# Macro-Strategy Key Issue

## Brexit – Impact on the EU

Economics

Europe including UK

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### Two crucial questions to determine the impact of a potential Brexit on the EU

We argue that the economic impact of Brexit on the EU – rather than the UK – would depend crucially on how EU-UK negotiations evolve and how the EU itself develops after Brexit. The two key questions will be whether (a) the negotiations between the EU and the UK proceed in an amicable or in a confrontational way; and (b) whether, over the longer term, the EU moves towards closer integration or disintegration.

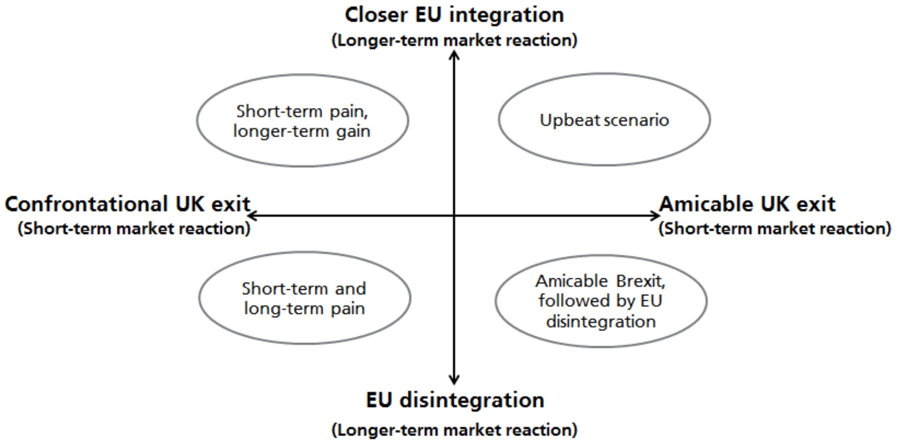
### EU-UK negotiations and EU (dis)integration post-Brexit as "axes of uncertainty"

Defining these two questions as key "axes of uncertainty", we establish a four-quadrant scheme that renders various shades of relatively benign and challenging scenarios, which allow for a nuanced assessment of potential outcomes. In an upbeat scenario, amicable EU-UK negotiations are followed by further EU integration steps over time. Such an outcome would minimise short-term costs and maximise long-term benefits. By contrast, a confrontational exit followed by further disintegration of the EU would likely imply higher short-run costs and damage to long-run growth prospects. It could also lead to new concerns about the integrity of the monetary union.

### Market reaction over the short and longer term

If the UK votes to leave the EU we would expect markets to react in two phases: In the *short term*, right after the referendum, we would expect markets to price in confrontational negotiations between the EU and the UK; sterling would be most vulnerable and peripheral spreads to Germany would widen, particularly in Ireland and Spain. Equity would likely see a risk-off trade with a move into quality and defensives. Over the *longer term*, the market reaction would depend more on signals as to whether the EU will move towards closer integration or disintegration. Closer EU integration would result in higher German yields and tighter peripheral spreads to Germany, and a closing of the US-Europe profit and valuation gap. In contrast, signs of EU disintegration would trigger sharply higher peripheral yields and more risk-off in Equity with relative out-performance of large cap stocks with international exposure.

**Figure 1: Brexit impact on the EU: two "axes of uncertainty" and four scenarios**




Source: UBS



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# The impact of Brexit on the EU

**Brexit impact on the EU: wide range of possible outcomes, depending on how EU-UK negotiations evolve and how the EU itself develops after Brexit**

UBS has already published extensively on the UK's referendum on EU membership, and the impact a potential Brexit could have on the UK.[1] In contrast, this report focuses on the potential market and macroeconomic impact of Brexit on the EU. We argue that this cannot be determined in a simplistic fashion and hence that individual data-point forecasts – above all for GDP growth in the EU and individual member states – are of limited value. Instead, we see an extensive range of possible outcomes, which will depend crucially on how negotiations between the EU and the UK evolve, and how the EU itself develops after a Brexit decision.

**Will EU-UK negotiations be amicable or confrontational? Will the EU move towards greater integration or disintegration?**

In our view, the two key questions will be: *First*, will the negotiations between the EU and the UK proceed in an amicable or a confrontational way? We think the answer to this question might become clear relatively soon, perhaps within a few weeks or months. *Second*, will the rest of the EU move toward greater integration or disintegration over time? We think it will take much longer – perhaps years – to gain clarity about the answer to this question. Defining these two questions as key "axes of uncertainty", we establish a four-quadrant scheme that renders various shades of benign and challenging outcomes, allowing us to make a more nuanced assessment of potential outcomes over time.

But before we come to that, we first present a few basic insights and facts.

### Some general considerations

**EU-UK exit negotiation likely to last 2 years**

The **legal basis** for the UK's exit from the EU would be **Article 50 of the EU Treaty**, which stipulates a 2-year period for negotiations, which can be extended if the European Council so decides. As no country has ever left the EU, there is no precedent for the procedure of secession.

**How will trade, investment and financial linkages be affected?**

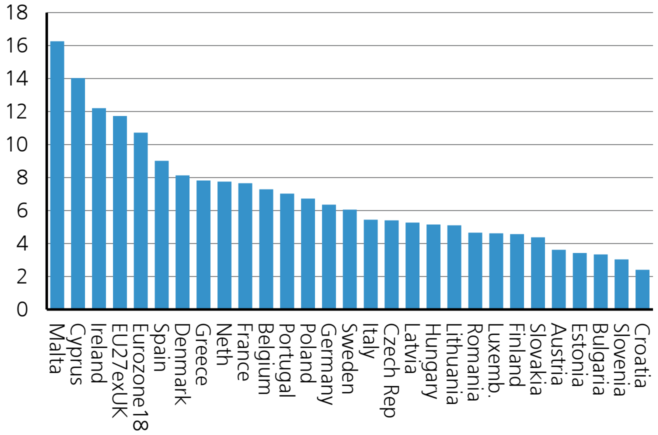
**Trade** in goods and services is considered to be the key transmission mechanism of the economic impact of Brexit on the UK and the EU, although investment and financial sector linkages are important as well.

**Ireland, Malta, Cyprus, Luxembourg, Denmark, Belgium, Netherlands have closest trade links with the UK**

According to OECD data, the share of (direct *and* indirect) EU-ex-UK exports of goods and services to the UK (i.e. those that finally end up in the UK even if they pass through third countries) is around 12% of total EU-ex-UK exports (Figure 2). As a proportion of value added (a proxy for GDP), the share is 1.9% (Figure 3). However, these measures mask substantial country-specific differences between individual EU member states. As a share of value added, **Ireland, Malta, Cyprus, Luxemburg**, **Denmark, Belgium** and the **Netherlands** have the highest trade integration with the UK – arguably putting these countries most at risk of suffering negative growth effects following a Brexit. Amongst the larger European countries, Spain and Germany are most exposed.

