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By the close of 2017, the United Kingdom (UK) is scheduled to hold a referendum on whether or not to stay a member of the European Union (EU). While some expect the United Kingdom's European Union referendum to roil equity markets, we believe this is unlikely. In our view, the feared political consequences, such as trade barriers or tariffs, are unlikely to be imposed. Second, we have observed comparable political negotiations in the past come and go with little effect on markets. Lastly, at the heart of the issue are two highly contentious topics—immigration and sovereignty—both of which require lengthy debate, giving markets ample time to digest the information and limiting the potential for system shock.

Potential Political Consequences

Should the UK ultimately vote to leave the EU, there are inarguably some outcomes which could have broader market implications—primarily if a UK exit prompted trade barriers or tariffs between the EU and the UK. However, the UK currently has a net trade deficit with the rest of the EU, so the chances the British decide to raise trade barriers seem relatively low. Similarly, the EU member countries also benefit from the increased trade with the UK that has followed the EU's formation—therefore lowering the likelihood any EU countries enact retaliatory tariffs should the UK exit.

However, a potential "Brexit" prompts several geopolitical questions—for example, would it significantly dent Europe's global political power and importance? Would it set a precedent for other countries currently seeing increasing support for nationalist parties, like France, Greece, Spain and others, ultimately leading to the total break-up of the EU? Does the UK's absence from the EU encourage Putin's territorial ambitions on Europe's eastern edge? All important questions—but in our view, affirmative answers to these seem like low probabilities at this point. It is also important to keep in mind geopolitical considerations rarely have more than a fleeting market impact given they are often fairly well-telegraphed, and therefore, lack much surprise power.

While a UK-less EU is arguably somewhat "less influential" from a global political standpoint, to some extent, it is already largely the case. The UK and the EU operate independently when it comes to many political (especially geopolitical) decisions. Furthermore, countries and entities have risen and fallen in importance historically for centuries without having a meaningful negative global market impact.

Given that rising nationalist parties in several EU countries predate the current Brexit conversation, it seems unlikely the UK's referendum outcome has much influence over those countries' decisions about their own EU membership—those countries likely make up their minds independent of the UK's decision. Then, too, a UK exit seems highly unlikely to translate into a Britain unwilling to support its still-staunch allies on the continent against any imperialist intentions Russia (or any other country, for that matter) might be inclined to pursue.

A Market History of Negotiations

With the concerns tied to a potential Brexit both relatively unlikely and overall lacking in significant market-moving power, we turn to history for an assessment of whether historical negotiations have proven detrimental to markets. Overall, we find previous UK-EU treaty negotiations have largely occurred without the feared negative market reaction.

