Brexit Commentary

27 June 2016

The decision by the British people to withdraw from the European Union (EU) took markets by surprise. Yet, it did not occur in a vacuum.

Britain's vote to leave the EU needs to be seen in the context of a confluence of global social and economic trends.

- Large scale **migration** within Europe (from East to West) as well as to Europe, from Africa and the Middle East. Lured by both the pull of better economic prospects and driven by the horror of war, these movements of people raise a formidable challenge to the social and political fabric of Europe.
- The long-running trend of international economic integration – **Globalisation** – has removed trade barriers and opened labour markets to competition, allowing both labour but especially capital to migrate across national borders. International business and political leaders promoted ever-greater internationalisation over the increasingly vocal fears and frustrations of the Western middle class who faced job insecurity and financial regression.
- A **European Union** whose weak form of political representation (at the European level) and barely integrated financial structure was ill-equipped to cope with the fallout of the Global Financial Crisis (GFC) in the absence of the traditional currency devaluation pressure-release valve.

The frustration and sense of powerlessness of the middle-class has become increasingly tangible since the GFC of 2008 and is manifesting itself in a shift away from traditional political parties of the center. The vote to 'Leave', is simply one expression of voter dissatisfaction with this state of play and, in the European context, downright anger at the refusal of the unelected bureaucrats in the European Commission to acknowledge their plight.

Turning to the 'Remain-Leave' campaign itself, the debate was focused on ideological and rhetorical arguments which were fanned by a cacophony of emotional pleas in the media, rather than points of fact raised by the Treasury and Parliamentary Commission in the lead-up to the vote.

So what now for Britain?

The prospect of a re-run of the referendum is unlikely, couched more in hope than reality.

The immediate effect will be a jolt to consumer and business confidence in Britain, depressing investment and spending, and resulting in significant economic weakness and probable recession.

The Bank of England is highly likely to cut interest rates from 0.50% to zero in coming weeks.

Further weakness in the British pound is to be expected. In the six months preceding the vote, the pound has traded in a range between 1.40–1.45 per US dollar. It's trading around 1.35 per US dollar today, a mere 5% depreciation from the mid-point of this range. Britain is now a small, open, economy that is heavily reliant on foreigners to finance its large current account deficit. We expect the pound to act as its primary shock absorber and depreciate significantly to absorb this economic shock, but first expect a back-up of decisions by consumers and businesses.

Turning to the Continent

We expect a re-appraisal of the relationship between the European Commission and the sovereign states of the Union and hence, implicitly, the electorate. This will result in some conciliatory measures to reassure voters who share the deep frustration and sense of powerlessness of their British counterparts. Less high-handedness by the Commission and a more consultative approach are likely. There will also be questions raised around the Head of the Commission who epitomises the powerful elite, unanswerable to the electorate.

Further accommodation by the European Central Bank (ECB) is also likely. It is imperative that it be seen to be doing *something*, at least to demonstrate that they are in control. This will represent a worrisome raising of the stakes. With sustained economic growth proving elusive despite negative interest rates and quantitative easing in full flight, the market is becoming increasingly unnerved by the seeming impotence of Central Banks globally. The ECB is thus forced to walk a dangerous line between having to do something and revealing its impotence.

Fiscal stimulus is now probable and we expect the 3% fiscal deficit ceilings to be ignored.

Looking further afield, we expect that the shockwaves will be felt in Emerging Markets, Asia and the United States. However, it is reasonable to expect the impact to significantly dissipate as we move from the UK and Europe.

The US dollar will likely absorb some of the shock for the world economy by appreciating while the prospects of higher interest rates in the US will be put on hold for some time.

Why should I own shares in this environment?

The 'Leave' vote is but one instance of a broader push back against ever increasing globalisation and demands for redistribution of the economic pie by a middle class that feels increasingly more marginalised and frustrated.

Where it can be expressed through the ballot box, governments will respond with measures to placate this angst. Ultimately, governments don't create wealth, they re-distribute it. This is already underway. Monetary policy is being used to push interest rates to zero or even into negative territory, effectively taxing savers. Fiscal expansion will need to be financed by taxes, excessive borrowing or simply by printing money.

While cash or bonds might *seem* like a safe alternative, they entail risks that need to be carefully weighed. As a saver holding cash or bonds, your interests are diametrically opposed to those of governments who are large borrowers and are in a position to dictate both your return on capital and return of capital. Essentially you need to believe that the government will act in your interest and not those of the electorate.

The global economy continues to grow and civilised society continues its inexorable progress, questions around the distribution of wealth notwithstanding. Shares represent an ownership interest in real assets and in corporations that can marshal human and financial resources to participate in various economic activities. Businesses are living organisms that possess the flexibility to adapt to new threats and opportunities, unlike bonds or cash. Good businesses will have numerous opportunities to grow and thrive, and reward their shareholders, regardless of the economic environment.

When fear and uncertainty prevail, share prices can fall sharply. While it may be tempting to simply respond to the financial pain that these price falls cause, it is worth remembering that it is precisely these price falls that open the best wealth creating opportunities.