

Thoughts on Brexit

Sprott Asset Management wishes to extend our condolences to the family of Jo Cox, Labour MP, wife and mother.

Background Information

Global markets (equities, credit, currencies, fixed income) have been roiled lately by the looming "Brexit" vote in the UK. This is a prime example of the political risks that many developed nations face this year and going forward as they attempt to deal with the low global growth environment.

The federal UK election of 2015 was too close to call going in (sound familiar?) and resulted in both the Labour and Conservative parties making very bold promises to UK citizens to sway their votes. One of the key promises the Conservatives made was to hold a national referendum on UK membership in the European Union ("EU"). The resulting decisive Conservative victory started the clock ticking and now UK citizens will vote on June 23rd as to whether they wish to remain in or exit the EU ("Brexit").

The EU is founded on the principal of 4 key freedoms of movement: goods, services, capital and labour. This is key because polls indicate that the number one issue for UK citizens going into the referendum vote is immigration (ahead of even the deteriorating economy). As a member of the EU, the UK cannot arbitrarily deny entry to EU citizens wishing to emigrate to the UK in search of jobs or a better life. Unexpectedly, this now also applies to Syrian refugees who have flooded into Europe to escape a civil/proxy war being waged in their country.

Exacerbating this sentiment is the downturn in the UK economy ("immigrants are taking our jobs") and the recent terrorist attacks (Paris, Germany, US) that have raised anti-immigrant feelings in the UK. Finally, UK citizens haven't had an opportunity to vote on their participation in the EU since they first voted to join the European Economic Community in 1967. Since then, the EU has grown to include the European Council, the European Parliament, the European Commission, the Court of Justice of the European Union and the European Central Bank. Older UK citizens may feel they did not originally sign up for all of this and may take this opportunity to "fix their mistake".

Voter Turnout

Normally, in these types of referendums, one can expect older voters to break in favour of the status quo or establishment position. This occurred in 2014 when a close vote ended with Scottish voters ultimately voting to remain in the United Kingdom in their referendum. However, as mentioned previously, polls indicate that older voters are actually skewed towards leaving the EU. Again, they feel as if the organization has grown large and invasive and many feel the UK would be better off without Europe. Younger voters are more likely to identify as European and polls indicate they are more likely to vote to stay in the EU.



Dennis Mitchell

Senior Vice-President,
Senior Portfolio Manager

"The EU is founded on the principal of 4 key freedoms of movement: goods, services, capital and labour."

Historically, older voters have turned out more consistently than younger voters so unless turnout is very strong, there is a risk that the vote will swing to Brexit. This younger voter turnout conundrum is further exacerbated by the fact that the Glastonbury Festival runs from June 22nd through June 24th. 175,000 people are expected to attend, many of them younger voters and there is talk that the Conservative government will attempt to place temporary voting booths at the festival to boost voter turnout. Finally, several “qualified” polls indicate that voters that are very likely to vote (i.e. stating that they are an 8, 9 or 10 out of 10 likely to vote) are skewed towards Brexit. All of this is in stark contrast to betting lines which show the remain camp with a comfortable lead/odds.

Consequences

Should the UK vote to exit the EU, it is likely that Prime Minister Cameron would initiate Article 50 of the Treaty on European Union, which would trigger a minimum two year negotiation process with the EU over the exit. He would then likely step down as Prime Minister, leading to a leadership contest in the Conservative Party and then another federal election. All this before the UK could get around to beginning the actual negotiation process with the EU. For reference, it has taken Canada five years and counting to negotiate a free trade agreement with the EU.

All of this uncertainty would weigh on consumer spending and business investment and the collapse of the Pound would send inflation up at a time when growth is falling – stagflation. It is likely that many international businesses would relocate their headquarters and listings out of the UK and into another city/country within the EU free trade zone, further damaging economic growth in the UK. Finally, since the UK funds approximately 16% of the EU’s operating budget, any negotiation with the EU is going to begin with annual payments that subsidize the EU budget and make it whole. UK voters will have succeeded in doing significant acute and structural damage to the UK economy, maintained their subsidization levels and denied themselves a vote on EU legislation and regulation. Hardly the desired outcome.