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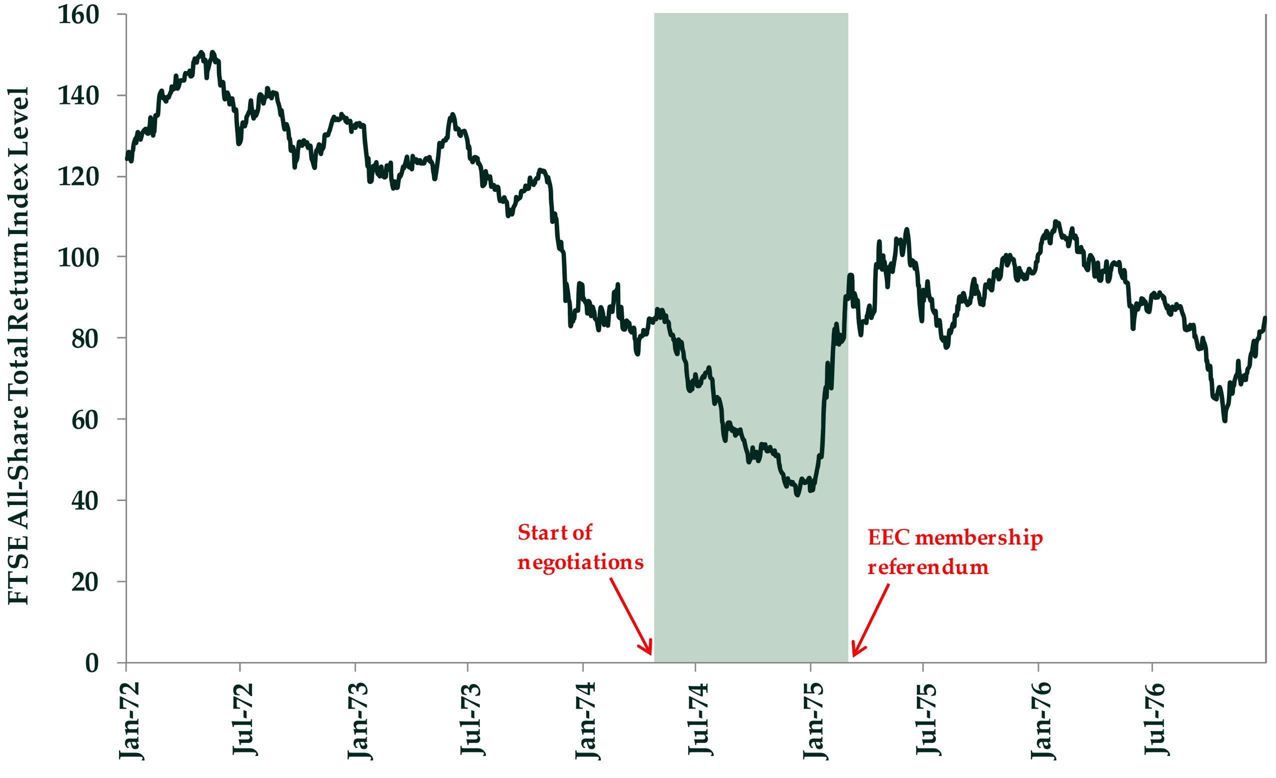
Renegotiating a major treaty takes years—not months or weeks—with lengthy discussions and well-telegraphed policy outcomes limiting market surprise power. Given current divisiveness in the UK—including questions about immigration and sovereignty, which likely lengthens debates and heightens transparency—we expect this time to be similar to the past. Furthermore, thus far, UK markets are doing just fine—as are European and global markets—indicating the referendum is not a major source of market concern.

Historical Negotiations with the European Community

History shows UK, European and global market reactions to European treaty renegotiations have historically been fairly mild. For example, the UK's critical June 6, 1975, European Economic Community (EEC) membership referendum did not stir markets much—from the negotiations' start to the day after the vote, the UK's FTSE All-Share Index returned 38.87% (Exhibit 1). Negotiations began in April 1974 as global equities were already 15 months into a bear market—EEC membership negotiations likely had little to do with the last eight months' decline, nor did markets likely bounce thanks to negotiations.

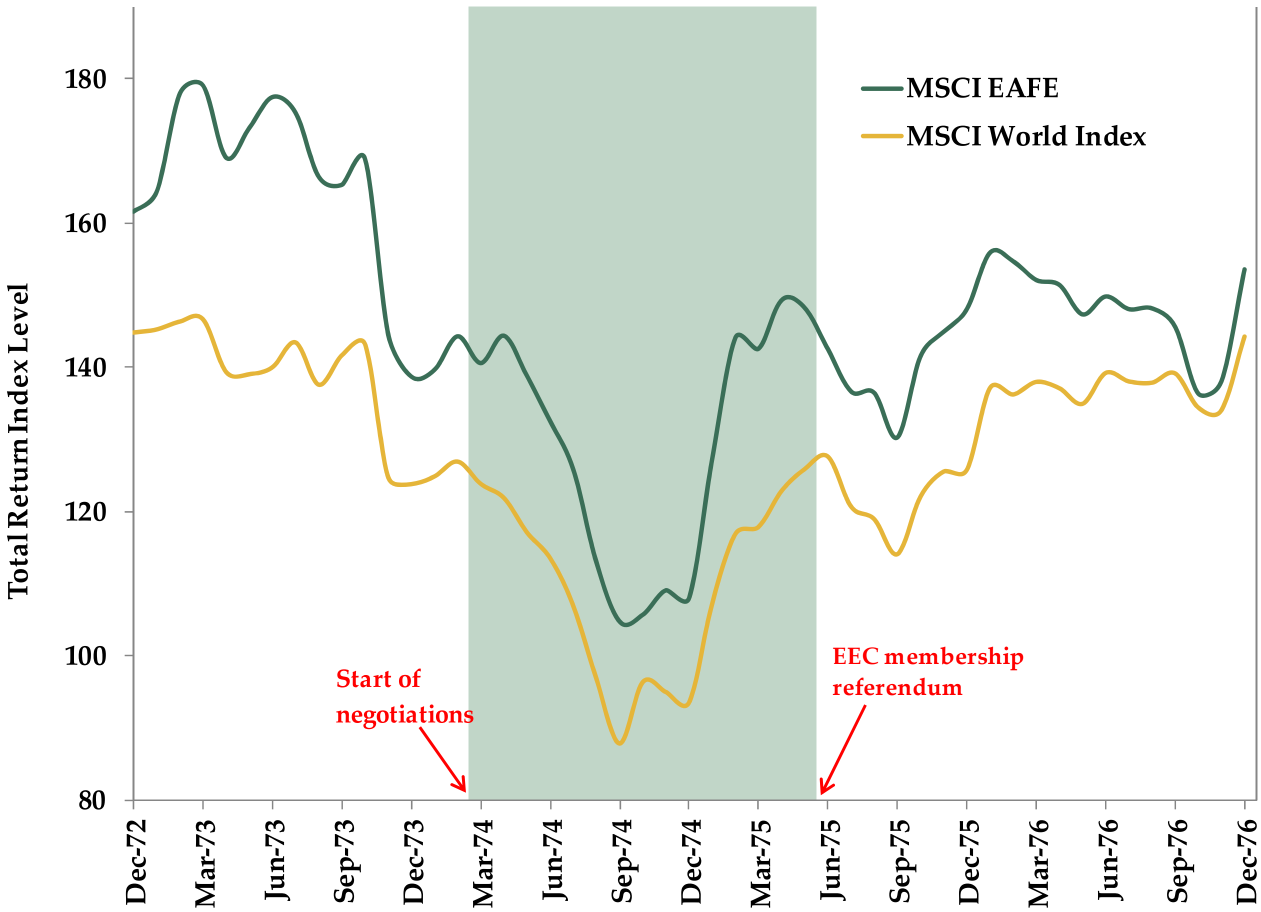
Exhibit 1: 1975 Referendum on the European Economic Community (EEC)



