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To: Investment Team, All Advisers

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Subject: Britain and the European Union (EU) – In or Out?

The Facts & Fiction

On Thursday, 23rd June, Britons will decide whether they want to continue their EU membership. Over the last few months I have conducted my own opinion poll when meeting clients by asking which way they will be voting. Some were fiercely anti-European and will vote to leave, some were in favour of continuing EU membership, and others were unsure and intended to make-up their minds in due course. I found no indifference, so on the basis of my crude poll, I suspect the turn-out on 23rd June will be high.

Some clients have asked for a COURTIERS view, which scares me witless as any answer, one way or the other, is likely to make me unpopular with a large group of our investors. However, the subject needs careful consideration, so I thought the fairest way to respond is to set out the facts, outline the uncertainties and then, if I am brave enough, say which way I will vote, and why. I begin with a bit of history followed by some basic facts that will hopefully provide a clear picture as to the EU's and UK's positions in the global economy.

A Brief History of the EU

Today's EU is an organisation of 28 member countries (see Chart A and Table 1) that form a political-economic union where trade can take place freely and where its members share laws and adopt common practices for labour and business.

The drive for European economic union started after the Second World War when political leaders sought to find agreement that would avoid the conflicts that had devastated Europe during the first half of the 20th century.

Chart A: EU Members





(source: eu.countrylist.com)

The first formal body was the European Coal and Steel Community (ECSC) which was formed by Belgium, France, Holland, Italy, Luxembourg and West Germany under the Treaty of Paris in 1951. The same six nations signed-up to the Treaty of Rome in 1957, which created the EEC (European Economic Community) and strengthened the economic and political ties between its members.

The EEC evolved into the EU (which is based on the Maastricht Treaty of 1992) and along the way other nations joined the original six.

Britain signed-up, along with Denmark and Ireland, in 1973 under the pro-European Tory Prime Minister Ted Heath. Two years later, Labour Prime Minister Harold Wilson held a referendum on Britain's membership and the British electorate decided overwhelmingly to stay in, with 67% voting "yes". The twenty-eight current members of the EU are shown in Table 1 below:-

Table 1: EU Member Countries

Country	Date Joined	2014 GDP (\$Billion)	2014 Population
 Austria	1 Jan 1995	\$438	8.508
 Belgium	1 Jan 1958	\$534	11.204
 Bulgaria	1 Jan 2007	\$56	7.202
 Croatia	1 Jul 2013	\$57	4.236
 Cyprus	1 May 2004	\$23	0.891
 Czech Republic	1 May 2004	\$205	10.512
 Denmark	1 Jan 1973	\$342	5.617
 Estonia	1 May 2004	\$27	1.319
 Finland	1 Jan 1995	\$273	5.451
 France	1 Jan 1958	\$2,834	63.92
 Germany	1 Jan 1958	\$3,874	81.1
 Greece	1 Jan 1981	\$238	10.993
 Hungary	1 May 2004	\$137	9.877
 Ireland	1 Jan 1973	\$251	4.61
 Italy	1 Jan 1958	\$2,148	60.783
 Latvia	1 May 2004	\$32	2.033
 Lithuania	1 May 2004	\$48	2.932
 Luxembourg	1 Jan 1958	\$66	0.55
 Malta	1 May 2004	\$11	0.425
 Netherlands	1 Jan 1958	\$881	16.864
 Poland	1 May 2004	\$548	38.018
 Portugal	1 Jan 1986	\$230	10.394
 Romania	1 Jan 2007	\$199	19.947
 Slovak Republic	1 May 2004	\$100	5.417
 Slovenia	1 May 2004	\$50	2.061
 Spain	1 Jan 1986	\$1,407	46.464
 Sweden	1 Jan 1995	\$571	9.747
 United Kingdom	1 Jan 1973	\$2,950	64.511

Source: IMF (International Monetary Fund), europa.eu & COURTIERS

Not all European countries are members of the EU, but some non-members, like Norway, have special trading agreements as part of the European Free Trade Association (EFTA). Nationsonline.org produces a helpful map of Europe showing EU members, EFTA members and non-EU members.

Chart B: Europe by Economic Grouping



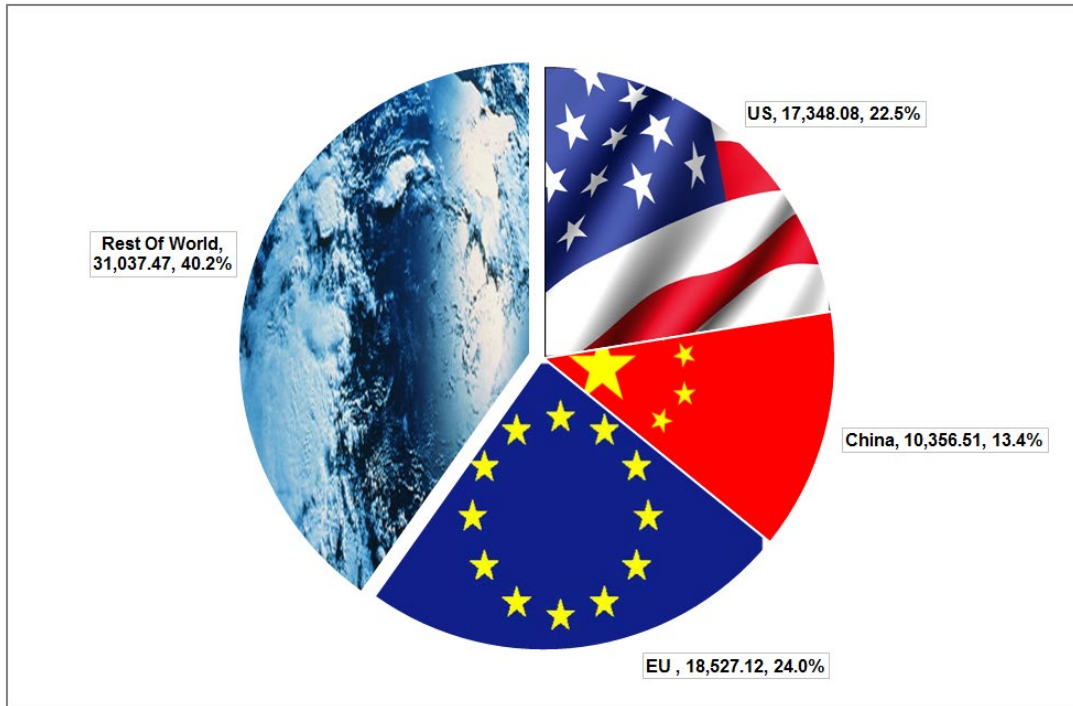
Source: nationonline.org

EU and Britain – Facts & Figures

The EU (including the UK) measured by GDP (Gross Domestic Product) (ie., the combined value of the output of all goods and services produced by member states) is the biggest single market in the world. According to the IMF, total GDP in 2014 was \$18.53 trillion, equivalent to 23.98% of total global GDP. For comparison, the US produced \$17.35 trillion (22.45% of global GDP) and China \$10.36 trillion (13.4% of global GDP) (chart C).

