

## To Brexit or Not to Brexit: That WAS the question

We suspect that all of you have heard that a referendum passed this past week in the UK that has endorsed that the UK leave the European Union. Clearly such a vote has political and economic implications, particularly for residents of Great Britain, and to a lesser extent residents and companies in the European Union and again to a lesser extent to the balance of the world. The results of the referendum were announced this past Friday and the ensuing days have really done little to add clarity to the results. We would like to take a quick look at what has happened, what has not happened, what could happen, and what will happen.

### What Has Happened

The referendum that passed did so by a small majority 53 to 47. This result surprised the political as well as the financial establishment throughout the world. Surprise to the political establishment has led to the resignation of Britain's Prime Minister, David Cameron, who argued strongly in favor of Britain remaining in the European Union. Surprise to the financial establishment always triggers a large response and one generally to the downside as "sell now, ask questions later" is the mantra of stock traders, who trade in very large blocks and whose long term horizon is the end of the trading day.

The vote to withdraw carried in most every voting district, with the notable exceptions of Scotland, Ireland, West London, Central London, Cambridge and Oxford. It is also clear that the vote was not a particularly informed vote. Following the announced vote to leave the EU, the second most Googled question in the UK was "What is the EU?". The vote itself was made with really little understanding of the benefits for Britain of being a full member of the European Union coupled with the perception of vast, unwanted migration of refugees fleeing from Eastern Europe to England as full membership in the EU allows for free worker migration between all the countries in the European Union. The opposition of the immigration was fueled by the British tabloids, which do carry a fairly large political weight in the UK, particularly among emotional voters in non-urban areas - precisely those voters that carried the day.

The surprise factor has also triggered a huge outpouring of headline garnering "news" from all sources most of whom are basically posturing for the future.

### What Has Not Happened

Britain has not left the EU. They will do so only by an exhaustive set of negotiations which will take place over a two year period, beginning with Britain formally filing for what is known as Article 50 of the Lisbon treaty which established the EU. The process to notify the EU is a bit messy, it fundamentally being the responsibility of the British Prime Minister. The existing Prime Minister has just resigned. Generally, a new Prime Minister must secure a majority vote in the House of Commons, before the Queen will make the appointment. The EU referendum vote notwithstanding, the existing members of Parliament strongly favor remaining in the EU by about 3 to 1. So presenting the EU with a formal petition to leave is a bit of a sticky wicket.

Lengthy rounds of negotiations must also ensue on virtually every front, but particularly on the issues of trade and movement of workers, both of which will be very heated and protracted and accompanied by

much political posturing. So really, at the moment, nothing has actually happened to restructure Britain's status within the EU.

### **What Could Happen**

All manner of parties will be affected by the process whereby Britain would leave the EU. All of those parties have their oar in the water, their own axe to grind and their own wish to affect the outcome. As a result, almost every affected party has begun the process of extrapolating possible outcomes far into the future. On a good day, extrapolating economic trends is a very risky business if your desire is to actually get the outcome correct. If your aim, however, is to nudge the process in the direction you desire, it is pretty easy to extrapolate. The latter is what you see published. Since there are no negotiations underway, no clear start date, no clear end date and a wide host of people and economic outcomes affected, it is pretty easy to extrapolate to virtually any conclusion on any particular vector. The reality is quite uncertain.

### **What Will Happen**

Several things are very clear going forward. These are as follows:

- 1) There will be economic uncertainty surrounding Britain. The closer to Britain, the more uncertainty.
- 2) Financial markets do not like uncertainty, so British assets, such as the British stock market as well as the British pound have been adversely affected in a sizable way, but how much further, if any, is pretty much anyone's guess.
- 3) For the short term, asset flows will likely continue to gravitate to "safe" investments, such as gold. It is very unclear what sort of a long term trend may unfold with these holdings.
- 4) There will be enormous political posturing by every party affected.
- 5) Meaningful changes will require lengthy political processes and as a result are likely to be very watered down.
- 6) To the extent that free trade is hindered between Britain and the rest of the world, Britain's economy will be the worse off for it. It is possible that Britain could "withdraw from the EU" and still maintain a free trade arrangement similar to that of Norway. In that case, free trade will not be substantially impacted and the detrimental impact on the British economy would be small.
- 7) To the extent that Britain can restrict the free flow of Eastern European refugees to the UK, the populous in the UK will feel they have been victorious. The populous may have a similar opinion to the extent that regulations from Brussels can be thwarted.
- 8) The impact on the US will be fairly small. The UK represents about 2.5% of the world GDP and about 3.2% of the US's total trade (somewhat less than the trade between the US and Korea). Total international trade for the US amounts to a bit less than 25% of the US GDP. Putting the two together, total trade with the UK constitutes less than 1% of the US GDP. It is likely the large majority of ongoing trade will continue between the UK and the US, which would mean the impact on US GDP will be a fraction of 1%.

### **What Will Not Happen**

The only clarity going forward is that a quiet transition will not occur.

### **What Should You Do and What Are We Planning To Do With Regards to Your Investment Portfolio**

Valuations for companies in the US were not exactly cheap last week with the S&P 500 within sight of its record high. Stock ownership opportunities in European stocks were a bit less expensive, a trend that has been extended with the recent relative losses of the holdings. As a result, we believe that it will be good to hold the domestic investment positions and look to add new ones in European markets. Along those lines, some perspective can be added by noting that as of June 28, the S&P 500 is within 1% of where it started for the year. You may recall that our thoughts for the year were for a small gain in the overall markets with somewhat more volatility than has been the case in the past 5 years. Both of those beliefs have played out so far this year. At the beginning of the year client portfolios were positioned in line with our outlook. Since that outlook is very much on track we do not foresee any substantial repositioning of most clients' investment portfolio.

As always, we wish to thank you for being clients and should you have any further questions about Brexit, we would be more than happy to encourage that discussion with us.