M&G Retail

Thoughts on EU referendum

There has been a sharp rise in global focus on Brexit risk in recent weeks, and we expect this to continue and even to increase in the run-up to the vote. Latest opinion polls show the 'remain' camp ahead, although survey results are likely to be highly changeable as undecided voters sway between one camp and the other. In all likelihood, the outcome of the referendum will be unpredictable until voting day on 23 June.

Fixed interest

The market implications of a Brexit are difficult to gauge at this stage, although it is easy to imagine a weakening in the value of sterling and UK assets in the immediate aftermath of a vote to leave. However, provided it is a 'friendly' exit – involving little or no loss of any trade agreements – we believe the longer-term economic and market impact should be limited. In the near term, we might also see a moderation in UK economic growth as capital expenditure is delayed and overseas investments are diverted away from the UK and towards the EU.

In the event of a more disorderly Brexit scenario, we would likely see increased uncertainty, with the prospect of a sharper depreciation in sterling, higher risk premiums in both the UK and Europe, and potentially a sharper slowdown in UK growth.

It is also important to note that a vote for the UK to leave the EU would not be the end of the Brexit process, but the beginning of a new negotiation phase that is likely to take at least a couple of years and, ultimately, have huge implications for the UK, from a legal, political and economic perspective. During this two-year period, existing EU laws and regulations would continue to apply to the UK. It is easy to forget that a vote in favour of Brexit would also have repercussions in Europe, as separatist movements would likely gain a stronger voice and attempt to question the very existence of the EU.

Gilts – The potential impact on gilt markets is difficult to predict. If sterling weakens because of Brexit, then we could see yields rise due to higher inflation expectations as import costs rise. Conversely, we could see gilt yields fall if an expected drop in economic activity causes the Bank of England to further delay any interest rate hikes. Should the 'remain' vote prevail, we would expect to see gilt yields rise as uncertainty is lifted. In any event, with yields near historic lows, we think valuations are unattractive, so we are generally positioned with a short sterling duration across the retail fixed interest fund range. However, on a relative basis, we think index-linked gilts look attractive. Indeed, as a result of the uncertainty around Brexit, corporations and households have delayed investments and spending in recent times. Should the 'remain' vote prevail, then we would expect a short-term boost in economic activity as the uncertainty is lifted, which should benefit index-linked gilts. Should the 'leave' vote win, the depreciation of sterling could create inflationary pressures, and so in any case, we expect inflation expectations to increase and index-linked gilts to outperform conventional gilts.

Investment grade credit – Since the beginning of the year, the markets' realisation of the risk of Brexit has caused sterling corporate bonds to underperform US-dollar denominated bonds, including those credits that, in our view, could be negatively affected by a Brexit vote. We think that in some parts of the market, this underperformance has been excessive, and therefore have recently switched some of our US-dollar denominated credits into sterling-based credits. For example, in our flexible fund – the **M&G Optimal Income Fund** – we recently sold some Apple, Verizon, and Anheuser Busch Inbev US dollar-denominated bonds and switched into the equivalent sterling-denominated bonds offering a higher spread.

In case of Brexit, although the impact on most UK corporates should be relatively limited (UK banks being an exception), we believe sterling credit spreads could widen immediately after as risk-averse investors sell their positions (although it also depends on how spreads move between now and 23 June). While the **M&G Optimal Income Fund** currently has approximately 25% allocated to well-diversified UK credits, non-sterling investors can access the fund through hedged share classes and therefore are not exposed to sterling risk. Meanwhile, our team of analysts continues to work hard in order to understand which individual credits are likely to be most affected – positively or negatively – by a potential Brexit. Despite any near-term Brexit volatility, we believe investment grade fundamentals remain sound and valuations are currently attractive, especially following the recent widening in spreads.

High yield bonds – we do not expect Brexit to have much of an impact on high yield credit. The UK accounts for only a small part of the global high yield market, and we still expect the oil and financials sectors, and overall prospects for economic growth, to remain the key drivers of returns in the short term. For the **M&G Global High Yield Bond Fund,** we are maintaining a relatively modest (c.10-15%) exposure to UK high yield issuers.

Emerging market bonds – the **M&G Emerging Markets Bond Fund** has a close to zero exposure to both sterling and UK corporates, so the fund would not be directly affected by a Brexit. There could be some indirect impact should core eurozone bond yields rise on risk aversion and there is a flight to US Treasuries, as the fund has around 0.5 year's worth of EUR duration.