Source: Global Financial Data, as of 7/10/2015. FTSE All-Share Total Return Index, 1/1/1972 to 1/1/1976 in USD. Shaded period includes the renegotiation period up to the day after the referendum (3/31/1974 to 6/7/1975)

Global and European markets behaved similarly throughout the period (Exhibit 2).

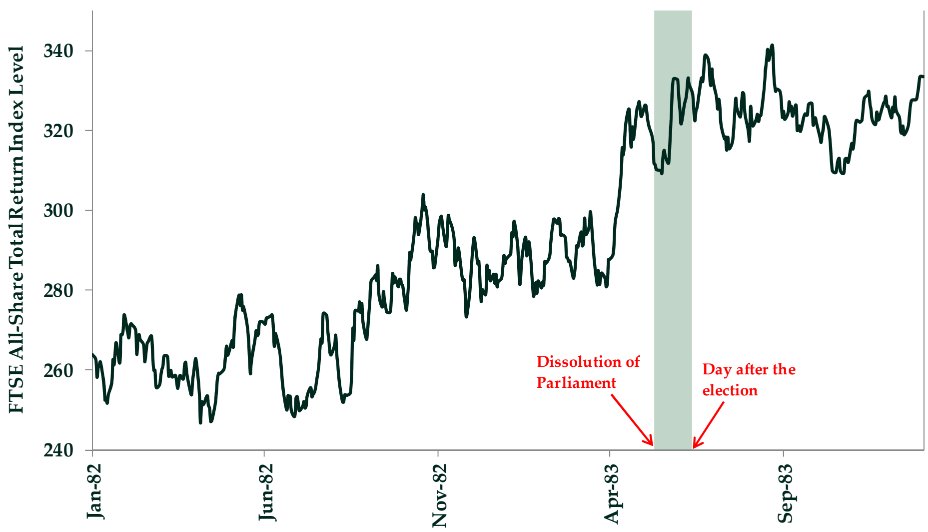
Exhibit 2: 1975 Referendum on EEC—EAFE and MSCI World Markets



Source: Factset, as of 9/14/2015. MSCI EAFE Index and MSCI World Index, 12/1/1972 – 12/31/1976 in USD. Shaded period includes 3/1/1974 through 5/30/1975).

