Market Commentary
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Brexit: Much ado about something

The U.K. Referendum, on whether to stay in the European Union (EU), vote will occur on June 23.

Market Impact: Greater long term uncertainty irrespective of the result, heightened volatility and higher risk premiums.

The “remain” campaigners are painting a dire economic picture if Britain leaves the EU while the “leave” campaigners are claiming that Britain can thrive if it extricates itself from the grips of the EU and it’s institutions that impinge on the nation’s sovereignty and wealth. Like most extreme views, the reality is likely somewhere in the middle. The U.K. is simply too integrated within the EU economy that it can’t be altered overnight. The extent to which the EU is a cost and a threat to the U.K.’s sovereignty is also greatly exaggerated.

The mere fact such a vote is taking place is a testament to the wave of uncertainty and trepidation with respect to the current global environment. It is being fueled by increasingly vocal and successful alternative parties from Europe to the U.S. Even if Trump and Sanders are from traditional parties their policies are not.

These voices are providing a platform for the backlash against the negative effects of globalization, to which one can add technology, and the ineptitude or mere negligence by traditional parties to address issues that have left many behind and often fearful with respect to the future.

A reversal in globalization has negative implications for markets and in this respect the Brexit vote is a precursor for other elections taking place in the next one and a half years in the U.S. as well as Europe.

The Brexit campaign is arguably the poster child of this broader debate happening throughout the world, which is likely to perpetuate beyond the U.K. vote irrespective of the result. It is also consistent with periods of heightened market volatility, a long-term theme at Signature. In all likelihood we are in the midst of a significant political/economic transition that will take years, and several election cycles, to determine but the result will ultimately be a new paradigm for how our political/economic systems operates.

What are the implications of Britain leaving the EU?

Under article 50 of The Treaty of the European Union, a nation that requests to leave the EU has a period of two years to negotiate its departure. The U.K. is very integrated in the European economy and it would likely take considerably longer to negotiate such a massive undertaking.

The extent of the integration means that there would likely be a long period of adjustment so as to allow the continent to reposition its services and industries. So the impact in the U.K. beyond a sudden and large fall in sterling would be limited economically over the short to medium term.

The city, as the London financial sector is named, would remain a leading global financial center. It is difficult to imagine global banks shutting down and moving to either Paris or Frankfurt.

Longer term, the situation is considerably more problematic for the U.K. Over time Europe's multinationals would likely restructure, deemphasizing or limiting U.K. exposure. U.K. services would gradually be phased out as the U.K. firms would have limited to no access, barring some form of bilateral agreement (more on this later.) In short this would result in less U.K. investment and declines in levels of employment in multinational firms operating in the U.K.

While London would maintain its status as a financial center, some services would migrate to the continent, as banks follow their customers, thereby impacting at the margin employment in the city.

The counter argument is that the U.K. will be able to negotiate bilateral agreements with Europe, mitigating the impact of Brexit since Europe needs Britain even more, the "leavers" say, than Britain needs Europe. This is highly questionable.

In the best of circumstances, negotiating bilateral agreements takes, on average, 10 years. Such agreements would need to be negotiated for all services, since they do not fall within World Trade Organization (WTO) rules that only cover goods. Europe would have considerably more leverage than the U.K. in negotiations given the difference in size. In fact, the U.K. is more dependent on Europe than Europe is on the U.K. Exports to Europe represent 13% of Britain's GDP, while EU exports to the UK represent only 3% of EU GDP.

Most importantly, and this appears to be lost on many, **Europe would be compelled to drive a very hard bargain in negotiations**. If Europe even appears to be soft, it will open the floodgates to more referendums, something which is likely to happen anyway. This political consideration alone is more powerful and important than access to the U.K. market.

Norway and Switzerland are often touted as examples for Britain since these countries have negotiated market access to the EU without being in the EU. The problem is that both Norway and Switzerland have to accept Europe's "freedom of movement of workers," something which the "leavers" argue is one of the primary reasons for wanting to leave the EU. The "freedom of movement" is one of Europe's four core principles since inception, which is the free movement of: goods, services, labour and capital. Moreover these non EU countries have to contribute to the EU budget, without having a say in defining the rules around areas such as environmental standards and consumer protection.