Outcome & Positioning

Our base case remains that it will be a close vote but that UK citizens will vote to remain in the EU. Should this occur, the Pound should rally meaningfully against most currencies and the FTSE 100 should also rally. Should the unthinkable occur and UK voters embrace Brexit, the Pound should fall dramatically (it has rallied recently with the betting lines) against most currencies and FTSE 100 stocks should also fall meaningfully.

We are NOT fans of binary outcomes like this and while our base case is upside on a vote to remain, we feel compelled to protect against the possibility of Brexit. Accordingly, through a combination of forwards and shorts, we have hedged away most of our exposure to this event. The combination should dampen the impact of the vote on our portfolios in either direction. We are also cognizant of the impact of a vote in either direction on our non-UK positions and have developed real-time contingencies for either scenario that we will deploy as necessary.

Binary macro events tend to swamp the fundamentals of a business as investors rush to leverage or hedge against them. Brexit is no different and at times the impact on portfolio performance will frustrate investors. We take comfort in the fact that Focused Business Investing results in concentrated portfolios of high quality businesses (strong return on invested capital, strong recurring free cash flow, irreplaceable assets capitalized with low debt). Purchased when they offer enough return for the risk they entail, investors should be rewarded with strong, risk-adjusted long term returns when the anxiety of binary macro events has long since passed. Until then...

Stay focused,

Dennis Mitchell

Senior Vice-President,
Senior Portfolio Manager
Sprott Asset Management

“Historically, older voters have turned out more consistently than younger voters so unless turnout is very strong, there is a risk that the vote will swing to Brexit.”

“We are NOT fans of binary outcomes like this and while our base case is upside on a vote to remain, we feel compelled to protect against the possibility of Brexit.”

www.sprott.com



Sprott Asset Management LP is the investment manager to the Sprott Funds (collectively, the "Funds"). Important information about these Funds, including their investment objectives and strategies, purchase options, and applicable management fees, performance fees (if any), and other expenses, is contained in their prospectus or offering memorandum. Please read these documents carefully before investing. Commissions, trailing commissions, management fees, performance fees, other charges and expenses all may be associated with investing in the Funds. This communication does not constitute an offer to sell or a solicitation to purchase securities of the Funds. The information contained herein does not constitute an offer or solicitation by anyone in the United States or in any other jurisdiction in which such an offer or solicitation is not authorized or to any person to whom it is unlawful to make such an offer or solicitation. Prospective investors who are not resident in Canada should contact their financial advisor to determine whether securities of the Fund may be lawfully sold in their jurisdiction. The information provided is general in nature and is provided with the understanding that it may not be relied upon as, nor considered to be, the rendering of tax, legal, accounting or professional advice. Readers should consult with their own accountants and/or lawyers for advice on the specific circumstances before taking any action.

The opinions, estimates and projections ("information") contained within this report are solely those of Sprott Asset Management LP ("SAM") and are subject to change without notice. SAM makes every effort to ensure that the information has been derived from sources believed to be reliable and accurate. However, SAM assumes no responsibility for any losses or damages, whether direct or indirect, which arise out of the use of this information. SAM is not under any obligation to update or keep current the information contained herein. The information should not be regarded by recipients as a substitute for the exercise of their own judgment. Please contact your own personal advisor on your particular circumstances. Views expressed regarding a particular company, security, industry or market sector should not be considered an indication of trading intent of any investment funds managed by Sprott Asset Management LP. Any reference to a particular company is for illustrative purposes only and should not to be considered as investment advice or a recommendation to buy or sell nor should it be considered as an indication of how the portfolio of any investment fund managed by Sprott Asset Management LP is or will be invested. SAM LP and/or its affiliates may collectively beneficially own/control 1% or more of any class of the equity securities of the issuers mentioned in this report. SAM LP and/or its affiliates may hold short position in any class of the equity securities of the issuers mentioned in this report. During the preceding 12 months, SAM LP and/or its affiliates may have received remuneration other than normal course investment advisory or trade execution services from the issuers mentioned in this report.

Sprott Asset Management LP: Toll Free: 1.866.299.9906. DEALER SERVICES: RBC Investor & Treasury Services: Tel: 416.955.5885; Toll Free: 1.877.874.0899.