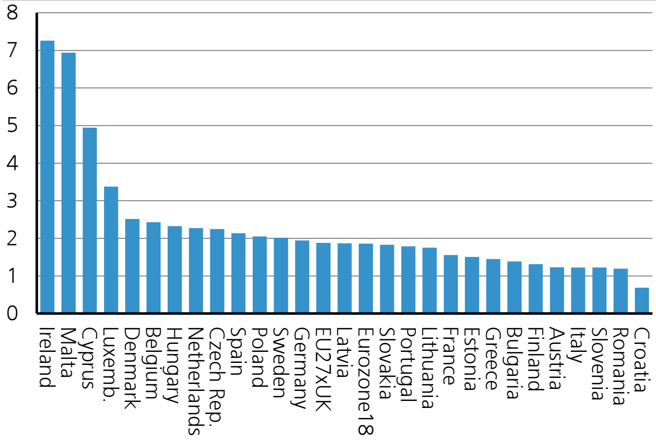
[1] Brexit: EU can go your own way?, 22 September 2015; Brexit Renegotiation, referenda and rate calls, 9 February 2016; Brexit: An ever closer referendum, 21 February 2015; A Brexit Map for Sterling, 28 February 2016; The UK's twin deficits, the Budget and Brexit, 11 March 2016.

**Figure 2: Final (i.e. direct and indirect) goods and services exports to the UK, % of total final exports, 2011**



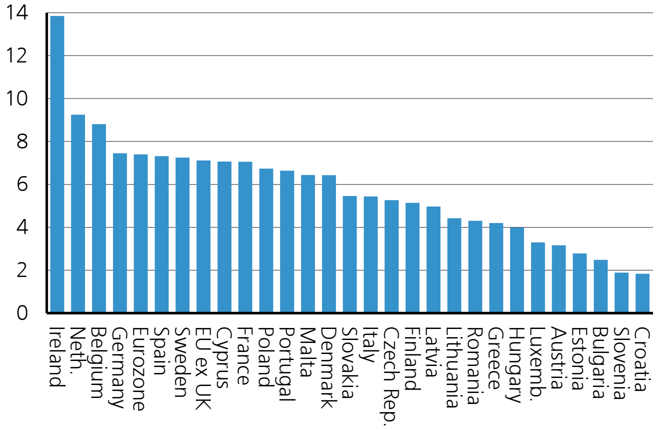

Source: OECD Trade in Value Added (TiVA) database, UBS.

**Figure 3: Final (i.e. direct and indirect) goods and services exports to the UK, % of total value added, 2011**



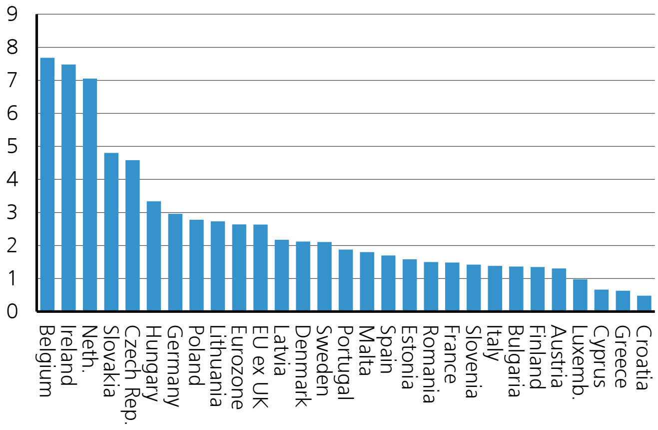

Source: OECD Trade in Value Added (TiVA) database, UBS.

**Figure 4: Goods exports to the UK, % of total goods exports, 2015E**



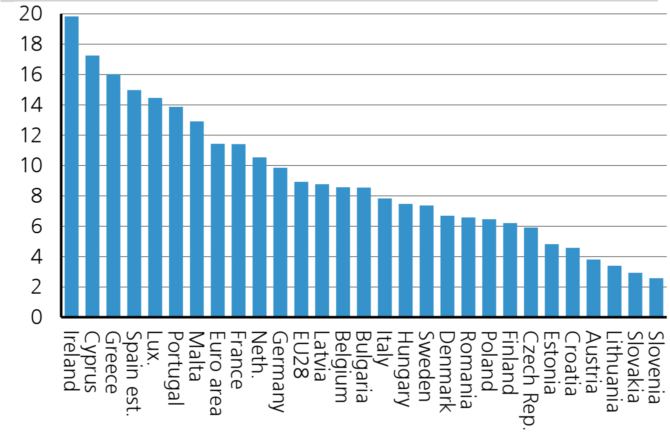

Source: IMF Direction of Trade Statistics, UBS

**Figure 5: Goods exports to the UK, % of GDP, 2015E**



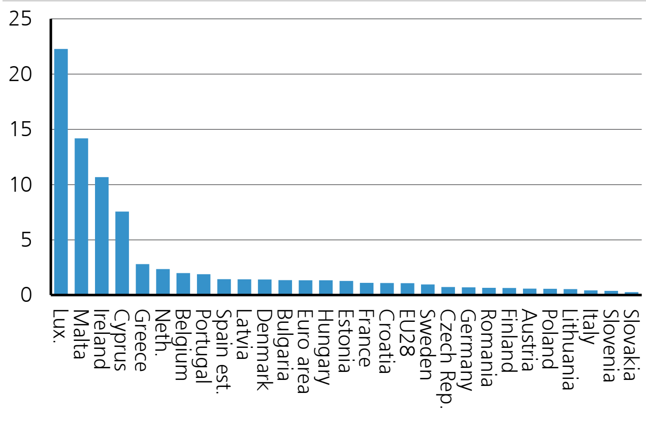

Source: IMF Direction of Trade Statistics, UBS

**Figure 6: Services exports to the UK, % of total service exports, 2014**




Source: Eurostat Balance of Payments Statistics, UBS.

**Figure 7: Services exports to the UK, % of GDP, 2014**




Source: Eurostat Balance of Payments Statistics, UBS.

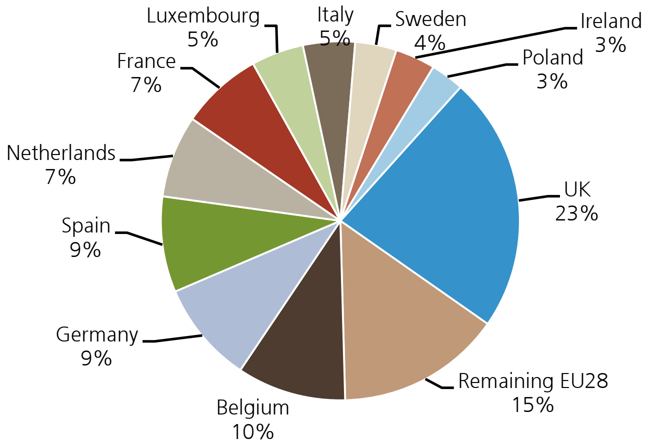
However, the way in which the **EU's trade relations with the UK** change after Brexit will hinge on the future integration model between the EU and the UK. Will the UK become a member of the European Economic Area (EEA), like Norway, Liechtenstein and Iceland, and thus continue to enjoy access to the EU's Single Market, with free movement of goods, services, capital and labour[2]? Or will the UK negotiate bilateral treaties with the EU as Switzerland has done? *In extremis*, and rather unlikely, the UK might have no preferential trade agreements with the EU, in which case bilateral trade relations would be governed by the basic rules of the World Trade Organisation (WTO).

**What will be the future integration model between the UK and the EU?**

This will also have an impact on **cross-border investment**. Over the last 10 years, the UK received almost a quarter of all FDI inflows into the EU (€978bn out of a total €4,242bn, Figure 8) and we believe Brexit would likely reduce this, in particular if the outcome of EU-UK negotiations is less favourable. Some of the FDI flows may be redirected towards the continent. There could even be some repatriation of existing FDI stock back to the EU.