Chart C: Global GDP, 2014 US\$ Billions

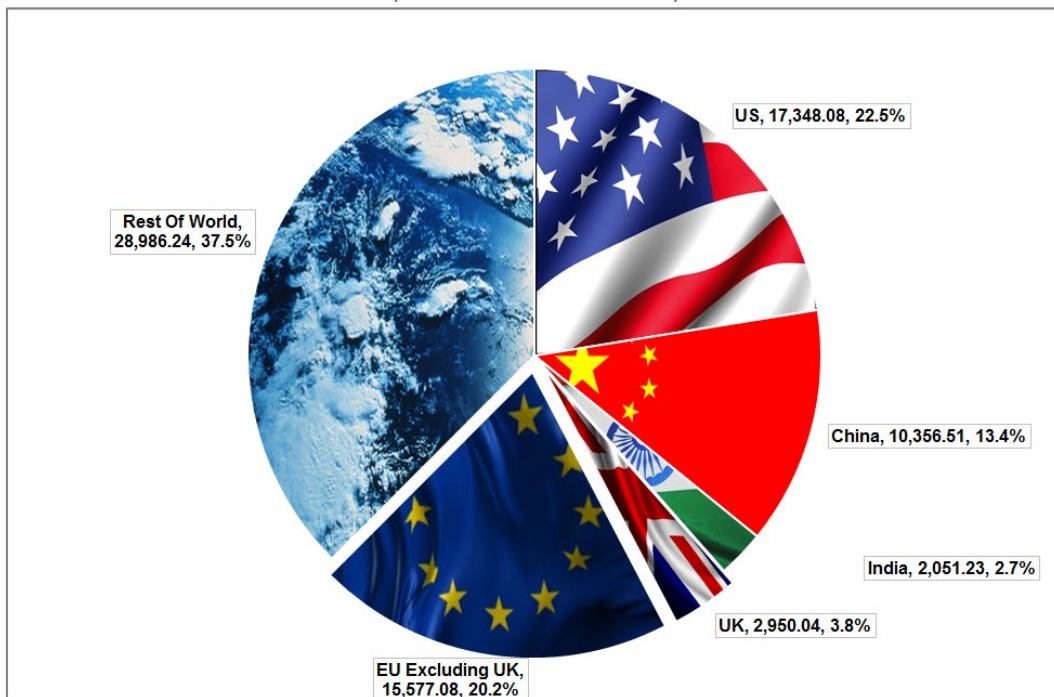
(source: IMF/COURTIERS)



UK GDP in 2014 was \$2.95 trillion (3.8% of world GDP). If the EU lost the UK as a member then its adjusted GDP for 2014 would be \$15.58 trillion (20.2% of world GDP), and it would drop behind America as the largest single market (chart D).

Chart D: Global GDP, 2014 US\$ Billions

(source: IMF/COURTIERS)

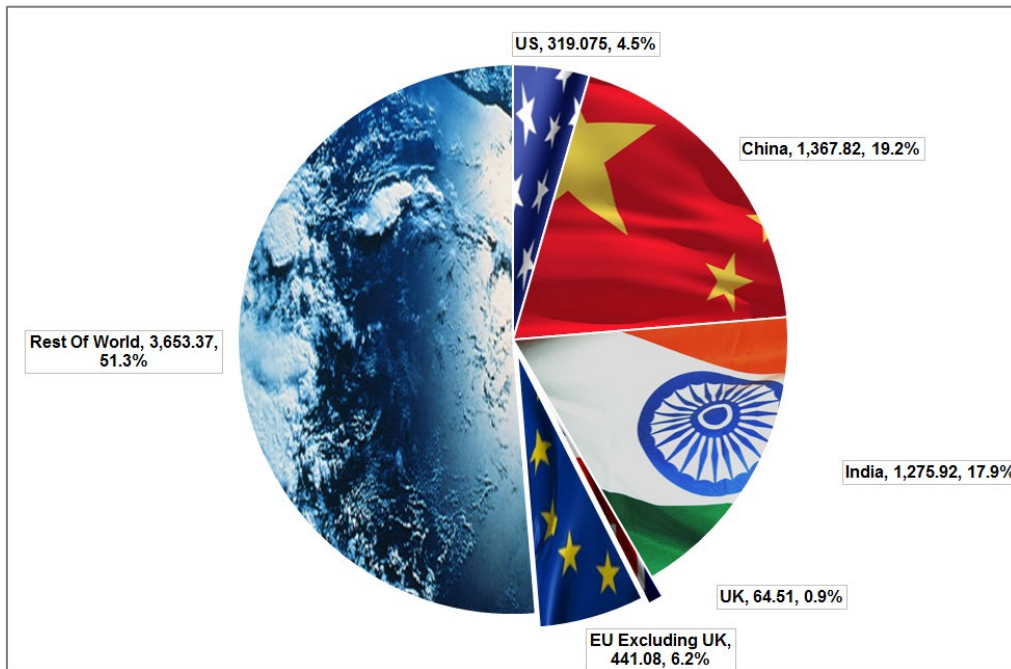


The population of the EU is 505.59 million, which is equivalent to 7.1% of the world population. This compares to a population of 319.08 million in the US, 1,367.82 million in China and 1,275.92 million in India. The UK

population, at 64.51 million, accounts for just 0.9% of the global population, and if the UK votes “out” in June, then the EU population would fall to 441.08 million (6.2% of the global population) (chart E).

Chart E: Global Population, 2014 Millions

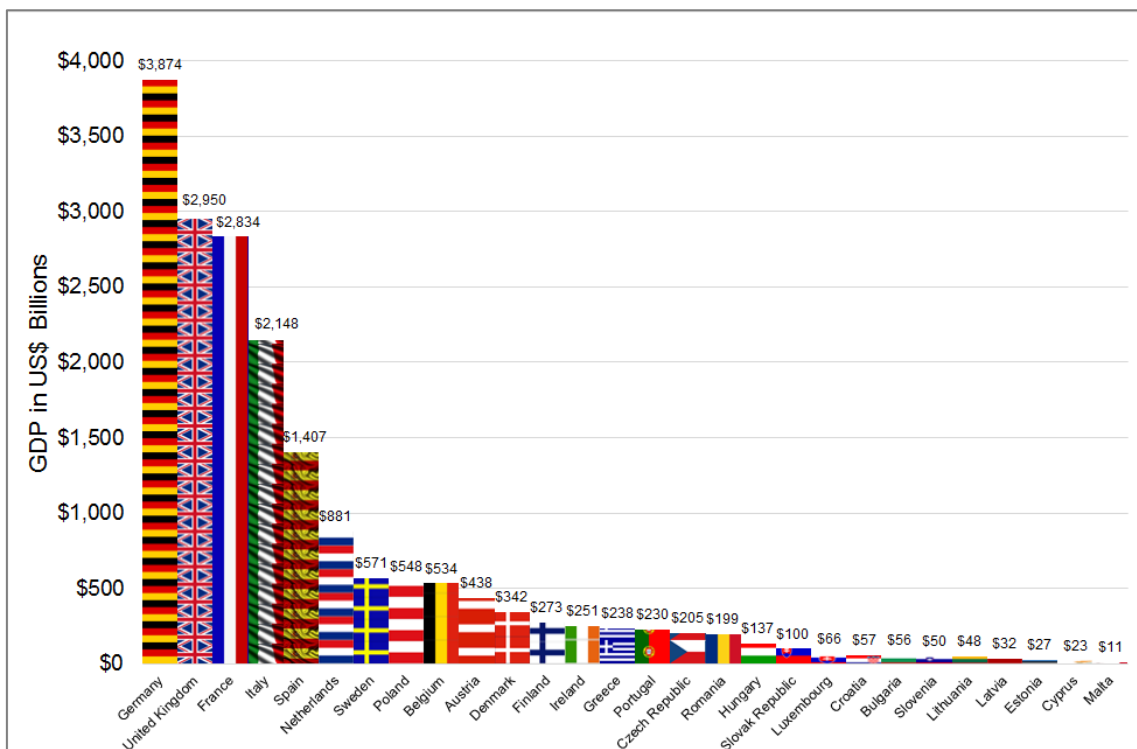
(source: IMF/COURTIERS)



Germany is the largest economy in the EU. Its output in 2014 was \$3.87 trillion, which compares to the UK and France (the 2nd and 3rd largest economies in the EU) at \$2.95 trillion and \$2.83 trillion respectively (chart F).

