"Politicians have the ability to foretell what is going to happen tomorrow, next week, next month, and next year. And to have the ability afterward to explain why it didn't happen."

Winston Churchill

Overview

Brexit, a contraction of the words "British exit," refers to the June 23, 2016 referendum by voters in the United Kingdom to leave the European Union ("EU"). The surprising outcome has injected uncertainty into financial markets, and triggered some major moves in currencies, bonds, and equity prices. In this paper we review and comment on the economic and political implications to this separation and financial markets.

History

The European Union is comprised of 27 nation members (post-UK exit) and was established officially in 1992 under what was called the Maastricht Treaty. It was heralded by then German Chancellor Helmut Kohl as issuing in a period of European unity that he called "irreversible".

Public perception of the EU, which was almost universally favorable when it was formed, changed because of three key reasons:

- Bureaucracy in Brussels (in effect, a quasi-government without a country) issued many regulations with little or no public input;
- Failure to provide an economic framework for sustained GDP or job growth; and,
- Border-free zone (resulting from the Schengen Agreement) created population control issues and unwanted immigration.

All three factors were implicated under the pejorative term "globalization" which became a battle cry of the Leave campaign.

The Brexit and nationalistic view was that globalization resulted in: (1) migrants taking jobs away from natives of affected countries; (2) a flood of cheap products from other world areas negatively affecting wages and benefits of middle class workers; (3) the highest income groups gaining assets and influence; and, (4) exorbitant expenses to support the EU bureaucracy in Brussels. Partially in reaction to globalization, angry populist movements developed in the UK, Europe, and even the US. The June vote in the UK was an affirmation of the power of this anti-globalization/anti-inclusive movement on a world stage. It's notable that the majority of voters over age 45 chose "Leave". In addition, the Brexit supporters were more rural, white and less educated than the Remain adherents, who were younger, more racially diverse, more urban and better educated.

Economic

The UK represents 18% of the EU's total GDP which represents 20% of the world's, implying that the UK accounts for roughly 4% of the world GDP. While meaningful, this separation is unlikely to precipitate a global recession. The EU banks have all promised to infuse liquidity into banks if they faced major withdrawals and to keep interest rates low. Thus, the world's financial system should be able to cope with the unpredictable twists and turns during the upcoming period of UK separation.

EU Country	GDP 2015 (billions €)	% of Total
Germany	3,025.9	20.7
United Kingdom	2,568.9	17.6
France	2,183.6	14.9
Italy	1,636.4	11.2
Spain	1,081.2	7.4
Netherlands	678.6	4.6
All others (19)	3,460.2	23.6
Total EU	14,625.4	100.0

Euro area GDP grew a modest 1.6% over the trailing year ending March, while the UK grew at a slightly faster 1.9% rate. Post-Brexit, we expect growth to slow for both areas, with a risk of recession for the UK because of the direct impact on trade and foreign investment coupled with the impact on consumer and producer confidence. Multinational companies may be unlikely to keep or increase their presence in London if they are uncomfortable with the uncertainty of regulations. Also, the red hot London real estate market is likely to cool. We expect European banks to maintain negative interest rates until economic activity improves.

The immediate impact since the vote has been a 15% decline in the British pound to a level below $1.30 per US dollar and a similar decline of 12% to the euro. This will be a severe headwind for UK buyers of imported goods and services and a tailwind to UK exporters.

Outside of Europe, Japan and China continue to struggle through material problems in their own economies and Brexit will not provide any benefit. The strength of the Yen on the Brexit news creates a problem for the export dependent Japanese economy and reduced foreign investment may curtail a weak economic recovery in the country. China, already dealing with oversupply, will most likely see reduced demand as a result of slower growth projections from Europe and the UK.

We expect that US exports to Britain will decline because of the currency effect but we will buy more UK products at lower prices. If the US dollar rises against the Euro as well as sterling, our domestic growth rate may be negatively affected. To keep our currency from moving much higher, we believe that the Fed will hold interest rates low until we see some sustainable recovery in Europe.

Political

There will be significant political fall-out from Brexit. Within the UK itself, we expect greater pressure from both Scotland and Northern Ireland (which both voted to remain the EU) to split from the UK and become independent.

In Europe, the popularity of highly nationalistic political parties (anti-immigration, anti-Brussels regulations, and anti-globalization) will be fueled by the Brexit vote. We expect other countries' activist political parties to insist on similar votes to leave the EU. These actions may create more headline news than reality, but no one took the UK Brexit odds seriously at first. The political uncertainty will cause market tension. It is worth remembering that Great Britain never embraced the Euro and is geographically removed from the Continent. We might expect that the governments across Europe to pay more attention to the type of angry voter who supported Brexit. This could result in some policy changes related to immigration, refugee resettlement, and austerity programs.
Russia and China have their share of political unrest but the citizens, currently, have limited outlets for their discontent.

The disaffection of many Brexit voters echoes the sentiment and views held by Donald Trump and many of his supporters. There are numerous differences in the US voter base compared to the UK, diversity being among the greatest, but polls have been very misleading throughout the primary season and the Brexit vote.

Financial Markets

The immediate reaction to the Brexit vote was a sharp market decline followed by a quick positive reversal that made up most of the loss. Markets hate uncertainty and the next few months are likely to witness continued volatility as the UK moves toward its separation from the European Union.

At Aureus, we believe the likely near-term implications include:

- The strengthening of the US dollar against the Pound and possibly the Euro. This will hurt US exports, sales and earnings of multinational companies, potentially lowering GDP growth. We will continue to favor companies with larger domestic exposure to the relatively stronger US economy.
- Continued market volatility. The S&P 500 rose 2.5% in the first half and we think that a similar result is very possible for the second half of the year as the US is considered a “safe haven” for global investors.
- Interest rates should remain low for longer than might have been the case without Brexit.

It is worth noting that the US economy has been improving with better jobs data, strong housing, strong consumer and corporate balance sheets, lower energy prices and generally moderating currency headwinds. While Brexit may create uncertainty, the risk for a recession in the US is relatively low and GDP could move toward 3% annual growth later this year.

We continue to recommend a portfolio with a balanced mix of asset classes, with more attention paid to equities for many clients. We believe that careful attention to the quality and strength of a company’s financials will be rewarded over time, and in a sustained low yield environment US equities remain an important source of potential return for investors. Over the coming weeks and months the market will continue to digest the implications of the Brexit vote. As we gain clarity over the fundamental implications to the financial markets and world economies, we will make adjustments to our asset allocation and equity portfolios.