Britain would attempt to sign bilateral trade agreements with other nations, including the U.S. but as discussed earlier these take on average 10 years and which is probably understated. Moreover, Europe has signed over 50 trade agreements globally, agreements that Britain would no longer be a part of. Even if it wanted to, the U.K. does not have the resources to negotiate multiple deals simultaneously.

The "leave" campaigners also exaggerate their case as they seek to appeal to those who have a visceral reaction to the oft tortuous relationship with the continent, predating the EU itself.

Immigration has become one of the dominant issues. "Leavers" say immigrants are coming to access U.K. benefits, health care in particular, and taking U.K. jobs.

There are around two million non-British EU nationals currently working in the U.K., as well as 1.2 million non-EU nationals, according to the latest statistics from the Labour Force Survey.

The notion that these people are taking jobs from Brits or coming to access benefits or keeping wages below what they otherwise would be, has been debunked. If anything, immigration has made Britain more productive, more competitive and wealthier than it otherwise would have been.

The other contention the "leave" campaign makes is that EU membership has not been worth it and costs too much. Yet as members of the EU, trade in the U.K. grew steadily as a percentage of GDP. Increasing trade might have occurred without membership, but it is difficult to make the argument that membership has held the U.K. back. In fact the U.K. has been one of the most successful nations economically within the EU.

The leave campaign has, to a large degree, successfully instilled the notion that the EU is a vast state enterprise that hoovers up the wealth of its members, and the U.K. in particular, with the cost of maintaining a bloated and inefficient bureaucracy. Most damaging is the notion that it also sucks the sovereignty out of its nation states through undemocratic rules whose ultimate goal is a political union.

The EU budget amounted to 0.35% of the U.K. GDP in 2015, an almost insignificant sum, and a far cry from the claims being made by the "leave" campaign.

Sovereignty is always a touchy issue but there is absolutely nothing that points to EU rules impinging on U.K. sovereignty with the sole exception of "freedom of movement." Leaving the EU would change little in terms of what the U.K. could do that it does not already. The U.K. has some of the most flexible labour laws in the world now. In no way has the EU altered any choices the U.K. has made in terms of its economic policy, nor political direction including war and peace.

In fact the U.K. already has the best of all worlds because unlike Euro currency treaty nations, it maintains its sovereignty over monetary policy, allowing it to competitively devalue against its EU trading partners.

A political union is the next logical step for Europe but this is for future generations in the most optimistic scenario. There is no political will, desire or environment to make progress on this front today.

So what if the Eurozone breaks up? Would Britain not be better off on its own?

A Euro breakup would hurt everyone including the U.K. But so long as the U.K. was still integrated in the EU and trading openly within the union, it would suffer no more than the rest, and possibly less given its more flexible workforce. Being outside would make it more vulnerable to be less desirable.

A Brexit would definitely be a negative for the future of the EU and the 50+ years of European prosperity and peace. Britain is one of the dominant voices by virtue of its size that can provide balance to Germany and France. Such a voice is arguably more important today given Germany is now the dominant partner within the EU and France is seen as its inferior counterpart.

Even if a "remain" vote provides a reprieve from those fears, they will not be going away soon. The malaise afflicting Europe and the rest of the world is still in the early stages of playing out. Austria just narrowly avoided electing its first extreme right wing president since WWII. Right wing, anti-EU parties are gaining ground throughout Europe.

For markets, this means continued periods of heightened uncertainty and volatility. A risk premium is warranted and likely to be integrated over time through lower valuations, to compensate for the risks. Those risks go beyond those discussed and include uncertainty in the Middle East, South China sea and global terrorism.

With respect to Brexit, the long-term costs associated with leaving outweigh potential gains. As Michael Bloomberg recently wrote on Brexit, "some risks are not worth taking." This is one of them.

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