BREXIT: HOW MATTERS WILL PLAY OUT OVER TIME

by Milton Ezrati, Chief Economist, Vested

Though the British public has opted for great uncertainty, for itself and for others, markets and media discussion will nonetheless follow well-charted channels. This first and present phase will continue for a while to reflect panic. It should continue, with greater or lesser degrees of intensity for a while longer. In a matter of weeks at most, however, people will return to rationality and, as investors begin to weigh probabilities and distinguish between distant repercussions and more immediate concerns, markets will traverse most of the ground covered during the panic. Success then will depend on an ability to ignore the far-fetched and focus on the likely. Successful communication then will anticipate the next probability to occupy the media's focus. On both fronts, it looks as though the greatest investment danger and the greatest communication issues will lie less with the UK and more with the EU.

For Now, Elements of Panic

While this phase lasts, investors on balance will continue to flee the epicenter of uncertainty, in this case Britain, as well as risk assets generally. Stocks and commodities will continue to lose out to high-quality bonds. As for the media, this period of free-floating anxiety should allowed much latitude for vague discussion that distinguishes little between distant and immediate concerns and that talks possibilities without considering probabilities.

Throughout this time, the critical thing to keep in mind is that Brexit, for all the turmoil it will cause, will neither end the world nor destroy its prosperity. Even if the pessimistic estimates of Her Majesty's Treasury are correct, and the break with the EU costs Britain 7.5 percent of its gross domestic product (GDP) by 2030, the loss would still only amount to 0.5 percent of real economic growth a year, unpleasant to be sure but not the end for the British economy. It would still remain the second largest in Europe and fifth largest in the world. If the Confederation of British Industry is correct, the shortfall would come closer to only 0.2 percent a year in growth, certainly not the end of the world. Meanwhile, the world's major central banks — the Federal Reserve, the European Central Bank, and the Bank of England — have committed to calm market turmoil with injections of liquidity and currency swaps. The Bank of England has made clear its willingness to support the U.K. economy should the shock of separation lead to any acute economic problem. No one should pretend that matters are easy and economies, most notably Britain's, will avoid pain, but panic is certainly misplaced.

As the shock of the vote wears off and people begin dealing with realities instead of vague fears, market patterns, as indicated, will reverse. The flight to quality bonds that drove down stock prices in every major market as well as commodity prices will recover most if not all of the lost ground, including in Britain. Even sterling, which remarkably lost some 10 percent of its value against the dollar on the first news of exit, will likely recover at least some of its panic-inspired loss. Some in the media will treat this recovery as a new trend, when in fact it will simply correct for an irrational panic. In doing so, a lot of commentary will mistakenly describe the recovery as a change of heart. Successful communication will then direct the conversation to the more fundamental issues surrounding Brexit.

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EU Pains

Here, the threat is existential. To be sure, British trade is important. The continent exports more to the UK than it buys from it. The EU's economy will suffer until its members can make new trade arrangements, though probably less than Britain's will. But this matter is far from the real threat to the EU and continual European investing. That lies in the significant chance that other member nations will now follow Britain's lead and hold their own referendums on exit. Polls make clear that more than half the French and Dutch publics are dissatisfied with arrangements in the EU. Italy's Five Star movement has already called for a referendum. As a minority party run by a professional comedian, such pronouncements normally might not trouble EU leadership, but the party recently won 19 of 20 mayoral elections, including in Rome and Turin. In France, the National Front also called for a referendum on the "decaying" EU. If such a contagion gains momentum, the union could come apart. Though at the moment such an event is hardly likely, the prospect will nonetheless overhang investing on the continent for a long while.

Even if the EU avoids such extremes, Brussels is well aware that a powerful reform movement seems to have developed. Italian Prime Minister Matteo Renzi has led the charge on this front, pushing in some respects for changes similar to those negotiated by David Cameron before the British vote but also demanding that the stronger nations in the Eurozone commit more resources to the needs of the union as a whole and that Brussels find ways to mitigate the huge advantages current EU structures give Germany. British exit will if anything intensify such demands, from Italy but also from other members of Europe's periphery, Greece, Spain, Portugal, and perhaps even Ireland, which long has had disputes with Brussels over tax law. If the union holds together under this strain, it will surely become a different place.

As all these pressures become evident, the media's appetite for insights on this front will increase hugely. For investors, these unfolding pressures can cut two ways. Threats of dissolution could carry markets down especially in the stronger Euro-zone countries, but reform, by bringing fresh answers to the ongoing fiscal/financial crisis facing the continent, could buoy markets. In the interim, the reform push and any developing talk of referendums will continually raise market-depressing questions about the direction of policy, including of the European Central Bank.