Chart F: EU Member Nations GDP, 2014 US\$ Billions

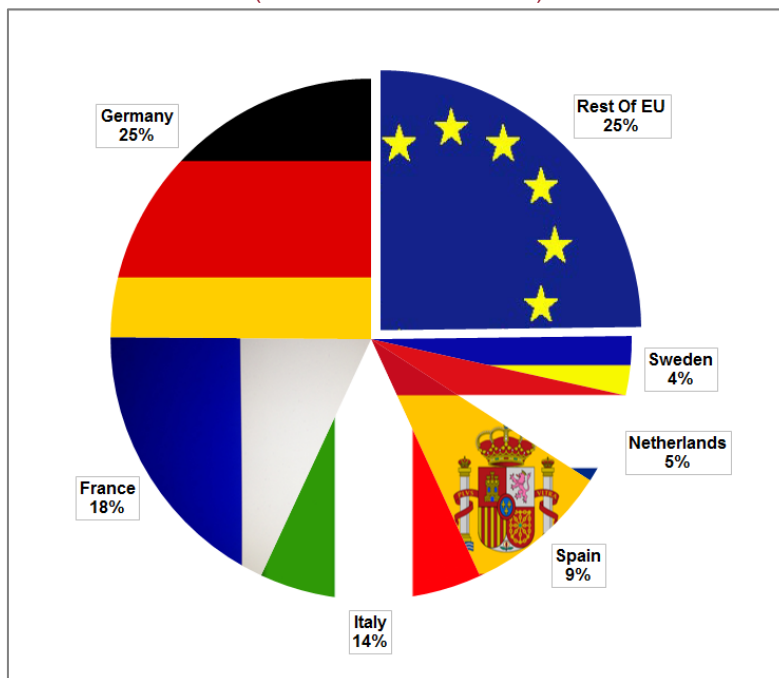
(source: IMF/COURTIERS)



If the UK were to leave the EU then Germany's share of total EU GDP would rise to nearly 25% and it would be bigger than the combined GDPs of the 21 smallest EU members. In fact, the six biggest economies of the 27 (excluding the UK) remaining nations (Sweden, Netherlands, Spain, Italy, France and Germany) would account for just over 75% of total EU GDP (see chart G below).

Chart G: EU ex-UK GDP 2014, US\$ Billions

(source: IMF/COURTIERS)



Britain's Trade Position

A large part of the argument for being in, or out of, the EU centres around Britain's trade position. Before looking at the potential effects of leaving the EU, I examine how Britain performs concerning exports and imports of goods and services.

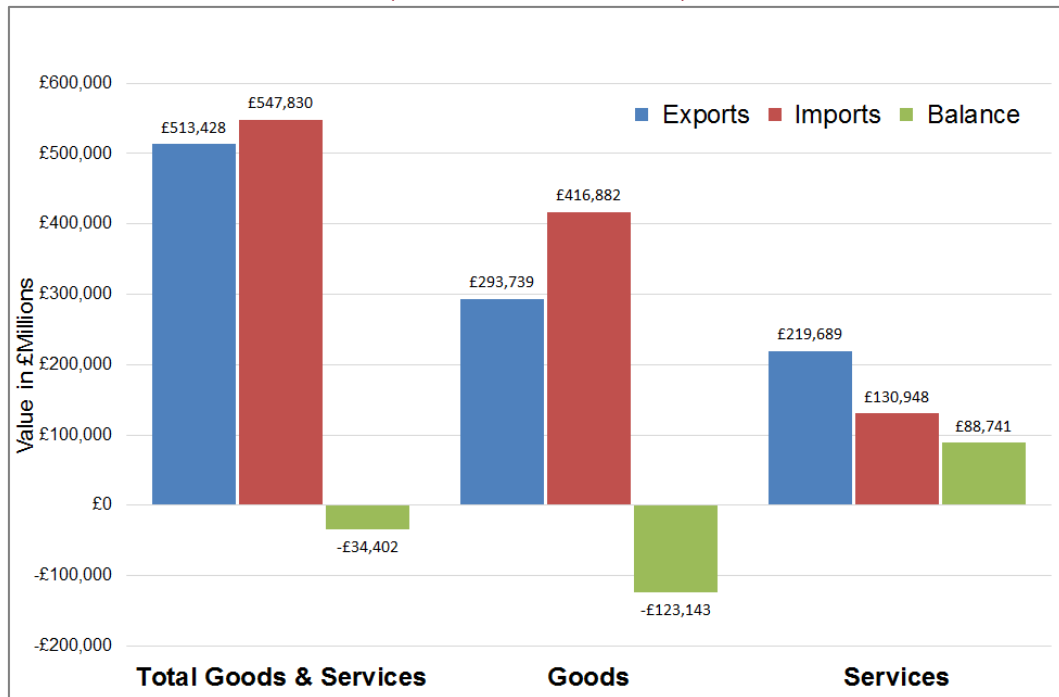
Britain's economy is heavily orientated towards services, which account for 79% of total GDP¹. This is the same as the US and France (both 79%) but higher than Germany (69%). Even those economies that have more recently been categorised as "developed" have services as the majority activity, for example, South Korea where services form 58% of GDP.

Britain tends to be very competitive regarding services, but less competitive in the production of goods. Chart H below shows total exports, imports and the resulting balances for goods and services in 2014.

¹ source: Economist – World in Figures, 2015

Chart H: UK Exports & Imports of Goods & Services in 2014, £Millions

(source: ONS/COURTIERS)

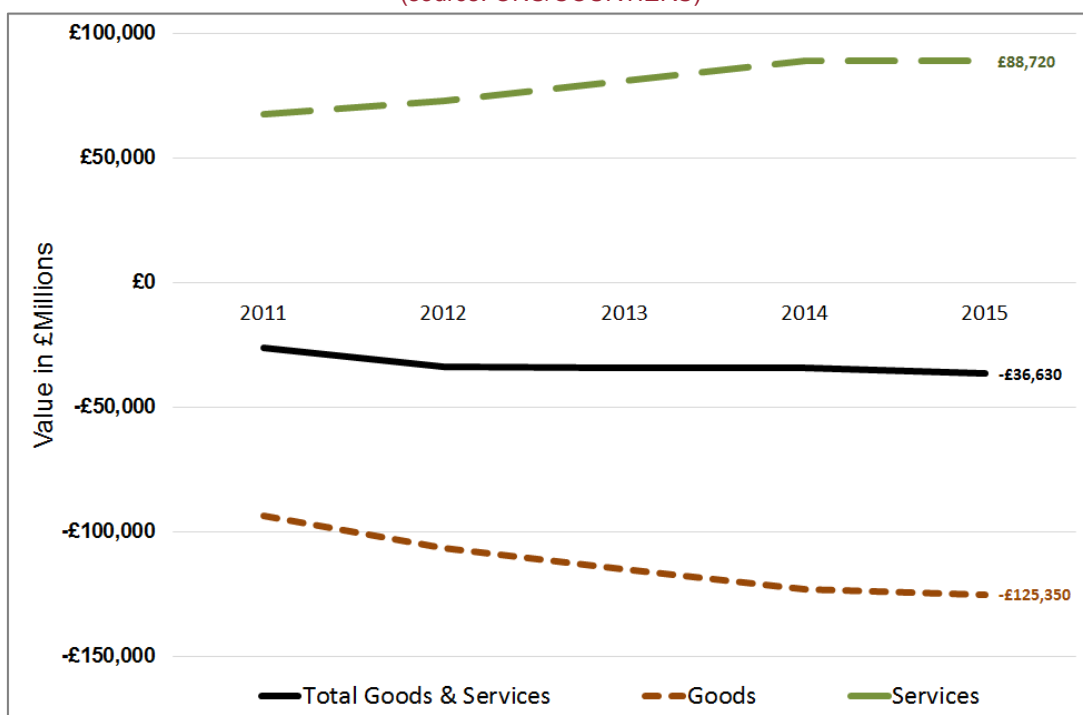


Although the UK exported £294 billion in goods, it imported £417 billion, causing a net negative trade balance in goods of -£123 billion.

The position is reversed with services, where the UK exported £220 billion in 2014 and imported only £131 billion, creating a positive trade balance of +£89 billion. The positive balance in services is not quite enough to offset the negative balance in goods, and so Britain's trade balance in 2014 was -£34 billion. The negative UK trade balance is not a new phenomenon and it has been worsening for some time. Chart I below shows the balances (exports minus imports) in goods and services since 2011.