**Would the UK remain successful in attracting FDI?**

**Figure 8: Inward FDI, 2005-14, % of total EU inward FDI**



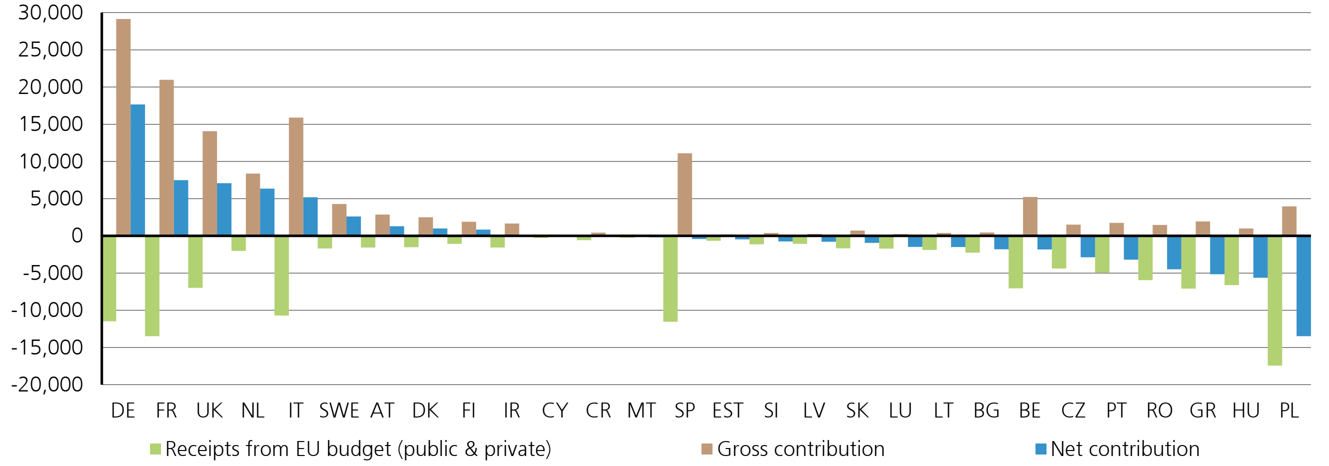

Source: UNCTAD, UBS.

Most likely, the eventual integration model would also determine whether the UK continues to contribute to the **EU budget**. According to European Commission data, the UK's gross contribution to the EU budget (post rebate) was €14bn in 2014, roughly 10% of the EU's total budget. The UK's receipts from the EU budget (both to the private and the public sector) were €7bn, leaving a UK net contribution to the EU budget of €7bn, or £5.7bn (Figure 9). According to data published by the Office for Budget Responsibility (ONS), the UK net contribution to the EU budget in 2014 was £9.8bn, but this figure does not include funds that went directly from the EU budget to the UK private sector, e.g. research funding paid directly to UK universities[3]. If the UK stopped its contributions entirely, the remaining EU countries would have to make up the shortfall or reduce expenditure. However, should the UK maintain a high level of integration with the EU, it might have to continue to contribute to the EU budget. For example, Norway reportedly contributed €388 million to the EU's budget last year (based on a population of merely 5.1m and a GDP of €350bn, i.e. 8% and 13.6%, respectively, of the UK).

**Will the UK still contribute to the EU budget after Brexit?**

[2] Given the sensitivity of the migration issue it might arguably be unlikely that, post Brexit, the UK would grant the citizens of EU member states free movement of labour.
[3] HM Treasury: European Union Finances 2015, December 2015, p 11-19

**Figure 9: Annual net contributions to EU budget (EUR mn, 2014)**

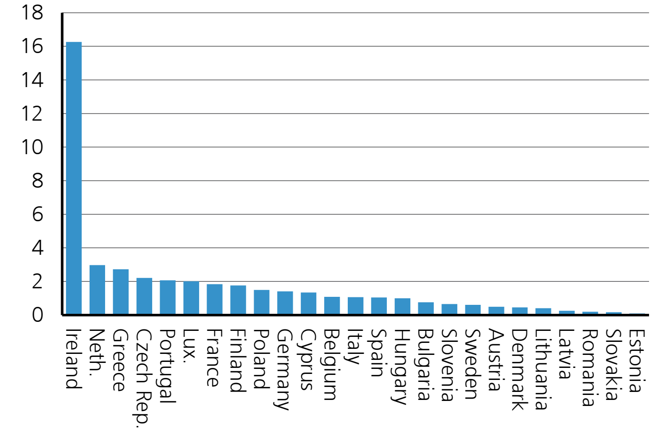



Source: European Commission, UBS

Another channel of spillovers could be **financial linkages**. Should UK banks restrict their activities in the EU, this could negatively affect credit conditions in the EU. This risk seems most relevant for **Ireland**, as claims by UK banks account for 16% of Ireland's total banking assets. For other countries, these linkages are much smaller, however (Figure 10).

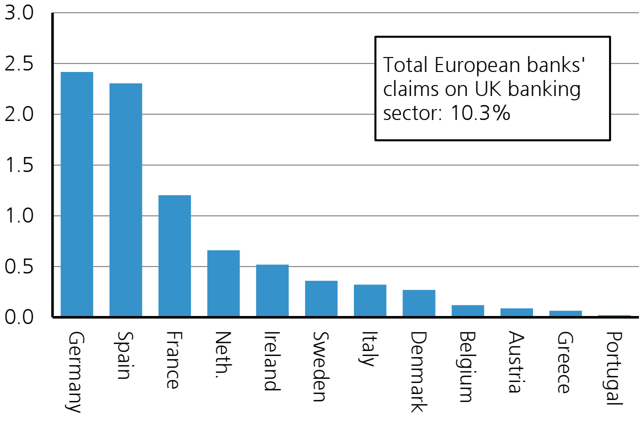
**Will UK banks reduce their exposure to the EU?**

**Figure 10: UK banks' claims on EU's banking sectors, % of total banking sector assets, 2014**




Source: BIS, Haver, UBS

**Figure 11: EU banks' claims on UK's banking sector, % of total UK banking sector assets, 2014**




Source: BIS, Haver, UBS.

Following a Brexit vote, **political uncertainty** might increase in the EU, potentially weighing on private sector confidence. We think this would be the case at least during the period of EU-UK negotiations, but could potentially be longer-lasting too, as businesses might worry about the future of EU integration. Scotland might hold a second independence referendum, potentially with implications for other regions in Europe. Also, Brexit would mark the first major step backwards after decades of increasing EU integration. All these concerns could weigh on investment plans.

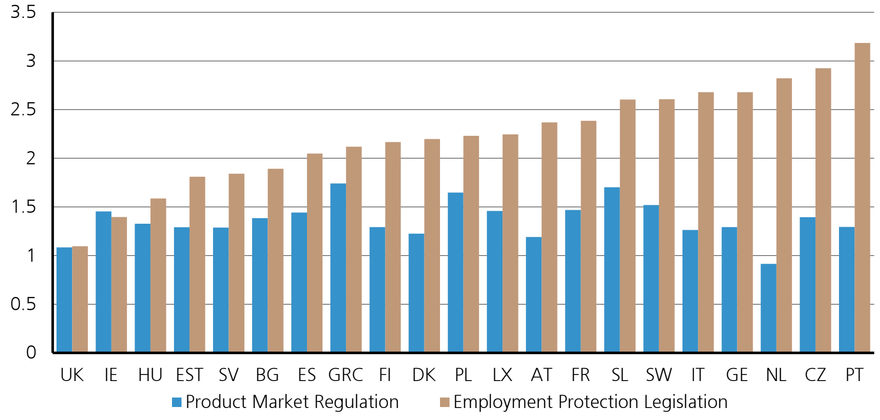
**Brexit would likely raise political uncertainty in the EU**

Closely related to this, question marks might also arise about the future direction of the EU's **economic policy**. Traditionally, the UK has argued for a more liberal policy approach. It has the lowest degree of product and labour market regulation in the EU, and concerns could increase that without the UK's free-market voice, EU

**The UK's "free-market voice" might be missed in the EU**

policy-making could become less liberal, which could weigh on business investment over time (Figure 12).