Britain's Burdens

By comparison, Britain's problems are both more straightforward and more circumscribed. To be sure, the immediate political pressures are as complex and unpredictable as ever. Prime Minister Cameron has resigned. A leadership battle will now ensue within his Conservative Party for the Prime Minister's office. This fray will make it even more difficult for the authorities to perform the needed role of bolstering confidence in the economy's resiliency. Though no doubt many in the UK and US media will speculate on the outcome of this leadership battle, any investment bets on the outcome could only be described as a fool's game. There is, however, a comfort that unless matters reach extremes there should be no need for another national election anytime soon. In any case, the Labour opposition is in no position to push the matter. The Brexit vote shows that its two main constituencies, the urban elite and the working class, are pulling in opposite directions. Once a new leadership is in place, the relief should help risk assets in UK markets and the pound's foreign exchange value, too.

More imposing and longer-term in nature are the centrifugal forces already acting on Britain. The Scottish Nationalists have seized on the fact that Scottish districts voted to remain in the EU to press for a new referendum on independence. It does not help that German officials have indicated an EU welcome for Scotland in the event. Sinn Fein in Ireland has seized on the pro-EU vote in Northern Irish districts to argue for Irish reunification within the bosom on the EU. The Irish event is less likely to become a reality than are Scottish dreams, which themselves will remain only a distant possibility for some time, but both movements will nonetheless complicate the political horizon and introduce uncertainties for a while to come. As long as they remain only a threat, they are unlikely to interfere with the government's economic efforts, but it would be fun to chart Scottish reactions when, after complaining so much about London-imposed austerity, they must deal directly with the arch austerity master, German Finance Minister Wolfgang Schauble.

On the economic front, the crucial issue is trade. If the UK is anything, it is the quintessential trading economy. Over half its GDP concerns either imports or exports of one kind or another. The drop in the price of sterling against most other currencies may well improve Britain's trade balance over time, but the more fundamental issues will revolve around London's ability to re-negotiate its trade relations with some 60 of its trading partners, including the 27 remaining members of the EU. Right now, of course, Britain's trade arrangements with all nations go through the EU. Still, arrangements with the United States, Russia, China, India, Japan, for instance, should go quickly enough. Many countries have rushed to reassure London of their interest in reaching arrangements in the near future. Even President Barack Obama has done so, strange since just a few weeks ago he told Britain that it would go to the "back of the queue" on trade with the United States if it voted for exit.

The fly in the ointment on this matter concerns Britain's critical relations with the other members of the EU. To be sure, the UK in recent years has exported proportionally less than previously to Europe. Even so, almost half its exports go to Europe and almost 55 percent of its imports come from Europe. These will now be governed by Article 50 of the EU's Lisbon Treaty. Written to deal with matters of exit, it puts all the cards in Brussel's hands and allows it two years to decide on new arrangements, giving Brussels considerable ability to make things easy for Britain or not. Indicators on whether the European elite wants an amicable divorce or a spiteful one lie on both sides of the question. Some have spoken of making arrangements similar to the favorable situations of Norway and Switzerland. The Germans have pushed for a friendly departure, inventing the prospect of an "associate partner country" status for Britain. But for all these favorable indications, there is also a chance that Brussels may try to discourage other exit referendums by punishing Britain. In any case, a two year wait would make the adjustment hard indeed for all concerned. In the interim, while all wait for the EU, each successful deal Britain arrives at with nations outside the EU will lift markets and color media treatment favorably.

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The US and Pulling the Threads Together Panic

The UK's troubles, severe and wide-ranging as they are, pale next to the threat of dissolution to the EU. Even Scottish secession is less threatening to London than are the exit referendums among member states to Brussels. On this basis, UK investing, fraught as it looks now, has attractions over EU investing, while the most urgent media attention will almost surely shift in time from Britain to the continent. Against this background, U.S. investing offers a welcome environment of relative calm. To be sure, any weakness in the EU will force Washington to rethink its European security policies, and now President Obama will almost certainly fail in his ambition to sign the Transatlantic Trade and Investment Partnership (TTIP) with Europe before his term ends. But these are small beer next to the matters facing the UK and especially the EU. The media will need input on what the issues are, whether they are circumscribed or whether they are not. Of those, it should be clear, the most potential for fear and upheaval lies more with the EU than Britain and certainly than the United States.

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