Chart I: UK Trade in Goods & Services, £Millions

(source: ONS/COURTIERS)

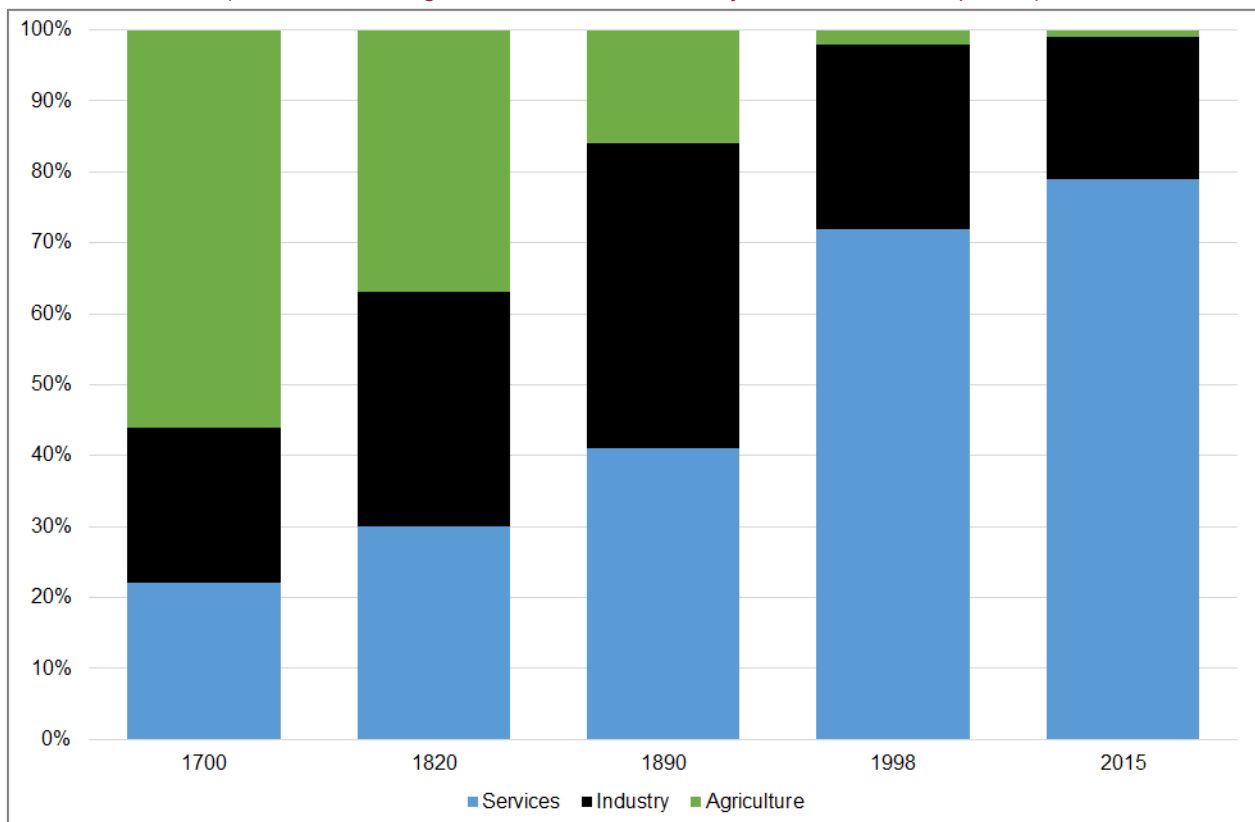


Between 2011 and 2015 total UK exports rose by 2.82%, but total imports rose by 4.67%, causing the UK trade balance to deteriorate by 39.76%. The UK's performance in trading goods was much worse, with exports of goods falling by -7.35% in the period and imports rising by just 2.28%.

The figures for services were much better. Exports of UK services rose by 19.41%, whilst imports rose by just 12.56%, which means the positive balance in the UK's trade in services grew from £67.33 billion in 2011 to £88.72 billion in 2015, a rise of 31.76%.

As economies develop they tend to firstly become more efficient at producing agricultural produce, secondly more efficient at obtaining natural resources and then more efficient at making goods. By "efficient" I mean that less labour is required to produce an ever increasing output. For example, in the UK, just 1.2% of the work-force is employed in agriculture. In the year 1700 it was 56%, with the remaining 44% split evenly between industry and services². The amount of the UK work-force employed in agriculture fell to 37% in 1820, 16% in 1890 and just 2% in 1998. Those employed in industry in the UK reached 43% in 1890, but this has now fallen to 26% as production methods have become more efficient.

Chart J: Composition of UK Workforce: 1700 - 2015
 (source: OECD/Angus Madison, World Economy, and Millennial Perspective)



Although we often bemoan the demise of manufacturing as a proportion of our GDP, it is an inevitable process for an increasingly efficient economy which releases labour to devise, and

² source: OECD/Angus Madison, World Economy, and Millennial Perspective

deliver, services that the population can afford as their cost of food and goods diminishes. One could argue, therefore, that with an already high proportion of GDP directed to services, and with generally a very efficient service industry relative to the rest of the world, the UK is well placed for future growth, and that this has been reflected in recent economic performance.

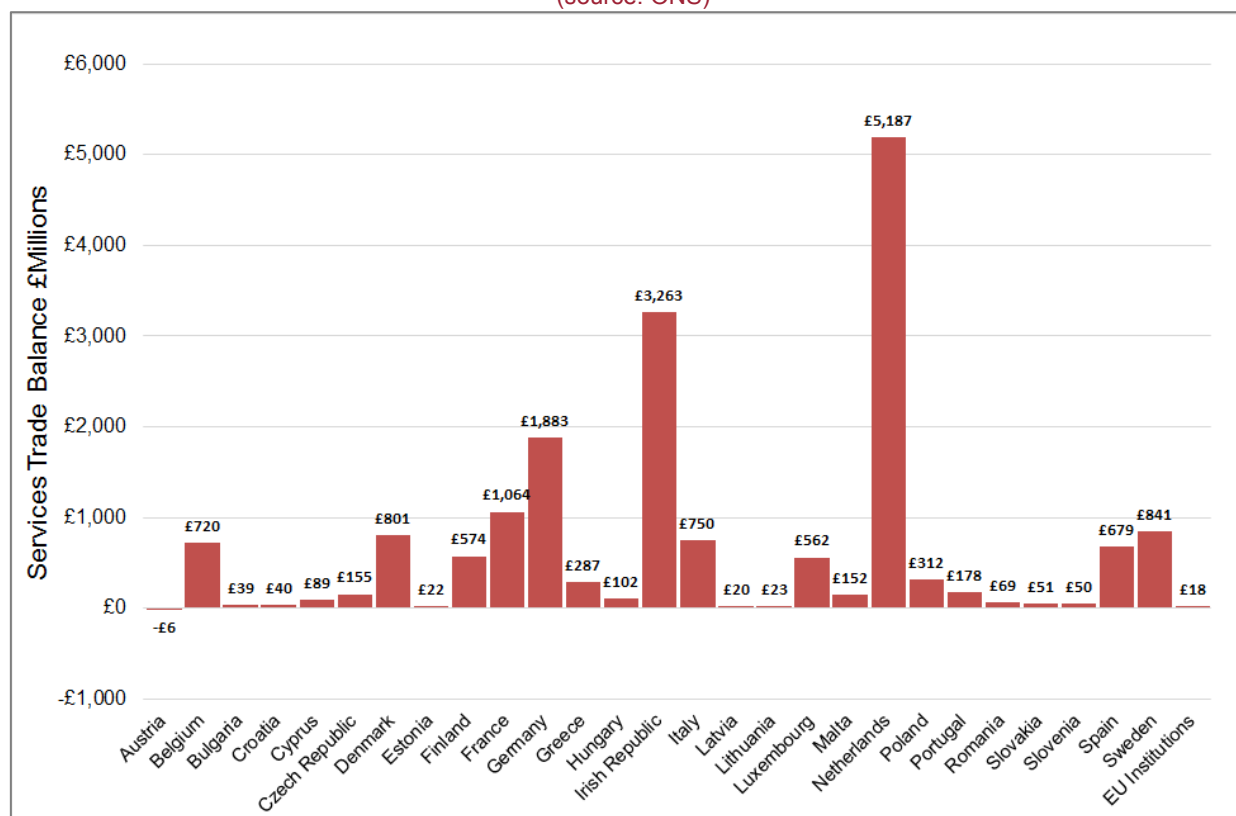
Britain's Trade Position with the EU

Britain's trade position with the EU follows a similar pattern to its trade position with the rest of the world: it runs a negative balance (exports minus imports) in goods and a positive balance in services. In 2014, the UK exported £42.48 billion³ in services and imported £24.54 billion creating a positive balance of £17.92⁴ billion. Regarding goods, total exports to the EU in 2014 were £146.02 billion whilst imports were £225.65 billion, leaving a negative balance of -£79.63 billion.

Charts K and L show the UK's net trading balances in goods and services with the EU (I have been able to show 2015 figures for goods but the ONS currently only shows services by country for 2014).