**Figure 12: Levels of product market regulation and employment protection legislation across the EU, 2013**




Source: OECD. Note: Higher value denotes stricter product market regulation and tighter employment protection legislation.

In the end, the economic impact on the EU will also depend on **financial market variables**. Whether the EUR appreciates against the GBP or depreciates against the USD, there would be implications for the Eurozone's export competitiveness and hence growth.[4] Whether Eurozone bond yields rise or fall, there would be an impact on private sector financing costs. And if Eurozone equity markets fall, this might have an impact on private sector confidence. Yet, how financial market variables move after a potential Brexit decision would depend crucially on how markets see the UK and the EU evolving in the aftermath – hence an element of circular reference is involved.

## Two key questions

In essence, the ways in which the EU and its member states are affected after a Brexit vote will likely depend on individual circumstances. In our view, the two most important questions will be:

**The most crucial questions for the period after Brexit:**

**1. Will EU-UK negotiations be amicable or confrontational?**

**2. Will EU move towards greater integration or disintegration?**

- Firstly, whether the negotiations between the UK and the EU following a Brexit vote are **amicable** or **confrontational.** We think the answer to this question might become clear relatively soon, perhaps within a few weeks or months.

- Secondly, whether the EU moves towards **further integration** or **disintegration** after Brexit, over time. We think it will take much longer – perhaps years – to gain clarity about the answer to this question.

We define these two questions as the crucial "**axes of uncertainty**". Combining them in horizontal and vertical directions yields our **four quadrant scheme** below (Figure 13), which allows us to discuss the potential impact of Brexit on the EU in a differentiated fashion.

[4] Potential safe-haven flows into Switzerland could be one concern, which would exacerbate the problems for the SNB.

## Life after Brexit – A scenario-based approach

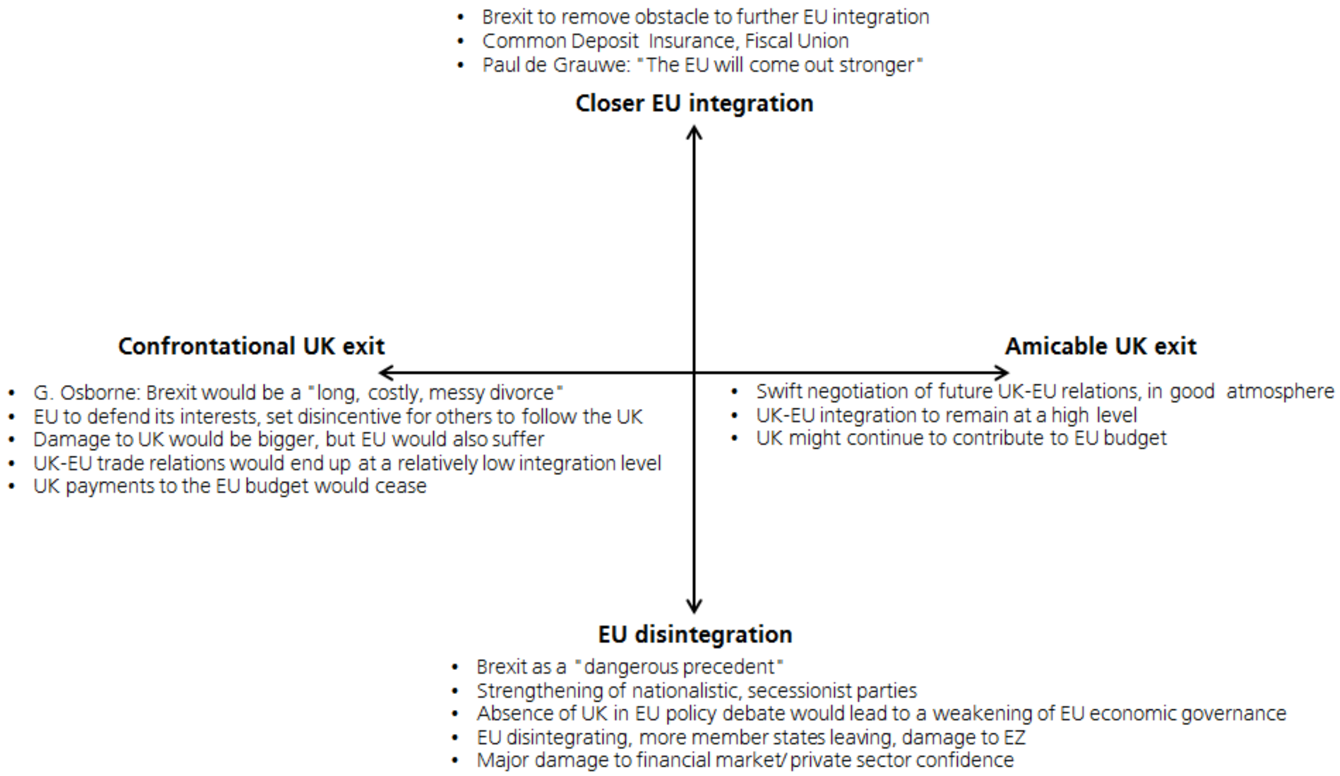
**Discussing post-Brexit scenarios in our 4-quadrant scheme**

The **horizontal axis** displays the various potential outcomes of **EU-UK negotiations post-Brexit**. *The initial reaction of markets following a Brexit vote will likely move along this axis.*

Movement towards the right denotes an amicable exit, wherein negotiations are cooperative and swift and a high level of integration is maintained, possibly with continued UK contributions to the EU budget.

By contrast, movement to the left denotes confrontational negotiations about the UK's exit and the future UK-EU integration model. This could lead, in the words of UK Chancellor George Osborne, to a "long, costly, messy divorce" which would result in limited integration between the EU and the UK.

**Figure 13: The EU after Brexit – two axes of uncertainty**




Source: UBS

The **vertical axis** displays a continuum of outcomes of **future EU (dis)integration**. *This axis will likely determine the movement of markets over the medium and longer-term.*

Movement north along this vertical axis denotes that Brexit would be followed by increased EU integration over time, such as a common deposit insurance scheme or moves towards a Fiscal Union – two of the key projects that were highlighted in last year's "Five Presidents' Report". As a result, monetary union would become more stable over time, with positive implications for growth. (However, progress towards Fiscal Union would require significant concessions, above all from Germany – which seems questionable in the current political context.) Professor

Paul de Grauwe[5] of the London School of Economics has argued that such integration steps would be more likely if the UK were to exit the EU, concluding, pointedly, that "the EU will come out stronger" from a Brexit.

Movements south along the axis denote the opposite development: Brexit would lead to a strengthening of nationalist, secessionist parties, and the absence of the UK's "free-market voice" would weaken EU governance and policies, making membership less attractive. The European spirit would wane over time.

