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Challenging Conventional Wisdom
NEWSLETTER

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BREXIT – BRITAIN'S POLL AND EUROPE'S PROBLEM

The Brexit vote looms large on Thursday and given the volumes being written and said on the matter bears pre-emptive commentary.

The debate has been venomous and aggressive on both sides. "Establishment" bodies such as the IMF, OECD and EU & UK governments have loudly proclaimed "Armageddon" as the likely outcome of Brexit, while ex-Establishment voices such as Nigel Lawson and Norman Lamont decry that viewpoint. The debate from both sides has frankly been duplicitous and dishonest. Economists are hugely divided too; Nouriel Roubini says "disaster" while Roger Bootle says "won't move the needle". We try to cut to the core to help see the trees for the leaves.

When France and Germany founded the EEC, their intention was to drive the foundation of a United States of Europe. Britain by contrast, tended to view the community through a lens of free trade. Inevitably these attitudes had potential for future collision.

The Bremain camp highlight the access that EU membership provides business with easy trade terms. By way of example, 50% of the European HQ's of all non-EU global corporates are based in the UK.

Although the Brexit camp has diversified into the immigration discussion, their core has always been the economic sustainability issues that continue to plague the EU. To illustrate the point, the Greek economy (GDP) has lost over 25% since the Global Financial crisis. The only worse economic disaster in recent times (excluding war-zones) is Zimbabwe – and not by much.

So – not an easy choice. Where the Bremain camp (particularly "Establishment" bodies) have already done damage, is that the campaign to keep Britain in the EU has tended to favour intimidation over persuasion. The consequences of this to financial markets are that markets (and particularly £) have ALREADY weakened on concerns of a potential Brexit, but are primed to short term volatility either way. Reasonable short term estimates are for Sterling to rebound 5% on Bremain and to fall 10% on Brexit. That said, the whole point of your own currency (in trade terms) is for it to act as a shock absorber. This is why we are reluctant to accept the arguments of instant recession for Britain on a Brexit vote.

Scenario 1: Brexit wins

Should a Brexit come to pass, it would not automatically take effect. According to Article 50 of the Treaty on European Union, members that want to leave the Continental bloc must first negotiate the terms of their exit and develop a framework for their future relationship with Europe. This process can take up to two years. Until the exit negotiations are concluded, Britain would still be considered a full EU member bound by the bloc's rules and treaties, and would continue to be part of the EU until at least late 2018. Just because Britain votes to leave the EU, doesn't mean that they cut trade ties with Europe at all. Europe would also be a big loser in the event of Brexit; Britain pays in 12% of the EU budget – the only positive contributor other than Germany. It wouldn't be in the EU's interests to have hostile exit negotiations, though watch out for France adopting a "spoiler" role.

Scenario 2: Bremain wins

A Bremain vote is clearly the outcome financial markets and non-UK events watchers prefer. However the whole voting process has destabilised the British political establishment. For Europe – its back to a different kind of business-as-usual. The sustainability of the Eurozone has been heavily (and justifiably) questioned, and it's a genie that won't just go back into the bottle. Britain would prove that governments could successfully exact concessions from Brussels, as Cameron did, and then reaffirm their support at home. Few EU members are as influential as Britain, but Euroskeptic parties and moderate governments elsewhere in the bloc might start planning to make their own demands, and there is little Brussels could do to stop them from holding similar referendums. Kicking the can down the road is becoming less of an option, and the EU can no longer waste the crisis.

So what?

The bottom line is that (to para-phrase Nixon) this is Britain's poll, and Europe's problem. We think that there would be short term turbulence in financial markets, but we don't accept the systemic damage viewpoint. Any excessive pullback in markets is more likely to present a buying opportunity in equities - even European equities (which offer quite good value – unlike their bonds).

How likely is it?

Current bookies odds today have a probability of only 22% for Brexit (down from 38% a week ago), however the fact that the average Bremain bet is £320 vs an average Brexit bet of £60, suggests a skew in that data. We think it's much closer to 50/50 and that the issue may well be decided by the final impressions of currently undecided voters.

- Warwick Lucas

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