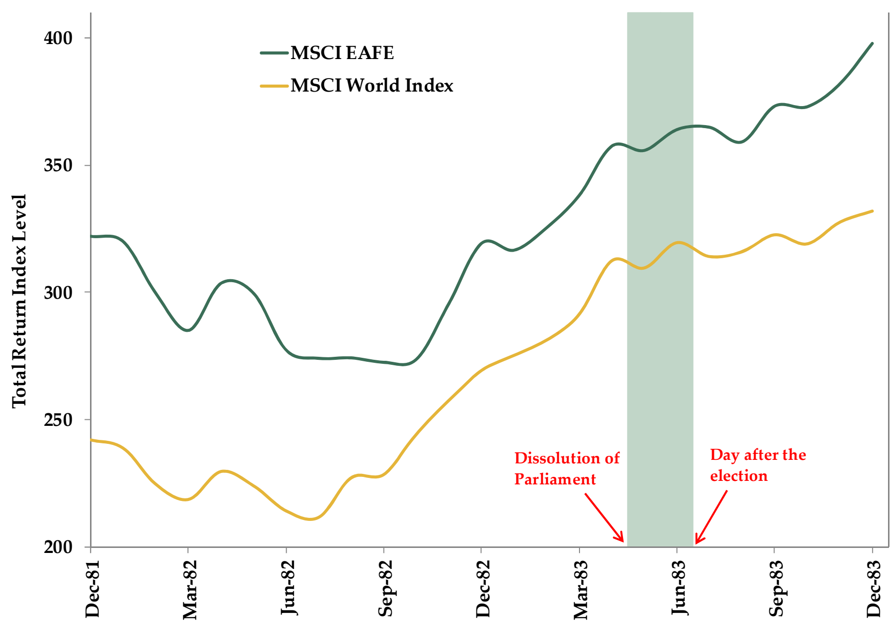
In 1983, Prime Minister Margaret Thatcher dissolved Parliament and called a snap election. The Labour Party campaigned on a platform of leaving the EEC—yet despite heightened political uncertainty, UK equities returned 6.84% in the month from Parliament's dissolution to the day after the election (Exhibit 3). While relatively flatter than UK markets, the MSCI EAFE and the MSCI World were also overall up over the brief period (Exhibit 4).

Exhibit 3: 1983 General Election with Labour Campaigning to Leave EEC



Source: Global Financial Data, as of 7/10/2015. FTSE All-Share Total Return Index, 1/1/1982 to 1/1/1984 in USD. Shaded period includes the dissolution of parliament to the day after the election (5/12/1983 to 6/10/1983)