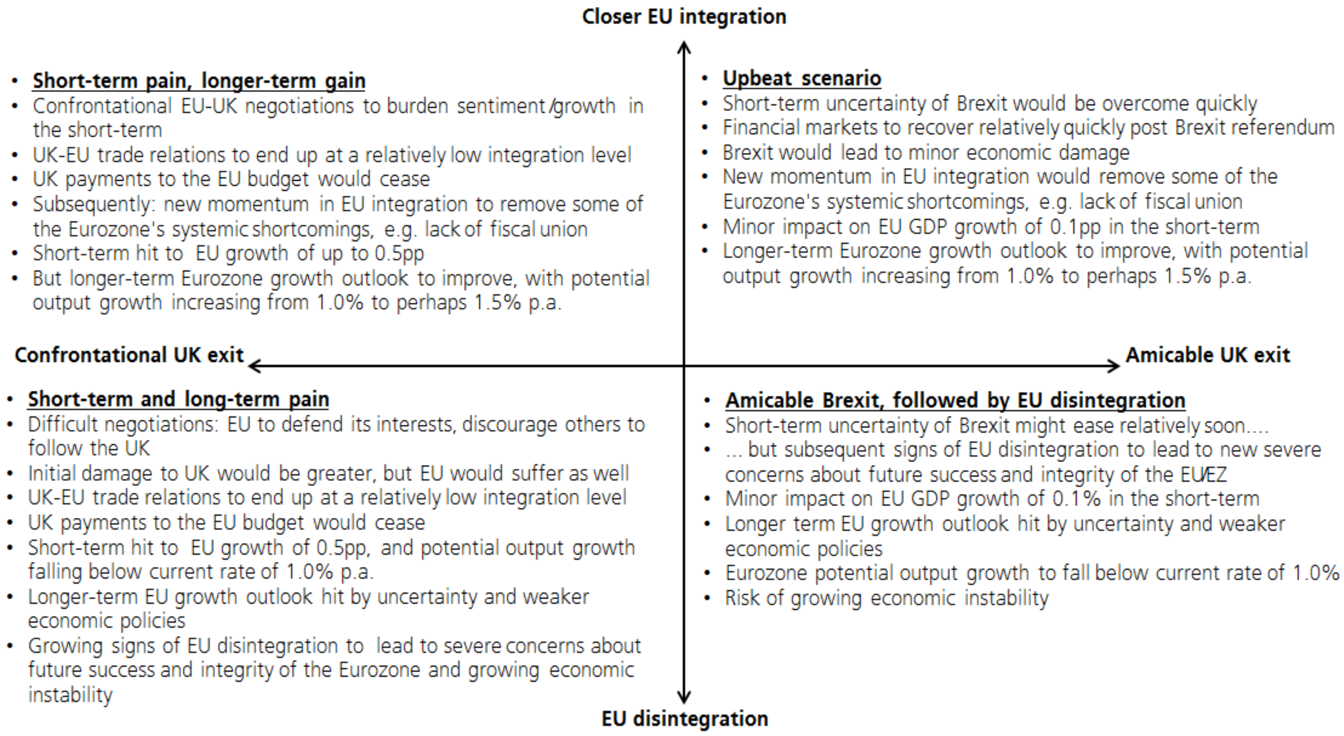
### Four scenarios, from relatively benign to challenging

**Four scenarios for the time after Brexit**

Combining different outcomes along these axes renders four possible scenarios:

1. **Upbeat scenario** (upper right quadrant): This combines an amicable UK exit with a longer-term move to a more closely integrated EU;
2. **Short-term pain, longer-term gain** (upper left quadrant): EU strategy of hard negotiations leads to a confrontational exit of the UK, but is followed by deeper EU integration over time;
3. **Amicable Brexit, followed by EU disintegration** (lower right quadrant): Amicable negotiations lead to a benign UK exit, but are followed by EU disintegration over time;
4. **Short-term and long-term pain** (lower left quadrant): confrontational EU-UK negotiations, followed by EU disintegration over time.

**Figure 14: The EU after Brexit – four key scenarios**




Source: UBS

[5] Paul De Grauwe, 22 Feb 2016: https://www.socialeurope.eu/2016/02/why-the-european-union-will-benefit-from-brexit/

### What are the costs associated with each outcome?

In our view, the question about the **type of Brexit** (horizontal axis – amicable vs. confrontational) will influence the **short- and medium-term** costs that the EU faces: a period of uncertainty, perhaps lasting 1-2 years, will be followed by a period of adaptation to the "new normal". In contrast, the question regarding the **degree of EU (dis)integration** (vertical axis) is more about **long-term** costs or benefits for the EU (because more/less integration has effects on, for example, competition and hence productivity growth, as well as on private sector sentiment and, ultimately, macroeconomic stability).

**Type of UK exit (amicable/ confrontational) affects the short-term costs; the question of EU (dis)integration is more relevant for the longer term**

The upbeat outcome (upper right quadrant) would combine minimised short-term costs with long-term benefits. We estimate that the short-term loss in GDP for the EU-ex-UK would be just 0.1pp, while the medium-term trend growth rate (potential output growth) could well rise substantially above the current rate of 1.0% p.a., to perhaps 1.5% p.a.

By contrast, the scenario of a confrontational exit and EU disintegration (lower left quadrant) would combine setbacks in EU-UK economic relations and potentially much more severe economic and political challenges for the EU over the longer term. We estimate that the short-term loss in Eurozone GDP as a result of a Brexit shock and difficult negotiations could be up to 0.5pp. However, the long-term damage caused by EU disintegration could be much more severe, as the potential output growth rate would likely fall further, and the Eurozone might sooner or later suffer another 2012-like confidence crisis, with strongly negative GDP shocks.

While the EU and the Eurozone are two different institutional arrangements, the linkages between the two are such that major disintegration forces affecting the EU would inevitably spill over into the monetary union as well, in our view.

We would therefore stress that the question of EU integration/disintegration is ultimately much more important than whether the UK's exit from the EU is amicable or confrontational. In the wider scheme of things, the two lower quadrants are therefore the more negative outcomes. If the EU moves towards disintegration, the question of whether Brexit negotiations have been amicable or confrontational will, in the aftermath, have largely paled into insignificance.

However, to repeat, the markets would likely get clarity about the type of Brexit (amicable/confrontational) much faster than about the future state of the EU (integration/disintegration).

## Market reactions in the aftermath of 23 June

The degree to which financial markets price Brexit risk prior to the referendum on 23 June is likely to be governed by how UK opinion polls trend in the lead-up to the vote.