Chart K: UK Services (excl. travel, transport & banking) Trade with EU Members (Balances £millions, 2014)

(source: ONS)

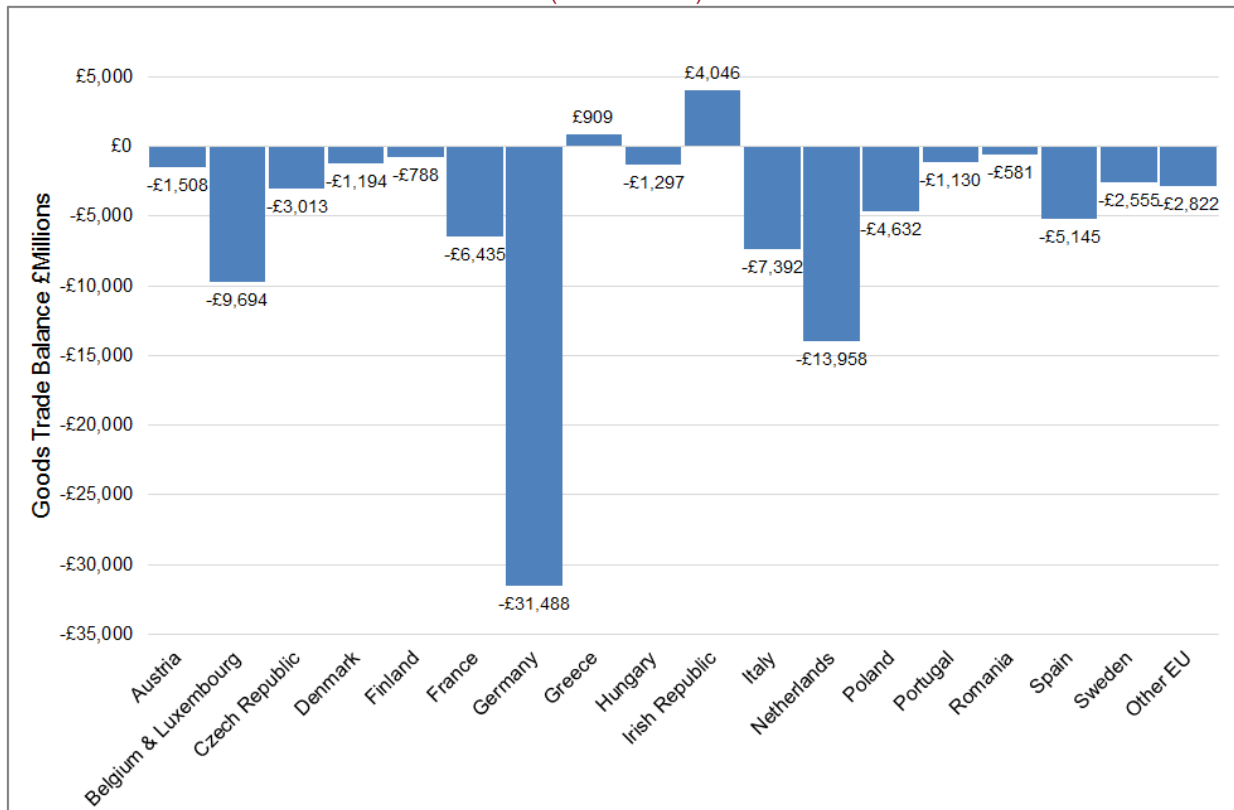


³ Source: ONS (Office of National Statistics) – note that services figures provided by the ONS exclude travel, transport and banking.

⁴ Differences in balance compared to exports less imports due to ONS including a balancing figure for EU institutions of £0.018 billion.

Chart L: UK Goods Trade with EU Members (Balances £Million, 2015)

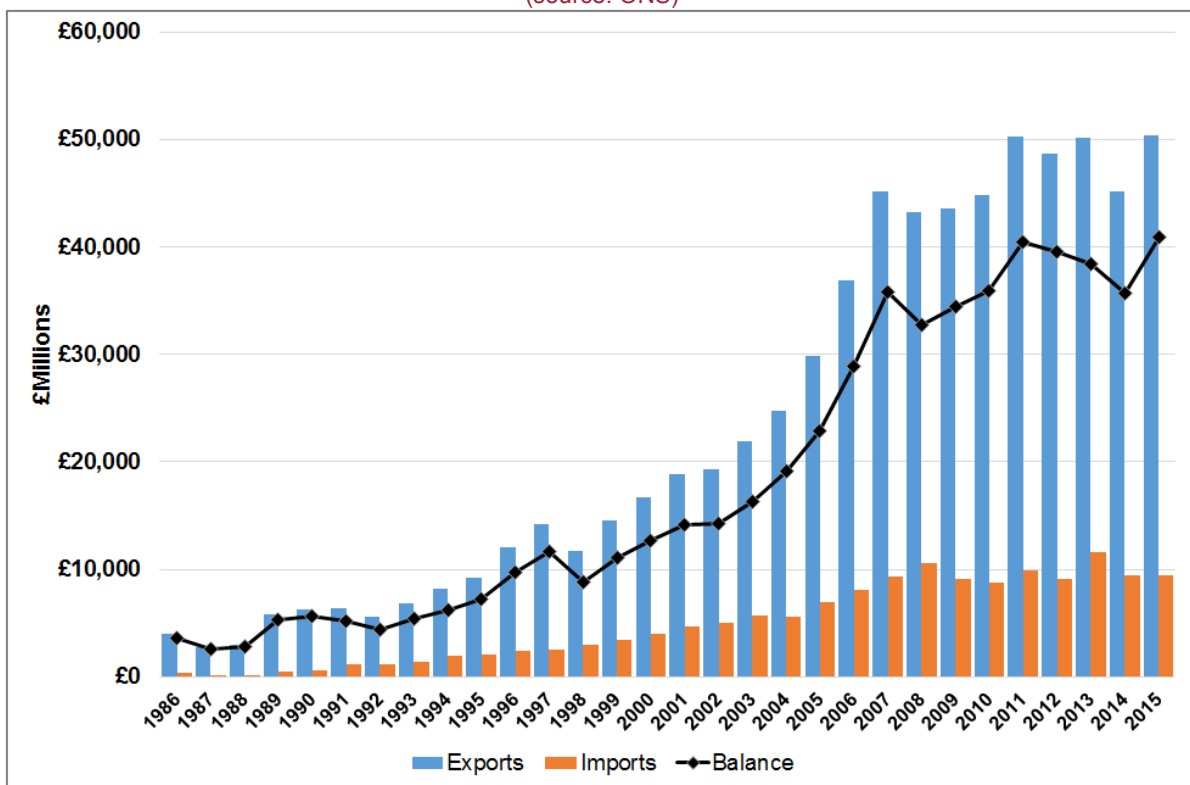
(source: ONS)



The ONS specifically excludes travel, transport and banking from its UK services data. The UK is a major provider of financial services. The following chart (chart M) shows exports, imports and the balance (exports minus imports), for the UK's trade in financial services.

