TEU), which gives any EU member the right to withdraw unilaterally. The procedure gives the leaving country two years to negotiate and conclude an agreement, which would include withdrawal arrangements, taking account of the framework for its future relationship with the Union.

However, untangling a 45-year partnership is not so easy and there are many hurdles to overcome. There have been delays and constant bickering in Parliament about the details of the exit agreement, which has left the UK taking it down to the wire. The UK was originally scheduled to leave on March 29, 2019. However, after UK's Prime Minister Theresa May proposed to extend the negotiations until June 30, 2019, the EU leaders rejected the proposal but instead offered a two-week extension until April 12, 2019.

The UK is the fifth largest economy in the world behind the United States, China, Japan and Germany. However, its growth rate slowed in 2018 as it grew by only 1.4% down from 1.8% in 2017 due to Brexit uncertainty and a weaker global economy. The government expects the country's economy to grow anywhere from 4-9% less than it would inside the bloc over the next 15 years, depending on how it leaves, which is outlined on the next page.



Hard Brexit

A hard Brexit is a term used to describe a clean break from Europe. The UK will no longer be able to freely trade with the other European countries without restrictions or tariffs. Supporters of this option want to be able to make their own trade agreements which unfortunately will be a lengthy process and will therefore force the UK to follow the less favourable World Trade Organisation rules until deals has been finalised.

However, this will have considerable economic impact. At present, about 45% of the UK's exports are to the EU while it imports 50% of its goods from the EU. A hard Brexit would result in a 10% tax for exported goods which would therefore increase their price and could result in declined sales. Increased prices on imported consumer and business items would be another consequence which would hurt consumers and businesses dependent on imported materials from the EU.

Even with a trade agreement, there are other disastrous consequences for the UK.

- London, the UK's financial centre, would no longer be used as an English-speaking entry into the EU economy. The City reported that potentially 5,000 jobs could be lost which could lead to a real estate collapse.
- UK companies would lose the ability to bid on public contracts in any EU country as bidding is only open to member countries.
- Services would also be affected as practitioners would lose the ability to operate in EU countries which could result in increased airfares and even internet and phone bills.
- UK could potentially also lose Scotland as it could join the EU on its own; taking example after some countries within the kingdom of Denmark.

Economists worldwide have repeatedly warned against a hard Brexit. However, there is an even more catastrophic scenario - a no-deal scenario.

Soft Brexit

The consensus amongst economists is that the best solution is for the UK to remain closely aligned to the EU i.e. a soft Brexit. This is expected to minimise the disruption to trade, supply chains and businesses in general. However, the EU has demanded that access to the single market can only be granted if all its principles, including the free movement of people, are respected. This is a major stumbling block for the UK as its politicians aren't willing to compromise on immigration stating that it would betray the wishes of the public.

The agreement Theresa May has proposed has a binding withdrawal agreement and non-binding set of principles to guide future negotiations. Under the plan:

- The UK will remain within a customs union for an unspecified period and no tariffs will be imposed on either parties' imports. As a result, there will be no hard border in Ireland.
- EU nationals can continue living and working in the UK with visas and vice versa.
- The UK would also abide by the European Court of Judgment and EU laws but will lose voting rights.
- UK cannot prohibit the free flow of persons from the EU, which was one of the referendum's primary purposes as they were concerned about increased refugees from Africa and the Middle East.

Current Status

On March 29, 2019, Theresa May presented to Parliament the 21-month transition plan that she negotiated with the EU. However, for the third and presumably final time, Parliament voted against the deal. The plan was previously defeated on January 15, 2019 and since then, May has been trying to get a bitterly divided Parliament to agree.

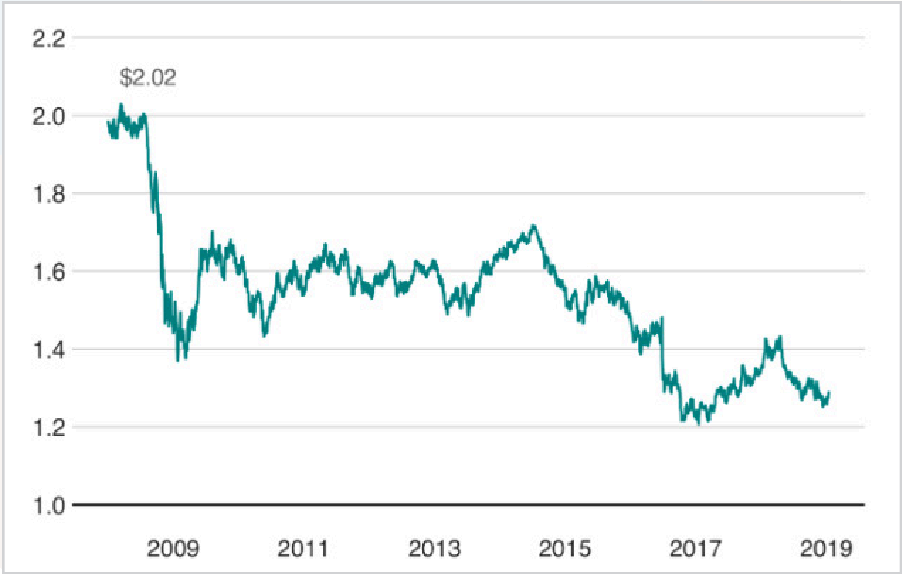
Parliament also voted on a series of alternative plans, none of which were approved. As a result, a no-deal Brexit occurring on April 12, 2019, looks more and more likely.