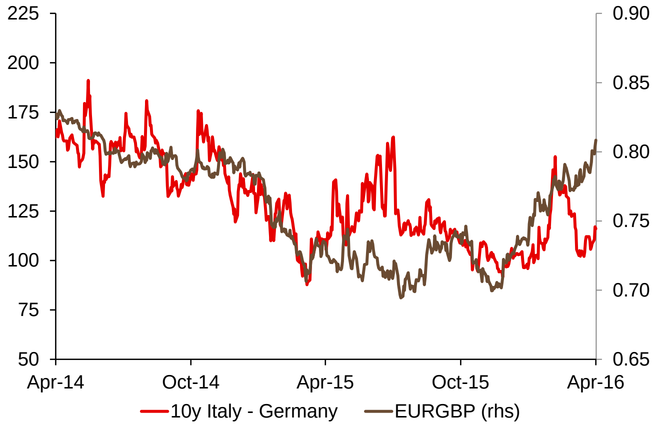
Polls continue to show that the outcome of the referendum is likely to be close. The response in currency markets since Q4-15 has been for a weaker sterling[6], in line with our expectations[7]. However, other assets such as peripheral Eurozone

[6] Global Macro Strategy: The pounding of the pound, 21 January 2016

[7] Global Macro Strategy: A "Brexit" Map for Sterling, 28 February 2016

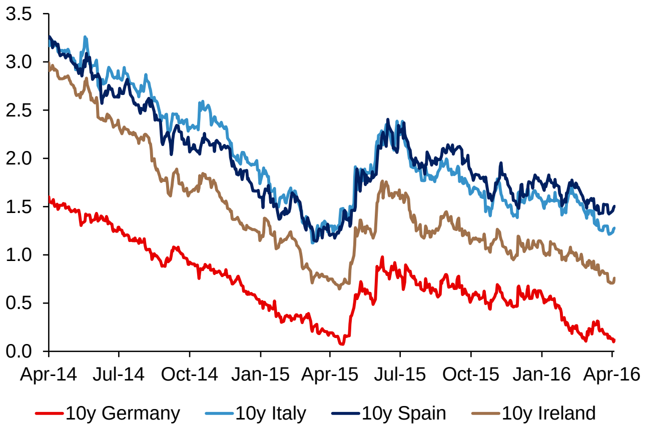
bond markets have not displayed any meaningful concerns so far, perhaps as a result of accommodative ECB policy rather than Brexit being seen by market participants as having a negligible impact on the periphery (Figure 15 and 16). Should a vote for Brexit come unexpected, we would anticipate a broadening of the pressure on markets.

**Figure 15: Peripheral spreads have remained historically tight despite Brexit concerns being priced into FX market**




Source: UBS Research, Bloomberg.

**Figure 16: Peripheral yields have trended lower in the past 12 months**




Source: UBS Research, Bloomberg.

## Implications of Brexit on FX and rates markets

If the UK votes to leave the EU, we would split the likely subsequent moves into two distinct phases:

- **Phase 1:** A near-term market impact where investors become concerned about the economic implications for remaining EU members. In this stage, the market reaction might depend crucially on whether the Brexit negotiations are expected to proceed in an amicable or in a confrontational fashion and whether the UK is expected to maintain a high degree of integration with the EU or not (i.e. movements along the horizontal axis of our 4-quadrant scheme).
- **Phase 2:** A longer-term market reaction based on expectations as to whether Brexit is followed by closer EU integration or EU disintegration over time (i.e. movements along the vertical axis of our 4-quadrant scheme).

### Phase 1: Near-term market impact (horizontal axis)

The sterling exchange rate has been the main source of vulnerability in anticipation of the referendum vote, and we would expect it to remain a central part of the Brexit adjustment. We forecast EUR/GBP rising to 0.84 by 23 June – with a 'Leave' vote potentially pushing the cross towards parity. The UK economy appears to be significantly imbalanced, reflected most clearly in its current account deficits, and Brexit would likely force a rapid adjustment[8]. Brexit might also trigger a kneejerk drop in EUR/USD, but we would not expect material euro weakness. Episodes of rising Eurozone political risks have continually failed to weaken the EUR. Similarly, risk-aversion might put pressure on the CHF, but we would expect the SNB to move against currency strength.

[8] Please see Could Brexit be a catalyst for GBP to par the EUR?, Themos Fiotakis, 13 April 2016, for more details.

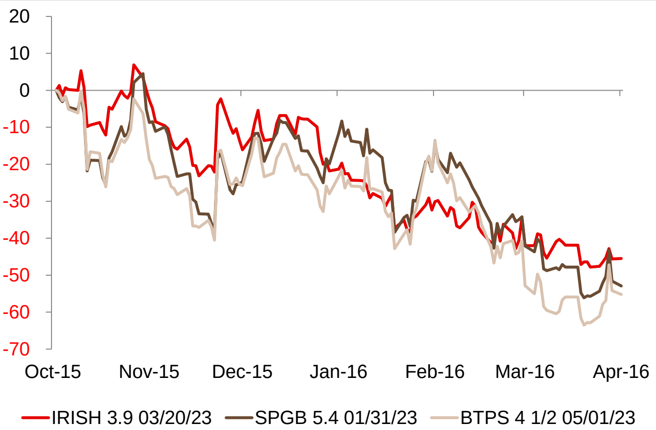
If the UK votes to leave the EU, heightened risk-aversion is likely to result in wider peripheral spreads to Germany (from current levels). The largest impact within Eurozone bond markets is likely to be on member states that have the largest fundamental exposure to the UK, such as Ireland and Spain. Within core markets, the Netherlands is the most exposed.

If Brexit occurs, we anticipate the 10-year Italy-Germany yield spread to initially widen above 175bp, Spain to underperform Italy, 10-year Ireland-Germany spreads to widen above 90bp, and Netherlands to underperform Germany.

The impact on 10-year German yields is likely to be asymmetric. On the one hand, a rise in peripheral yields is likely to put downward pressure on 10-year German yields due to safe-haven flows. However, 10-year German yields are already low (0.15%) and valuations are too pessimistic given fundamentals, in our view[9].

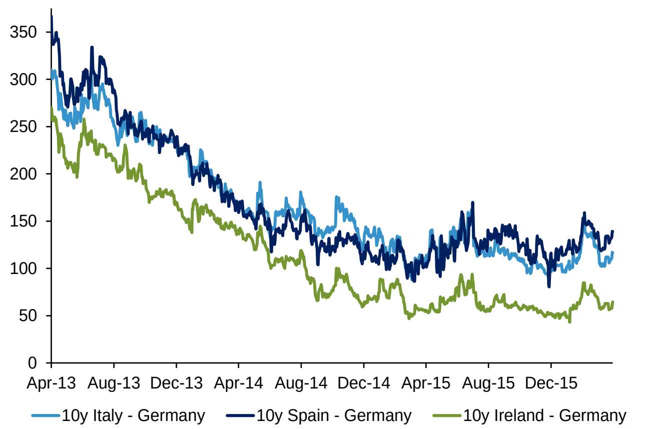
Overall, we believe the market would expect difficult negotiations between the UK and the EU in the event of a 'Leave' vote, although it might not have a strong view, at that juncture, about the future integration or disintegration of the EU. In terms of the spirit in which Brexit negotiations might be conducted, public remarks by senior EU politicians in the aftermath of 23 June will likely be important. For example, should the European Council indicate a strong sense of goodwill and determination to finish negotiations quickly and in a cooperative fashion, and with the aim of maintaining a high degree of integration with the UK, market concerns might dissipate relatively quickly – although this would have to be confirmed once negotiations actually get underway.

**Figure 17: Normalised yield changes: Ireland has underperformed Spain & Italy**




Source: UBS Research, Bloomberg.

**Figure 18: 10-year yields spreads to Germany (bp)**




Source: UBS Research, Bloomberg.

**Phase 2: Longer-term impact (vertical axis)**

Following the initial move described in "Phase 1", the longer-term impact on FX and rates markets is difficult to assess, as it is likely to play out over a longer period. It would take significant evidence to show that disintegration would materialise before peripheral spreads are deemed to widen well above the levels that we anticipate in the immediate aftermath of a UK vote to leave the EU. Indeed, initial risk-aversion and market moves may overshoot and reverse.