Exhibit 4: 1983 UK General Election—EAFE and MSCI World

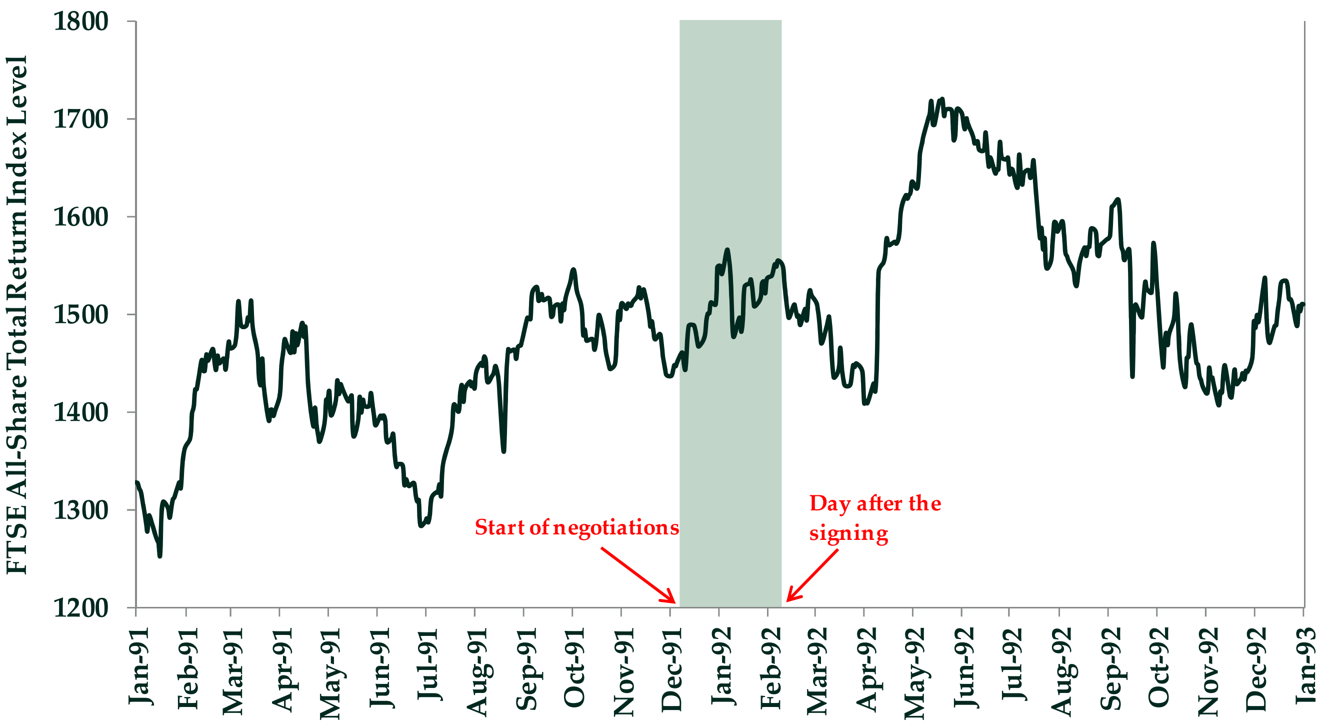


Source: Factset, as of 9/14/2015. MSCI EAFE Index and MSCI World Index, 12/1/1981 – 12/30/1983 in USD. Shaded period includes 5/1/1974 through 6/30/1983).

Amid 1991 debates on adopting the euro and signing the Maastricht Treaty, the FTSE All-Share Index returned 6.44% in just a few months (Exhibit 5). Eurosceptics were concerned about economic disparities among Europe's northern and southern economies and the difficulties of maintaining a monetary union without a fiscal union. The UK eventually opted out of the euro—though the market was seemingly unfazed.

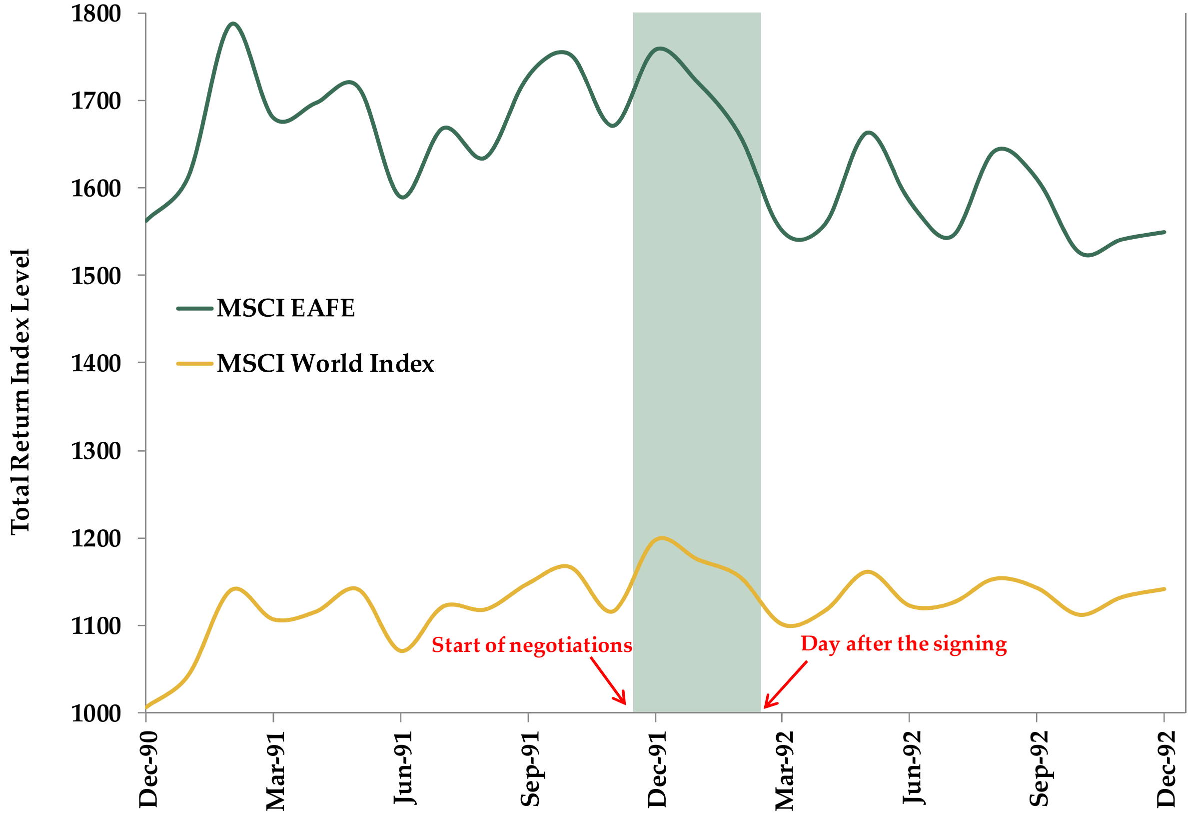
Elsewhere, the Soviet Union collapsed in late December 1991, which likely roiled European—and, to a lesser extent, global—markets (Exhibit 6). Given the disparate movements of the European, global and UK markets, though, the likelihood the ongoing Maastricht Treaty debates were the underlying cause is fairly low.