Impact of Brexit on the Pound (GBP)

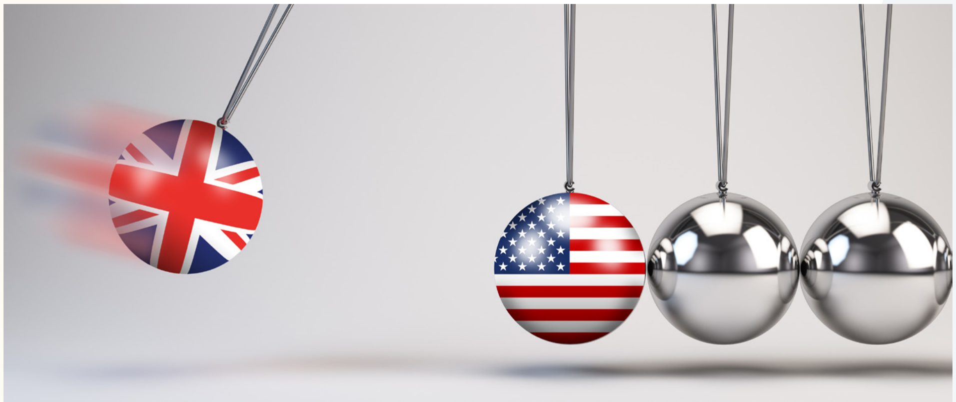
Generally, financial markets are not fond of indecision and uncertainty. The entire Brexit process greatly impacted the British pound sterling (GBP) and posed many unforeseen challenges and has been a rollercoaster ride for valuations (see chart 1). This can be easily observed as periods surrounding key diplomatic and political events were quite volatile.

- **June 2016: Brexit Vote**
  Immediately after the vote, the GBP declined sharply and fell to a 31-year low. The following months continued along the same path, culminating in a 6% flash crash against the USD in October 2016. The bearish sentiment continued over the next 12 months and by June 2017, the GBP had lost 15% of its value against the USD.
- **March 2017: Article 50 Triggered**
  Unlike the Brexit results, which many analysts considered a surprise, the triggering of Article 50 was expected, and downside volatility was able to be limited as it had already been priced into GBP valuations.
- **December 2017: EU/UK Reach Divorce Deal**
  An agreement to orderly part ways was a positive beacon to currency traders as it was considered that much of the ambiguity had subsided and thus confidence increased, allowing the GBP to rally 0.9% against the USD.

Chart 1 – GBP exchange rate with USD



Source: Bloomberg



Impact on the United States

Brexit not only impacts the main parties involved i.e. the UK and the EU, but it will have a wider reach as the global economy is too entangled. The International Monetary Fund has warned that that a no deal could risk initiating a further slowdown in global growth.

The US stock exchange has felt the brunt of the chaos associated with Brexit. After the referendum in 2016, it is reported that the global markets lost $2 trillion in value. The Dow Jones Industrial Average also dropped tremendously as it lost 608 points, or almost 3.4%, the day following the vote.

The uncertainty surrounding Brexit has also caused investors to raise concerns about US companies in the S&P 500 that collect significant revenue from the UK. Even though only 1% of all S&P 500 sales come from Britain, there are companies that have high exposure to the UK. Goldman Sachs has reported that the companies in the S&P 500 with the highest sales exposure (more than 11%) to the UK include eBay, PayPal and News Corp.

The analysis conducted by Goldman Sachs also indicates that due to political uncertainty throughout 2018, the S&P 500 stocks with high UK-exposure lagged US-focused stocks by more than 1,000 basis points. On the other hand, when the decision was taken to delay the Brexit vote in December 2018, this same group of stocks outperformed US stocks by 190 basis points.

Peter Earle, economist and research fellow at the American Institute for Economic Research, has also suggested that bond yields could also be affected as investors and different entities in other markets jump into government bonds for safety.

US multinational companies will also be more directly impacted as Brexit will complicate matters as many American businesses use the UK as a gateway to trade with other EU countries. Additional paperwork as well as the potential for double tariffs – firstly on entry into the UK and then further tariffs upon entering the EU, could lead to delays and increase the price of goods.

It is therefore essential that investors worldwide pay attention to the developments impacting the local and international markets as well as the market sentiment.

Investment Checklist

If there is one thing that unsettles the financial markets, it is indecision, and the unclear nature of the UK Brexit deal falls well into this category. As a result, investors face difficult decisions when trying to determine the best course of action for their investment portfolio during uncertain times such as these. However, you can use the steps outlined below as a guide to help you to ride out the peaks and troughs of the market achieve your long-term financial goals.

1. **Keep perspective**
   It is usual for there to be uncertainty in the financial market which sometimes can result in downturns. However, it is essential to remember that stock markets have been able to recover from declines and can still provide investors with positive long-term returns.

2. **Be comfortable with your investments**
   Ensure that you are comfortable with your investment portfolio. If market downturns are too nerve racking, the level of risk in your portfolio may be too high, you may want to re-evaluate your portfolio composition to find an allocation that is more in line with your risk tolerance which will still help you reach your long-terms goals.

3. **Stay disciplined**
   Instead of trying to base your investment decisions on prevailing market conditions, if you take a disciplined approach to making investment decisions weekly, monthly, or quarterly, you can avoid the perils of market timing and short-term downturns will not have much of an impact on the performance on your portfolio in the long run.

4. **Talk to your financial advisor**
   If you are unsure what would be the best course of action and to help ease the pressure of making the decisions by yourself, you can reach out to your financial advisor. They can help evaluate the available information and offer insights to help you make the best investment decisions

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