[9] Global Rates Strategy: Euro Area – Bund blues, 24 March 2016

While clarity about the future degree of EU (dis)integration would likely emerge only slowly, expectations about the EU's longer-term path could stabilise more quickly if the European Commission or the European Council were to present a comprehensive "Plan B" and outline its plans for future integration.

- **Integration:** This would be supportive for higher German yields and tighter peripheral spreads to Germany.
- **Disintegration:** This scenario would have the biggest risk for peripheral Eurozone markets, as the probability of a Eurozone break-up might arguably rise, triggering a substantial rise in peripheral yields.

### A vote to remain in the EU

The pound has weakened significantly since Q4 15 (Figure 15), and we would expect a 'Remain' vote to reverse the recent course of EUR/GBP and push it towards 0.73. Greater clarity about the outlook for the EU should also result in tighter 10-year Italy-Germany spreads, which we expect to narrow to 90bp by end-2016, from currently 117bp. However, when considering current valuations in 10-year Italian government bonds, the risk-reward on taking new (long) positions versus Germany seems unattractive to us.

## Equity market reactions

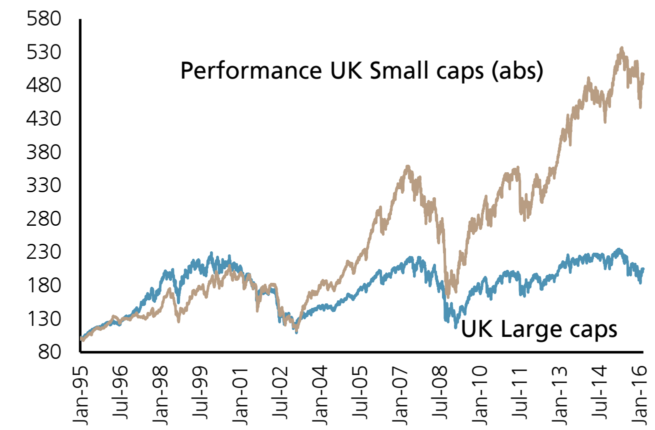
### Phase 1: After Brexit vote (horizontal axis)

**Foreigners might sell the UK**

The immediate reaction might be to sell the UK, especially for foreign investors who will likely take a further currency hit from their UK-denominated assets. That doesn't seem to be priced in: FTSE 100 implied equity volatility is lower than it was in February and much lower than at prior EU crisis points. Within the UK, stock-pickers will likely favour UK large caps given 75% of UK large caps sell internationally so a weaker pound should boost earnings. Large caps are lagging in performance and are cheaper on valuation (Figure 19 and 20). However, the large cap UK stocks that will not be immune will be the domestic UK banks.

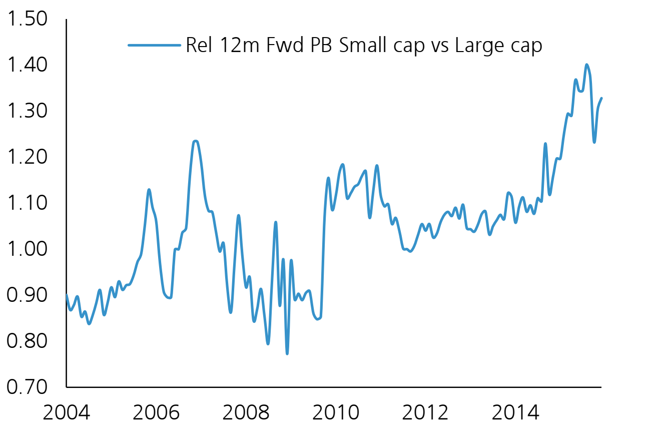
**Large cap stocks with international exposure should be less at risk**

**Figure 19: Brexit favours large caps: they lagged as small domestics proved a haven from global troubles**




Source: Bloomberg, UBS European Equity Strategy

**Figure 20: Small caps are more expensive too – so will suffer more in the event of turmoil at home**

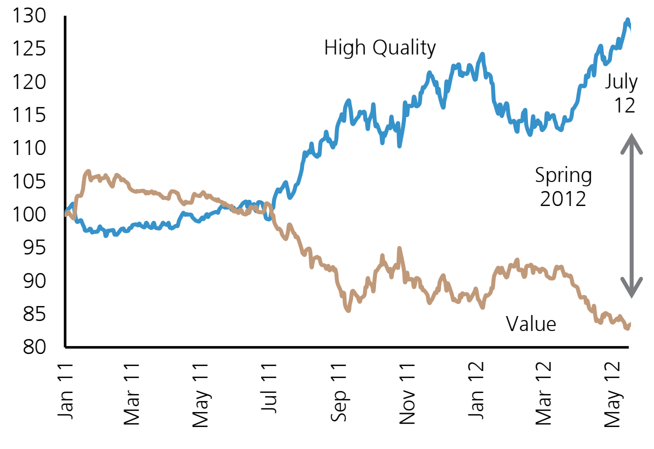



Source: Thomson Datastream, UBS European Equity Strategy

If concern were to shift to the EU, a wider risk-off trade would be triggered. Pre-OMT, between March and July 2012, we saw investors racing into Quality (lower-volatility stocks and sectors or countries with higher ROCE) (Figure 21). Switzerland was the only country not to be upset when investors started to worry seriously about the integrity of the Eurozone in the spring of 2012. Switzerland is 50% defensive and defensives were in favour during this risk-off period (Figure 22).