Chart M: UK Financial Services Trade Balance (£Millions)

(source: ONS)

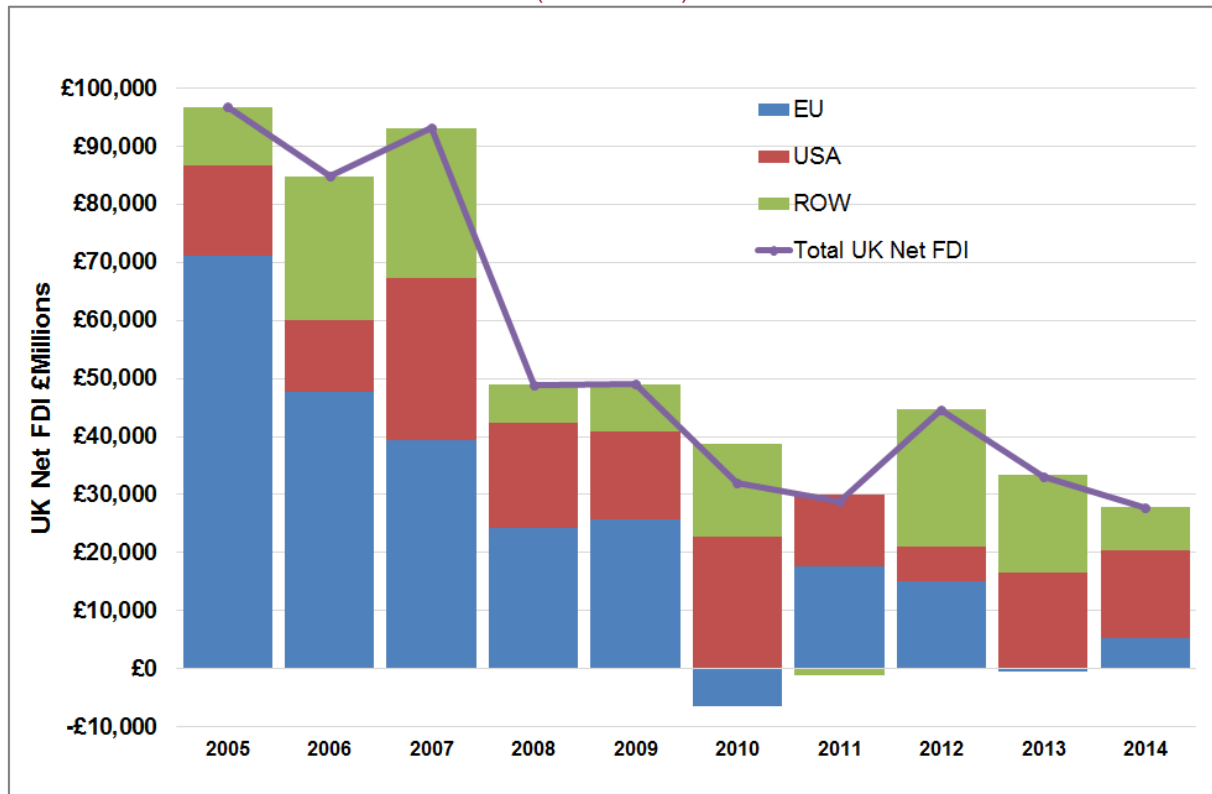


In 2015 the UK exported £50.33 billion in financial services, imported £9.43 billion and ran a positive balance (exports minus imports) of £40.90 billion.

Apart from being successful with financial services, the UK has enjoyed positive FDI⁵ (Foreign Direct Investment) for many years. This is highlighted by chart N.

Chart N: UK Net FDI (£Millions)

(source: ONS)



In 2014, net FDI (Foreign Direct Investment) in the UK was £27.80 billion. The majority (£15.18 billion) was from the USA, with the EU contributing £5.27 billion.

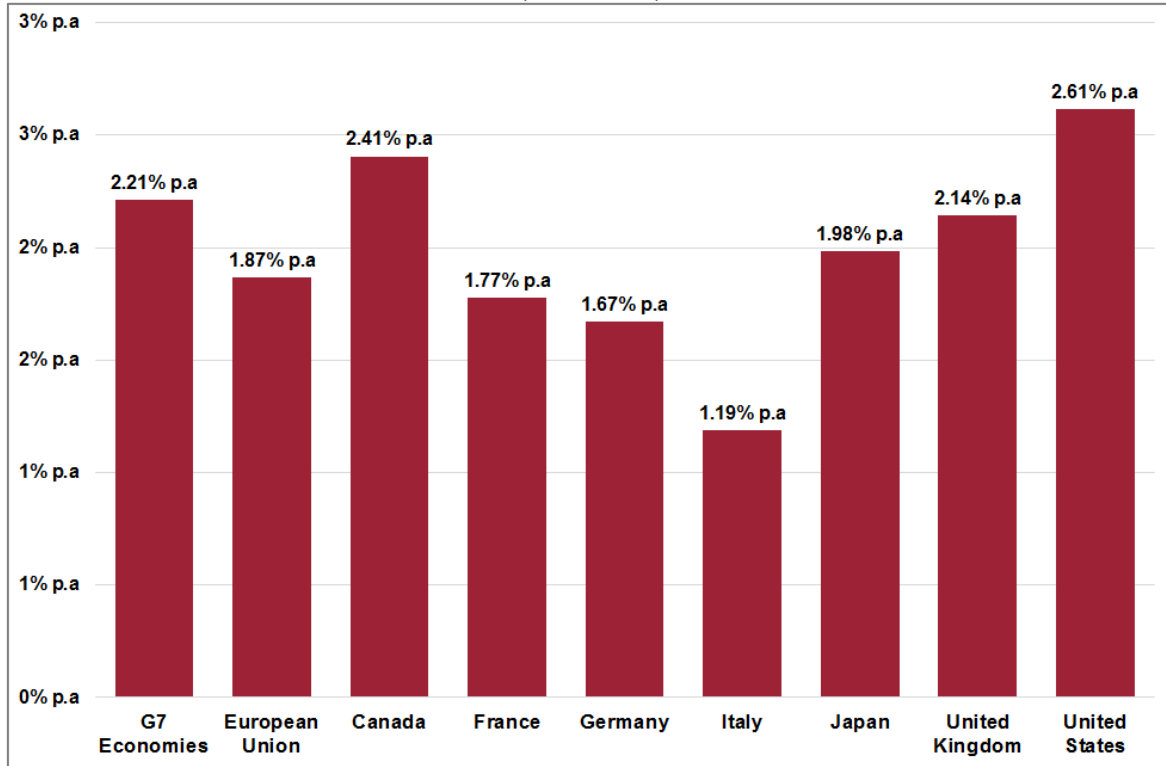
How Has the UK Economy Performed?

Performance of the UK economy over the last 35 years has been strong compared to the other developed nations. This is highlighted by the following chart which shows annualised growth from 1980 to 2015 inclusive.

⁵ Investments in companies and infrastructure, etc.

Chart O: Annual GDP Growth from 1980 to 2015

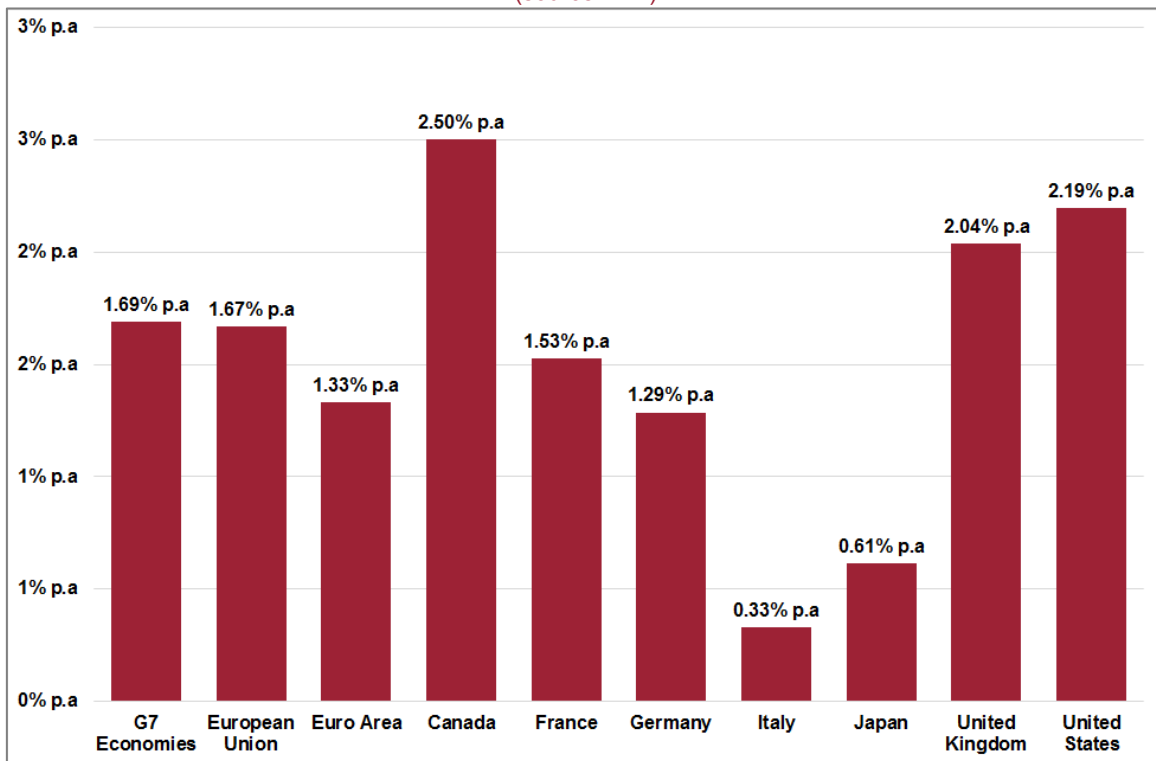
(source: IMF)



This performance is a lot better than Britain could have expected after gaining the 1970's accolade of "the sick man of Europe" due to its then industrial unrest. Britain's out-performance against major economies, and the EU, has been even better since the euro was introduced at the beginning of 1999, as highlighted by chart P below.

