Trade Idea – Foreign Exchange
Trading the EU Referendum
10th June 2016

Brexit possibility rekindled

After the “Remain” camp took a seemingly unassailable lead in voting polls towards the end of May, a bout of Sterling strength reflected market relief as a degree of uncertainty was removed from the upcoming vote. However, this reprieve turned out to be short lived, as six out of eight of the latest polls have shown the “Leave” camp ahead with an average lead of three percentage points (Source: FT Brexit poll tracker), rekindling investor concerns and stressing the considerable stakes at risk on June 23rd. Interestingly, average gambling odds (sample of 24 bookmakers analysed) have put the likelihood of a “Brexit” at around 30%, but this is unlikely to provide much comfort to market participants with assets to protect (see Figure 1). With a US interest rate hike looking increasingly unlikely this month, the EU referendum is the biggest event in the calendar and preparing portfolios adequately will be top of the agenda for investors. Below, we look at the primary assets that we expect to be impacted by the vote and the Exchange Traded Products (ETPs) that can be used to trade either scenario.

Sterling – Direct exposure

Leave: In the event of a “Brexit” the most immediate impact is likely to play out on currency markets, with the Sterling likely to see significant moves lower against its major trading counterparts. Recently, the Sterling has been the clearest barometer of the market’s concerns over a “Brexit” scenario, having already fallen 9.1% since mid-November (on a trade weighted basis). The largest consideration over the decision to leave is the uncertain impact that it will have on the UK's trading relationship with the EU, the largest consumer of its exports (EU accounts for 47% of UK exports, Source: ONS). Various scenarios outlined in academic studies by PWC, Oxford Economics and the Centre for Economic Progress (CEP) all predict UK trade to be adversely impacted by a decision to leave the EU, explaining why the Sterling is likely to be the primary victim should a “Brexit” materialise. As a vote to leave would be the first decision of its kind, forecasts over the extent of a Sterling fall are disparate, ranging from 12% by the Treasury to over 20% by some sell-side analysts, such as Credit Suisse.

For foreign investors potential Sterling weakness can either present a risk to unhedged UK holdings or a tactical opportunity. In either case, a capital efficient means of gaining short Sterling exposure is using leveraged currency ETPs. ETFS 3x Short

*All figures quoted are sourced from Bloomberg unless stated otherwise.
**UK equities – Financials and Real Estate vulnerable**

**Leave:** For UK equities the outcome is not as binary. For the large firms that comprise the FTSE 100, a much smaller portion of revenues are generated in the UK compared to the broader FTSE 250 index. A “Brexit” scenario would provide a competitive boost for larger, more internationally focused firms through a weaker Sterling, but would hurt smaller enterprises that generate revenues domestically. Therefore, while we expect the impact of a “Leave” vote to be, on balance, negative for the FTSE 100 index, we believe the downside effects will be more pronounced for the more domestically focused FTSE 250 index.

**Stay:** One of the largest drawbacks of a “Leave” vote would be suffered by those financial services firms that rely on “passporting” to conduct business throughout the European Union, which would explain why the sector has been the second worst performing in the FSTE 100 year to date. Real estate firms also stand to suffer from the weaker economic prospects associated with a decision to leave the EU, being highly domestically focused and vulnerable to trends in consumer confidence. A vote to “Remain” would alleviate pressure on both these sectors and should see them exhibit a relief rally similar to that experienced last year following the surprisingly favourable majority outcome of last year’s general election.

Investors can express high conviction views on UK equities in either direction via [ETFS FTSE 100® Leveraged (Daily 2x) GO UCITS ETF (LUK2)], [ETFS 3x Daily Long FTSE 100 (UK3L)], [ETFS FTSE 100® Super Short Strategy (Daily 2x) GO UCITS ETF (SUK2)] or [ETFS 3x Daily Short FTSE 100 (UK3S)] the largest ETPs (in terms of AuM) in Europe offering short and leveraged exposure to the FTSE 100.

**Gold – Attractive hedge for GBP investors**

**Leave:** Gold has traditionally been viewed as a safe haven investment, offering protection during periods of elevated uncertainty and market turbulence (see Figure 3). In terms of acting as an event hedge against a “Brexit”, gold is a particularly attractive option...
for Sterling denominated investors for the two following reasons. Firstly, gold, like most commodities, is priced in US dollars so a “Brexit” induced fall in the GBP would simultaneously increase the Sterling price of gold, contributing to the total return. Secondly, a “Brexit” would increase the market’s appetite for safe haven assets which could, according to our model estimates, catalyse a move in the gold price to as high as $1,400/Oz should net speculative positioning rise accordingly (see Economic recovery unlikely to derail gold prices).

Most investors choose to gain gold exposure through physically backed ETPs, as the storage of bullion can be operationally complex and expensive. The largest and most liquid gold ETPs in Europe are ETFS Physical Gold (PHAU) and Gold Bullion Securities (GBS) which have seen a combined US$1.9bn of net inflows year to date, the largest inflows of any commodity ETP in the region.

Stay: Gold is less likely to experience a sharp reaction should the status quo in the UK be maintained, with investors instead turning their attention back to the US for any indications from the US Federal Reserve of further monetary tightening.
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