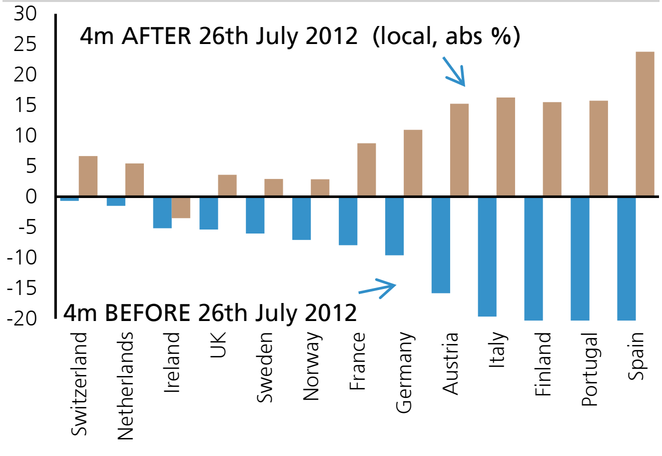
**Go for Quality – like Switzerland**

**Figure 21: Quality beat Value by c30% in March-July 2012**




Source: UBS Quant and European Equity strategy

**Figure 22: Country performance. Switzerland is a quality safe haven: 50% of market is Pharma & food producers**



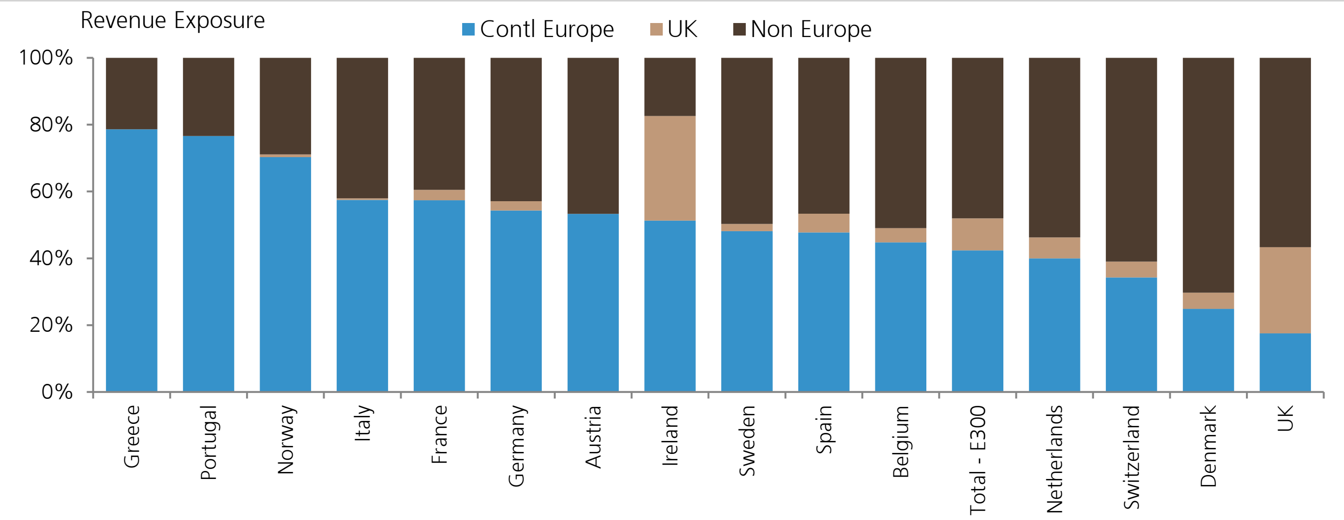

Source: Thomson Datastream, UBS European Equity Strategy

## Phase 2: Scenario of EU disintegration (vertical axis, lower part)

If the focus were to move to disintegration, investors would likely start to focus on fundamental exposures. In this case Switzerland and the UK look all right because their fortunes are more linked to the rest of the world (see Figure 23 below). Investors would likely favour large cap international stocks that are less exposed to Europe, but countries and sectors too. The chart below shows that of the major countries, Switzerland has the highest 'Non Europe' exposure and the lowest exposure to continental European (next to UK).

**Who is most/least exposed to Europe?**

**Figure 23: Sales exposure by region – dark brown represents non-Europe exposure of European large caps**

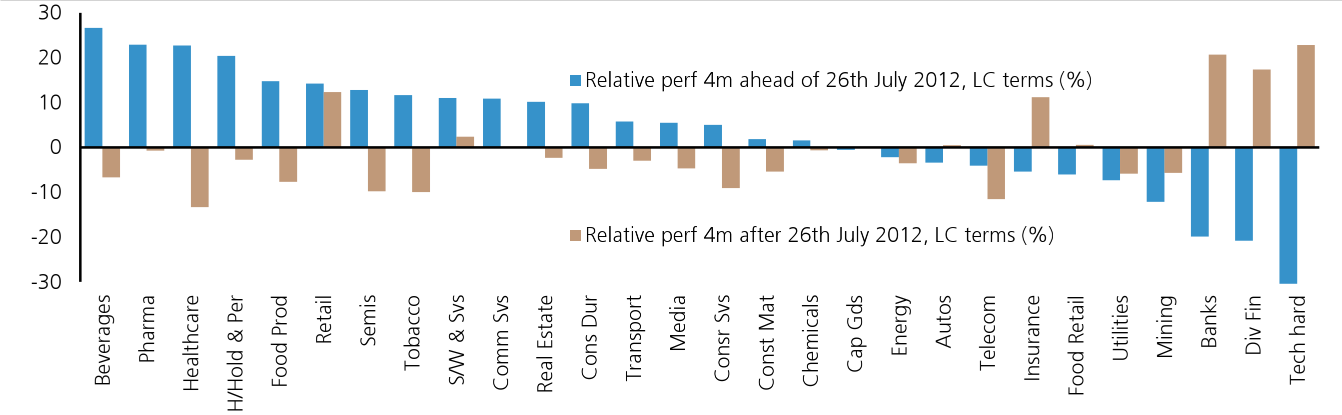



Source: UBS European Equity Strategy

Investors tend to crowd around Defensives in a risk-off trade. Beverages and Pharma were popular (Figure 24) and make up close to 50% of Switzerland's market cap. Much of the performance reversed after comfort was provided by ECB President Draghi in his 'we will do what it takes' speech on 26 July 2012.

**Protection: Defensives (Beverages & Pharma)**

**Figure 24: Defensives (to the left) offered protection ahead of the "Draghi moment" on 26 July 2012**



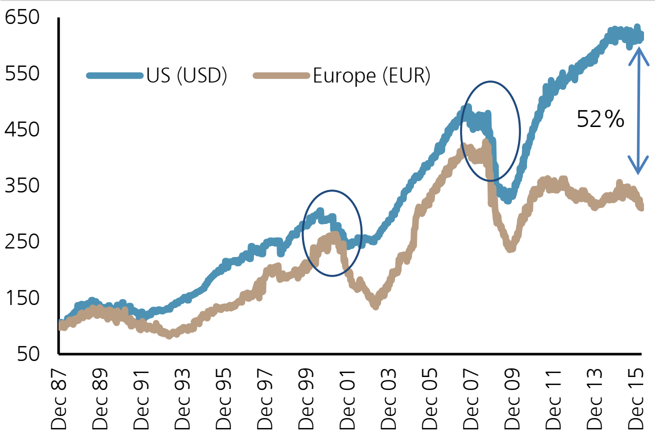

Source: Thomson Datastream, UBS European Equity Strategy

### Scenario of closer EU integration (vertical axis, upper part)

If instead we end up with a more closely integrated EU with more structural and institutional reform this would be a positive. It may act to finally close the profit and valuation gap that emerged in 2011 between Europe and the US as the sovereign debt crisis took hold (Figure 25). Profits of US companies are up 25% since the last cycle peak while profits in Europe are still 27% below. This is why, even on a sector-adjusted price-to-book, Europe trades in recessionary territory relative to the US, because it cannot generate the same return on capital (Figure 26). Many international investors we meet would like to invest more in Europe, but they need to see more integration/reform first.

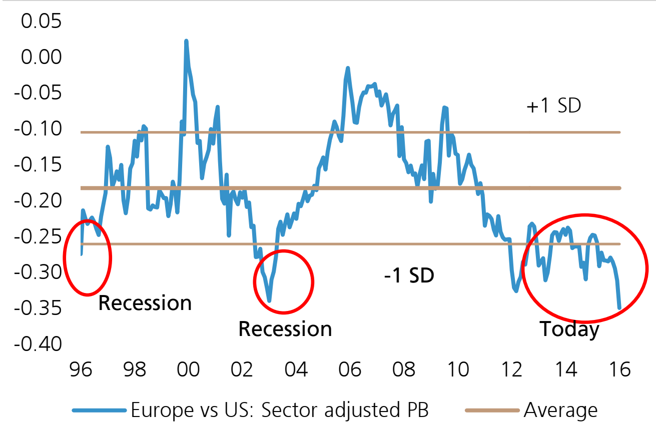
**More EU integration could trigger a closing in the profit and valuation gap between the US and Europe**

**Figure 25: US vs Europe profit gap opened up post Sovereign debt crisis. US up 25% - Europe down 27%**




Source: Thomson Datastream, UBS European Equity Strategy

**Figure 26: US vs Europe: Sector adjusted Price to Book (using global weights), Europe is extremely cheap today**




Source: Thomson Datastream, UBS European Equity Strategy

For more detail, see also [Full Brexit: Stocks, EU risk and Swiss protection](), 13 April 2016.

**Valuation Method and Risk Statement**

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

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