Brexit a Catalyst for Necessary Reforms

“The strongest argument against democracy is a five minute discussion with the average voter.”

-Sir Winston Churchill (1947)

Winston Churchill’s simple statement captures many of the dynamics at play in the decision of the majority of British citizens to leave the European Union after 43 years. Calling the referendum on remaining in the EU was essentially a tactical move by Prime Minister Cameron to silence his opponents and consolidate power. Mr. Cameron, soon to be returned to private life, clearly never had a “five minute discussion with the average voter.” If he did he would have sensed the anger of a populace that has watched their leaders focus more on immigrants and international bailouts than the plight of their own citizens.

The Brexit vote has recalibrated the survival instincts of the world’s politicians from protecting the status quo to embracing their constituents’ anger and frustration. This has empowered a new type of aspiring leader with a clear focus on domestic policy. They range in rhetoric and ideas from well-meaning populism to the darker side of nationalism, but a common theme is helping local citizens in the face of the dual threats of immigrants and the bureaucrats in Brussels. Previously minor parties in France, Italy, Finland, Spain, Denmark, Sweden, Germany and the Netherlands have been winning legislative seats and local elections. Nearly all of them heralded the British “leave” vote as part of a larger movement for greater sovereignty and economic justice, calling for some similar referendum on Europe. Even staunchly pro-European German Chancellor Angela Merkel was clearly shaken by the vote and called it “a watershed event for all of Europe.”

Investment Ramifications of a Divided EU

Brexit and the building popular uprising in Europe mark the end of the unhealthy dependence on the distortive policies of central bankers and a shift to reforming underlying fiscal and structural barriers to growth. Part of our expected move from unsustainable to sustainable economic growth is this reconnection of the real economy with the financial economy. This clearly will be driven by an angry populace that is disillusioned by low growth and rising financial inequality. This anger transcends the normal division of liberal and conservative with both the uncontrolled welfare state and crony capitalism the target of populist ire.

Unexpected outcomes and uncertainty create positive time-arbitrage opportunities for investors that take a longer term point of view. Our minds tend to overweight negative news by a factor of 10 and, according to psychologist Daniel Kahneman, we feel the pain of loss at twice that of the joy created by a gain. The Brexit
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British pound is no longer overvalued relative to the euro and is now cheap relative to the U.S. dollar (USD). This will help rebalance the gap between domestic and external demand through lower current account and household sector deficits relative to GDP. Brexit consensus winners are mostly defensive sectors such as pharmaceuticals, consumer staples, beverages, telecoms and utilities. Most hurt are banks/financials, housing/real estate, industrial services and apparel retailers.

In the near term, expectations will be reset for capital markets and economic growth. Economic and political uncertainty in Europe and the UK will harm corporate investment and hiring until confidence is restored in the existing union or a new structure is created. Managements in the UK and Europe are likely to take a conservative stance on earnings guidance. This could temper the recent improvement in earnings expectations and weigh on near-term stock market performance. Global central banks are likely to provide all the liquidity the financial system needs. Governments will sharply expand fiscal spending through “Overt Monetary Financing” which is basically the direct monetization of deficits. The Bank of Japan is now more likely to ease monetary policy in July. Cuts in the fed funds rate next year are now being assigned the same probability of increases in a massive shift in monetary policy expectations. At some point sentiment could begin to shift to the expectation of a new QE program by the Fed. The yen has appreciated strongly as a safe haven currency and continued uncertainty in the EU and UK should provide similar USD support. An overly strong USD and capital flowing back into U.S. Treasuries would serve to tighten global liquidity and be a potential source of contagion for emerging markets and China.

Impacts on the United Kingdom

In the hours after the Brexit vote, many Brits experienced “Bre-gret” and the top Google searches included “What is the EU?” and “How will leaving the EU hurt the UK?” This highlights that the “Leave” proponents were successful with their simple argument against Brussels, uncontrolled immigration and London’s riches. It is less about having a detailed plan for the future on the morning after. If the new leadership does not fill this policy vacuum then consumer confidence could suffer. A key issue for the UK in the negotiation with Europe is maintaining the “financial passport” that is critical to keeping London a growing global financial center.

Bank of England (BOE) Governor Carney is in a tough situation facing both the potential of recession and currency-driven inflation. The UK economy was already slowing to sub 2% growth and with the disruption from Brexit, we believe it could result in GDP contraction (-1%) in the fourth quarter of this year. Given the political climate, we believe the BOE will choose to debase and reflate and will probably dismiss any spike in domestic prices as transient. Fiscal policy had been tightening in the UK with the budget showing a small surplus. So while the overall debt levels are high relative to GDP, the government does have room to add fiscal stimulus. The central bank could also expand its balance sheet relative to GDP from the current 20% given the U.S. Fed at 25% and the Bank of Japan a staggering 81%.

Impacts on the European Union

The vote reveals an EU disconnected from the concerns of its citizens with the main hot button issue being uncontrolled immigration. People throughout Europe are railing against policies that have tended to favor select debtors and owners of financial assets. Now the citizens are demanding action by their leaders who will respond with expanded fiscal deficit spending. European leaders now want to speed up the leave process to limit political damage while the British appear to favor a longer time frame. Germany’s response to Brexit and leadership in Europe is critical. The country can move towards a closer fiscal and monetary union but this will take a greater willingness to accept the sharing of financial responsibilities. Pressure is high to focus on domestic economic and social priorities, shying away from the increasing risks in peripheral Europe. So far, Germany is the most constructive on exit negotiations with Britain and is discussing making the UK an “associated partner country” to minimize the negative economic impact.

Much could change across Europe in the months ahead as the results of Spain’s parliamentary election showed no clear majority among the four major parties. Local and federal ballots are also upcoming in Germany, France, Italy and the Netherlands. Ireland sold off significantly but could be a net beneficiary of Brexit as an English-speaking financial and business center within Europe.
A successful Brexit has reignited interest in independence for Scotland, which rejected a referendum to separate from the UK in 2014. But the Scots’ earlier vote to remain complicates their own independence efforts as they have too high a fiscal deficit to be accepted into the EU on a standalone basis.

The greatest fear of European leaders is that the UK is actually better off in the long run outside of the common market. This could be the case if British leaders take advantage of the increased freedom and self-determination to cut taxes and regulatory costs in conjunction with a globally competitive currency.

**Impacts on Other Markets**

Emerging markets could prove surprising resilient as they offer the best global growth dynamics at an attractive valuation. These countries should benefit from a U.S. Fed that is reluctant to raise rates. The key to EM stocks outperforming is for the dollar to not jump sharply higher and for commodity prices to not collapse. In terms of Brexit, not a single Asian country sends more than 1% of its exports to the UK. These economies are more dependent on domestic demand which hinges largely on the successful transformational policies in China and India.

Japan is the poster child for the policy failure that remains ignored by central bankers intent on more QE, zero/negative interest rate policy and the coming monetization of deficit spending. Japan is likely to move to a more aggressive and direct form of QE that is popularly known as “helicopter money,” permanent monetization of budget deficits or direct central bank transfers to the private sector. This creates a rising risk that eventually the yen and Japanese government bonds decline in value and points to the next potential global macro dislocation.