Exhibit 5: 1992 Maastricht Treaty Negotiations



Source: Global Financial Data, as of 7/10/2015. FTSE All-Share Total Return Index, 1/1/1991 to 1/1/1993 in USD. Shaded period includes the start of negotiations to the day after the Treaty of Maastricht's signing (12/9/1991 to 2/8/1992)

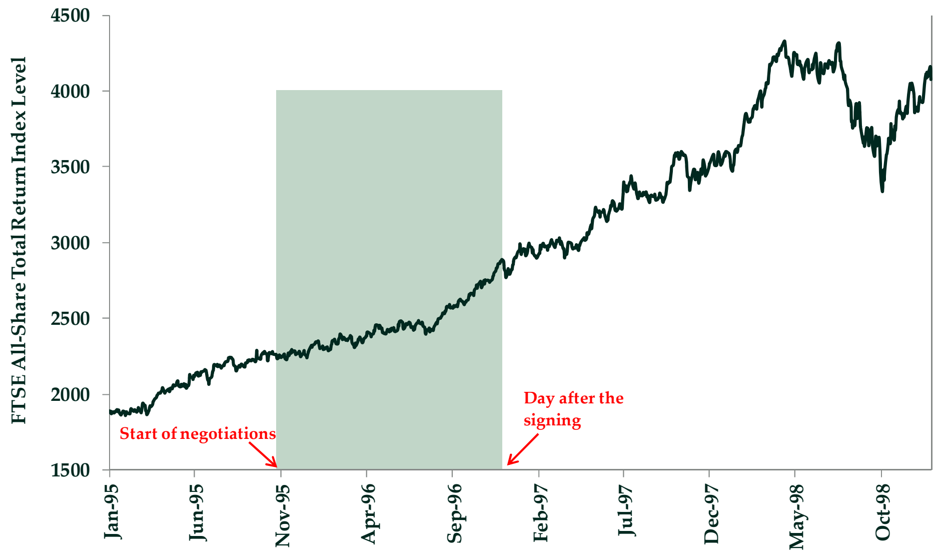
Exhibit 6: Maastricht Treaty—EAFE and MSCI World



Source: Factset, as of 9/14/2015. MSCI EAFE Index and MSCI World Index, 12/1/1990 – 12/31/1992 in USD. Shaded period includes 12/1/1991 through 2/28/1992).