UK Equities

Depending on who you believe, a UK exit from the EU would either cause a crisis that is on par with what happened in 2008, or herald the start of a British economic renaissance. The truth, of course, is that nobody really knows what will happen because the outcome depends on what policies and institutional arrangements are put in place following the referendum. Specific forecasts and estimates of the impact are based on a lot of assumptions that are spurious at best. So the impact is uncertain, which we are aware is less than comforting.

Currently, UK equity market valuations don't offer much room for error, particularly given the relative longer-term strength seen in the FTSE 250, which has predominantly more UK focus, in terms of revenues. In contrast, the FTSE 100 has been a relative laggard (largely on the back of the underperformance of oil & gas and basic materials) and derives c.72% of its revenues from overseas, which should benefit from sterling weakness. However, it's not as simple as looking for currency weakness.

We have already begun to see the market attempt to price the decision to leave in some assets and sectors. The impact on the UK has primarily been felt in domestic cyclical plays and real estate-related investments. In addition, UK consumption numbers and retail sales have been exceptionally weak. However, the situation has created opportunities, and it is important to remain vigilant and take advantage of exceptional buying opportunities when they arise.

We are taking a measured approach to these price reactions. While we believe that fear of the unknown and the case for the EU will ultimately be made more convincingly and result in Britain remaining. This, however, is not guaranteed, and so we do not want to commit ourselves unequivocally.

Multi Asset

As the 23 June referendum date draws nearer, we have been hearing all sorts of analysis, predictions and arguments on the likely results and potential implications of a Brexit for the economy. Whatever the individual commentator's pre-set beliefs, 'evidence' has been found to support their view. But the reality is simply that no one can know either the result or how either scenario would play out. As fund managers, we will not be expending time and energy ourselves on attempting to predict the outcome of political events.

We are always careful about over-estimating the link between policy-making and real economic conditions. In this case, we are not even really talking about policy-making, rather 'politicking'. David Cameron was responding to pressure from his political rivals, both inside and out of his own party, to be seen to be standing up for UK interests in Europe, ahead of last May's general election. This is certainly not the first time the Conservative party in the UK has had an existential debate on Europe. At its heart, though, it is not even a UK-specific issue. A level of public disaffection with the EU, based on a confluence of factors, including the economic downturn and migration issues, resonates with a fair amount of the political discourse across other EU nations. Such discourse will endure both before and after the UK's referendum on 23 June, with varying degrees of attention being paid by financial markets, whose myopic tendencies suggest more of a flirtation than long-lasting fixation with the issues.

So what if there is a Brexit? Our feeling is that, yes, ultimately, there would be costs, but it is difficult to argue that it is clear there would be significant, permanent investment implications. So, certainly at the moment, this topic has not caused us to adjust our outlook for the UK economy, which is based on what we believe to be more important factors, such as long-term trends in fundamental data.

On this basis, we have not been provoked by this issue into making any changes to our portfolios. However, while we find it difficult to discern with any precision and clarity any meaningful long-term implications for the economy, the possible short-term impact on markets is something we will be observing carefully. This includes likely volatility in sterling, gilts and the UK equity market, but also markets outside the UK. This is in line with our 'episode' investment philosophy, under which we seek to exploit phases of volatility in which assets may become temporarily mispriced. This mispricing is caused by market participants over-reacting to short-term newsflow on topics that may have little to do with long-term fundamentals.

In this respect, even before we can know the result, we will be watching markets on the journey to the referendum. The consequences of uncertainty on that journey are an entirely different issue to the consequences of a Brexit. We will be dealing with the former, first. The market probably won't analyse whether it's meaningful or not. If enough people are making noise about it, it will believe it is, for a bit at least. As always, our portfolios will be positioned on the basis of having discerned fundamental from non-fundamental factors. We are more likely to view some non-fundamental price volatility as a potential opportunity for those with patience and the fortitude to see it through. Therefore, we are comfortable that the portfolios are currently positioned in the right way, for the right reasons, and are ready and willing to use our flexibility to respond to any 'episodes' that may arise.

In summary:

- No one can predict the outcome of the referendum; we must avoid being distracted by 'noisy' commentary.
- Even if there is Brexit, it is not clear there would be significant, permanent investment implications, so we maintain our current view on the UK based on current economic fundamentals.
- Therefore, we have not adjusted our portfolio positioning, but will be watching closely for potential opportunities where uncertainty drives market volatility, causing asset pricing to become dislocated from fundamentals.

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