Chart P: Annual GDP Growth from 1999 to 2015

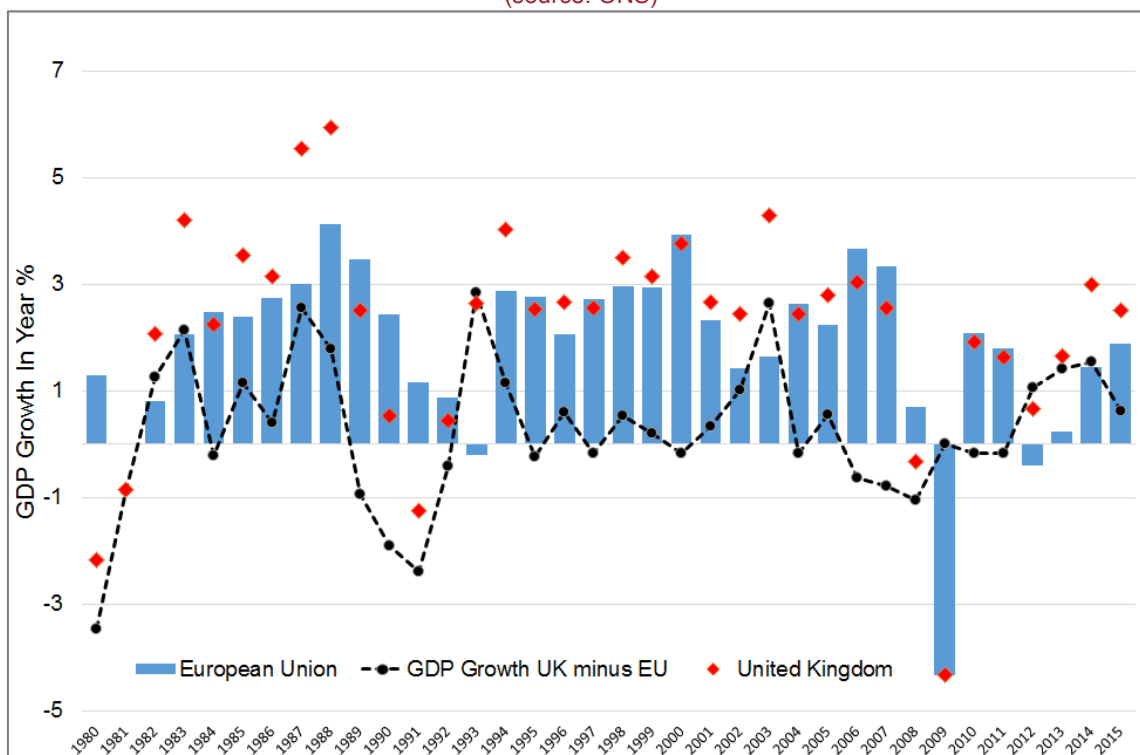
(source: IMF)



From 1999 to 2015 inclusive the UK economy grew by 2.04% per annum compared to 1.67% per annum for the European Union overall, and 1.33% per annum for the Euro Area. The following chart (chart Q) shows UK GDP growth in the year (the diamonds) compared to the EU (the blue bars) and the difference between them (the black dotted line with circles). It can be seen that for the majority of the period the UK has grown at a faster rate than the EU, and sometimes by considerable margin (I will comment on this again later).

Chart Q: GDP Growth in Year (%)

(source: ONS)



In and Out Forecasts

Both the “out” and “in” camps support their positions with economic forecasts. These forecasts are normally derived from models that predict the future levels of UK GDP based on a number of variables. For those of you unfamiliar with the world of economic forecasts, let me warn you that economists, whilst being generally highly intelligent people with sharp mathematical brains, are frequently wrong. In 1981 many venerable academics were included in the 364 economists that signed the letter to the Times saying that the Government’s budget would prove a disaster, causing recession and damaging the UK economy – the exact opposite happened! This is just one example of many that have earned economists the description of “...*someone who will tell you tomorrow why the things they predicted yesterday didn’t happen today...*”.

Both camps are, generally, pro free-trade. Accordingly, the “out” camp believe that free-trade will be improved outside of the EU and that this will accelerate economic performance. Professor Patrick Minford is a highly regarded economist who says the UK should vote “out”. He believes that

the UK, free from the EU's Common Tariff, could enjoy an improvement in GDP of around 3%⁶. On balance, more economists seem to favour “in” rather than “out”, so it is easier to find forecasts that show UK GDP deteriorating if we vote to leave the EU (but I should point out that Professor Minford was one of only a handful of prominent economists that disagreed with the 364 that signed a letter to The Times in 1982 – so he has a good track record!). PWC recently published an analysis estimating that UK GDP could, by 2030, be lower by between 1.2% and 3.5% following an exit from the EU⁷.

If an exit from the EU produced freer trade, enabling the UK to sell and buy goods around the world with fewer tariff restrictions, then UK GDP will improve. If, however, the UK, on leaving the EU, is unable to negotiate free-trade agreements that at least match those that it currently enjoys as part of the EU, then GDP will suffer.

Conclusion

G K Chesterton once said that you should never take down a fence until you know what it is there for. Using that analogy we need to be certain that the loss of the benefits we derive from the EU (and free trade in the world's largest market is a considerable benefit) would not be lost following an exit, and that the potential rewards to the UK economy are worth the risks of Brexit.

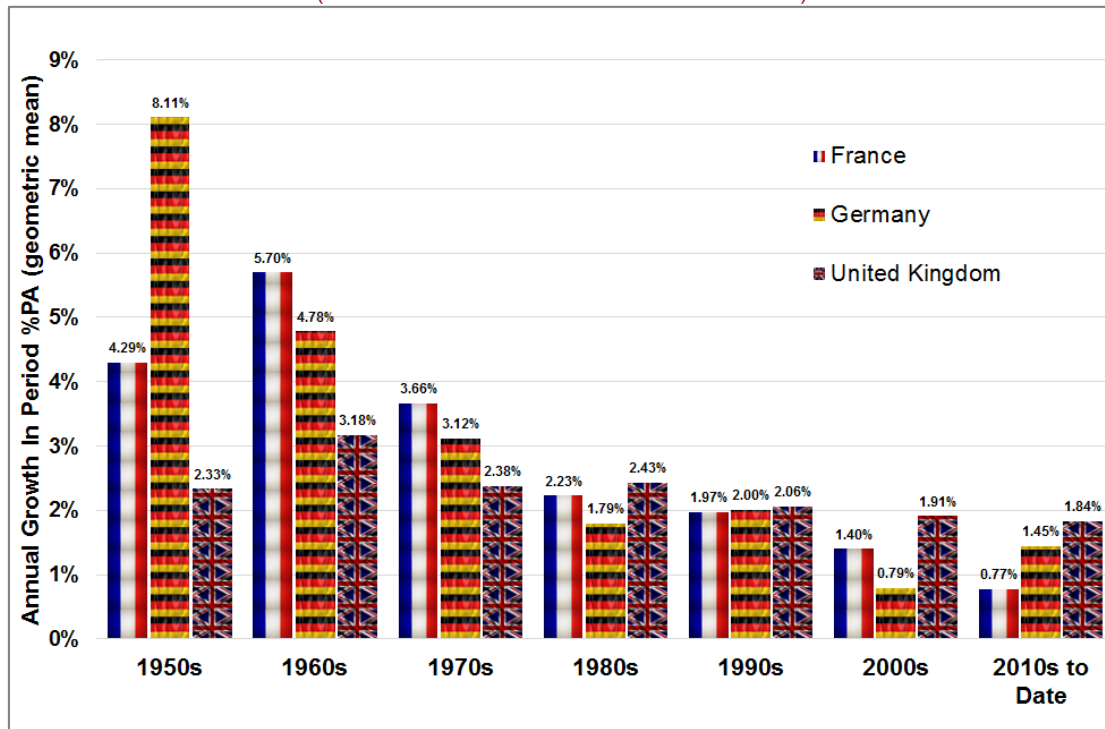
As I said above, there is no point basing a decision on economic forecasts because both camps can come up with models and estimates to support their case. We can, however, look back in history and our chart below shows the average annual growth of the French, German and UK economies in various decades from the 1950s to date.