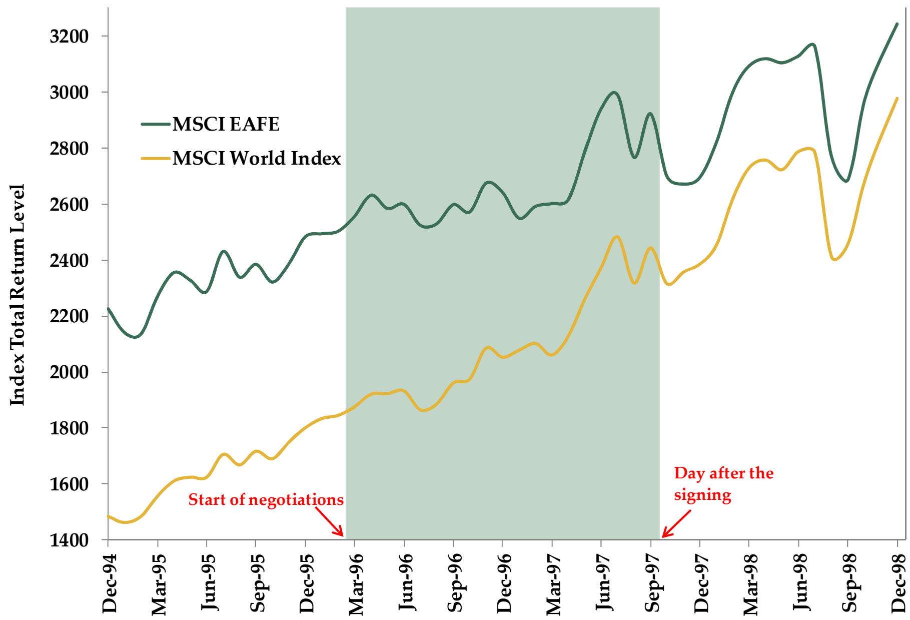
From Amsterdam Treaty discussions' March 1996 beginning to the treaty's October 1997 signing, the FTSE-All Share returned 51.93% (Exhibit 7), with European and global markets largely following suit (Exhibit 8). EU members debated allowing 10 new Eastern European members—raising immigration and other concerns (much like the current debate). The treaty took effect in May 1999 after 2 separate referenda and 13 decisions by national parliaments.

Exhibit 7: 1997 Treaty of Amsterdam Negotiations



Source: Global Financial Data, as of 7/10/2015. FTSE All-Share Total Return Index, 1/1/1995 to 1/1/1999 in USD. Shaded period includes the start of negotiations to the day after the Treaty of Amsterdam's signing (3/1/1996 to 10/3/1997)

Exhibit 8: Treaty of Amsterdam—EAFE and MSCI World



Source: Factset, as of 9/14/2015. MSCI EAFE Index and MSCI World Index, 12/1/1994 – 12/31/1998 in USD. Shaded period includes 3/1/1996 through 9/30/1997).

Immigration and EU-UK Sovereignty

Immigration and sovereignty—two main issues in the UK tied to EU membership—require lengthy debate before the UK's expected 2017 referendum. This allows markets sufficient time to digest possible outcomes, diminishing surprise power.

The EU's "free movement of people" policy—guaranteeing free travel across EU borders—is highly controversial. In 2014, 318,000 immigrants entered the UK—over half from the EU and three times Prime Minister David Cameron's target—raising concerns among UK citizens about "benefit tourism," or immigration primarily to use and benefit from another country's (presumably, superior) welfare system. Under the current treaty, EU migrants receive out-of-work and child benefits after three months and upon passing a "habitual residency test." Eurosceptics feel benefit tourists unfairly use the UK's welfare system—and likely double-dip across multiple countries' social programs.

Several political groups have proposed ways to minimize this outcome—i.e., limiting immigration from new member countries for a specified time. During the UK's 2015 election, Cameron proposed delaying benefits for four years instead of three months—Eastern European EU members voiced their opposition. Other suggestions include immigration quotas, points-based visa applications and stricter citizenship tests. However, altering the policy requires changing the EU treaty, which requires member countries' unanimous agreement—near-guaranteeing prolonged debate.

Sovereignty questions—i.e., agricultural and fishing policies, banking regulations, etc.—are equally controversial. By treaty, European law overrides domestic law in EU member countries. In the UK, this conflicts with parliamentary sovereignty principle—by which Parliament can overturn or renegotiate all past legislation and treaties.

Upon entering the EEC in 1973, the UK introduced about 2,900 new pieces of European law—and subsequently experienced periodic legal conflicts. In 2009, the Lisbon Treaty allowed member states to temporarily block proposed laws with the "yellow card"—offering some protection for individual countries' sovereignty. Opt-out measures also allow exceptions to EU law, especially on more divisive policies like the common currency, among others.

Given immigration and sovereignty questions' legal and political complexity, any EU referendum likely takes years. Furthermore, should the UK decide to leave the EU—which would be near-unprecedented (no country has left the EU, though Greenland exited the EEC in 1985)—it would go through at least a two-year exit process. Thus, a lengthy, highly politicized debate seems guaranteed—minimizing an unexpected outcome's likelihood.

Conclusion

Though historically and politically important, European treaty negotiations have had limited market impact—illustrating markets move ahead of events, not in response to them. Similarly, the UK's current EU referendum likely requires several years to resolve—giving investors and markets ample time to digest various possible outcomes. Furthermore, widespread investor fear of a false factor presents opportunities to those able to recognize them and capitalize.

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