⁶ The Hampden Trust, Balance of Competencies Review, author Professor Patrick Minford.

⁷ Leaving the EU: Implications for the UK Economy, PWC, March 2016.

Chart R: Annual GDP Growth By Decade

(source: The Conference Board/COURTIERS)



The UK dramatically under-performed Germany and France in the 1950s, '60s and '70s. The 1950s were somewhat unusual because Germany, largely destroyed in the Second World War, was being re-built and so enjoyed a period of strong growth, but from a relatively low base. The UK's under-performance persisted through the booming '60s and continued into the '70s as deteriorating industrial relations and poor manufacturing efficiency caused Britain to lag behind other developed nations in competitiveness.

Throughout the '80s, '90s, 2000s and 2010s, the UK economy has out-performed both France and Germany and has been successful in the EU. It is possible, of course, that the UK may have been even more successful outside of the EU! However, comparing Britain in the '70s, with its leaning towards protectionism, and the improved trading arrangements that the country has enjoyed under the EU, it is difficult to dream-up a scenario where, from 1973, the UK would have performed better on its own. More likely, the EU forced Britain to consider its inefficient practices, engage in free-trade and become more competitive. It is also highly unlikely that the UK would have enjoyed the levels of net foreign direct investment that it has experienced over the last 35 years if it did not have free trade access to Europe. Many jobs have been created by foreign automobile companies investing in factories to build cars in the UK.

If the argument for EU membership were based solely on which option provided freer trade then I suspect the country would overwhelmingly vote to stay in. However, other issues are affecting the decision, in particular the thorny subject of migration.

The Brexit campaign has rallied a lot of support around its position on limiting immigration, particularly low-cost labour from Eastern and Southern Europe. Freedom of movement across borders, under The Schengen Agreement (of which the UK is not part), has, like the euro common currency, been badly handled. But movement of workers across borders have likely provided a net benefit to the UK economy where the demographic outlook is healthy compared to, say, an ageing Germany (although that situation may have improved following Germany's acceptance of large numbers of Syrian refugees). Evidence suggests that EU migrants are net contributors to the UK Treasury and frequently take jobs that indigenous Brits are not prepared to do.

I agree with Patrick Minford that, if trade restrictions could be further reduced outside of the EU, then the UK, with its open and strongly serviced based economy, could flourish. However, there are many hurdles to overcome and, following the UK giving notice of its intention to leave the EU, we would have just two years to overcome them. Amongst these various hurdles are:-

- 1) The necessity of re-negotiating free-trade agreements with the remaining 27 members of the EU.
- 2) Negotiating free-trade arrangements with those economies with which the EU already has agreements in place.
- 3) Ensuring that laws that are effective automatically in the UK as a result of our membership of the EU, are included within UK legislation.
- 4) Reforming the current UK government, or transitioning to a new UK government, that is committed to running Britain outside of the EU.

Re-negotiating free trade agreements may be more problematical than the "out" campaigners claim. Canada has been trying to negotiate its own free trade agreements with the EU for many years and Norway, whilst not an EU member, has to adhere to most major EU regulations, including free movement of people, and pay a fee to maintain access to EU markets (and it has no vote on EU affairs).

Whilst Germany is likely to favour a negotiated trade settlement with the UK (we run a huge trade deficit with Germany, so it would be in Germany's best interests to act quickly), the agreement would be on a one-country-one-vote basis requiring the consent of all the remaining 27 members. That is likely to prove tough, particularly as the UK, having been a member of the EU for many years, does not have the departments and institutions in place to immediately commence trade negotiations.

Even if the "out" campaign's argument is that the trade deficit with Europe would force the Europeans to do a deal, that does not apply to the Americans, with whom we run a trade surplus. If the "out" campaigners are hoping to maintain cordial trade relationships with our cousins across the

Atlantic then, in the event that we exit, we will be placing heavy reliance on the “special relationship” that perhaps a protectionist president like Donald Trump would ignore.

The UK has an efficient legal system, and given time (and we would have two years to leave) it could adopt whatever legislation was necessary to replace laws and directives that had previously been issued by the EU. However, the TUC (Trades Union Congress) is concerned that outside of the EU, the UK will weaken employment law to the detriment of British Workers⁸. The TUC is in favour of remaining within the EU.

Finally, there is the issue of how Britain would be governed the day after we voted to leave the EU. Our current Prime Minister was returned to Government in 2015 with a majority on the basis of a re-negotiated settlement with the EU and a referendum on Britain’s on-going membership, at which he would vote to stay in. The Prime Minister, Chancellor and the Home Secretary are all of the same opinion, but will they be able to remain in Government if they lose their own referendum? If they don’t, then who will lead the new Government? The “out” campaign is an amalgamation of people from different political persuasions. The right wing of the Conservative Party favours free trade (but not free movement of people) outside of the EU, whilst one of the most militant trade unions, the RMT (The National Union of Rail, Maritime and Transport Workers), also favours being “out” on the basis that trade is already too free and the EU offers too little protection for British workers. A fractious disagreement is likely to break-out between the “out” campaigners the moment after they win the referendum.

These difficulties of governing the country after our existing leaders, having gained a majority last year, are either weakened or gone, will be complicated by an SNP that wants to stay in the EU. An exit would cause the SNP to pursue a second referendum for Scottish secession from the union, which it is likely to win. As well as negotiating with the EU, the Americans and all our other major trading partners, the new British Government will probably be negotiating with the Scottish Parliament over a wide range of issues including Scotland’s share of current UK debt, membership of the pound and the date of its secession from the Union.

My own view is that Patrick Minford has a good case. I think the Common Agricultural Policy, and the weakness of the EU to promote completely free trade in services, and the existence of a damaging single currency at the heart of Europe, causes problems. However, there are undoubted benefits in our membership and it is very difficult to argue that the UK has not flourished, at least to date, as a member of the EU.

⁸ Workers’ Rights From Europe: The Impact of Brexit, Michael Ford QC, 10th March 2016

I am not, therefore, fully persuaded by the arguments to leave. But even if I were, I would want greater certainty about the UK's exit and would only vote to leave if the "out" argument was shared by the existing Government so that it would remain in place to negotiate on the UK's behalf.

In the long run, of course, the UK may do better outside of Europe, but it would be some time before it comes to fruition, especially as it will take two years before we leave. The interim would be a period of considerable unrest.

Concerning markets, presently the EU referendum is causing uncertainty, which is increasing volatility, especially of the pound. The uncertainties that I described previously will worry investors, who will fear that UK GDP will deteriorate, foreign direct investment (FDI) will fall and that industrial unrest will rise as unions pitch for equivalent, or stronger, labour laws than currently exist in the EU. In this environment UK Government bonds are likely to weaken, and the pound is likely to get trashed. This would put upward pressure on UK inflation.

Unlike some of the geo-political risks that currently exist around the world, Brexit is local to the UK, although the UK departing the EU would have consequences for Europe. With the UK Government, the Labour Party, the SNP and the TUC all supporting Britain's continued membership of the EU, I suspect the "in" camp will win by a reasonable margin. Nonetheless, we need to mitigate some of the risks that would arise if the country votes "out" on 23rd June, and the best way to do this is to maintain a long position in the US dollar versus sterling. Although recent wobbles to the pound are due to concerns about the outcome of the Referendum, it is unlikely that the full consequences of an exit are included within the current price. The other benefit of this long US dollar position is that, even if the UK votes "in", the pound is unlikely to rebound strongly due to the UK's large current account deficit and a US economy that is doing quite well. The long US dollar trade therefore seems to offer considerable upside, but limited downside, which makes it a good hedge.

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