BREXIT: The Basics

June 27, 2016

WHAT IS THE "BREXIT"?

The "BREXIT" is a catchy term used to describe the exit of Britain (also known as the United Kingdom) from the European Union (EU). Just as a quick reminder, the United Kingdom is composed of four countries: England, Scotland, Wales, and Northern Ireland.

The issue of whether or not to remain a member of the EU has been a topic of debate for years in the United Kingdom:

Proponents for staying in the EU argue that it is a stronger environment for economic trade because of its single market structure with no tariffs imposed on imports and exports. Additionally, "Remain" supporters claim that Britain is an important stepping stone for global businesses that desire to integrate more closely with the EU (primarily due to the use of the English language, flexible labour laws, and the ability to easily expand throughout the rest of Europe).

Proponents for leaving the EU argue that Britain does not have full control of its affairs, especially with respect to its borders. Supporters of "Leave" are concerned that the loose border policy between EU members and the lack of immigration control represent security threats. Given the apparent rise in terrorist activity over recent years, this has become a central issue. Additionally, some believe that Britain pays too much in EU fees while receiving too little benefit from the trade agreements.

On June 23, 2016, the United Kingdom held a referendum (a vote by the general voting public) to decide whether or not it will remain a member of the EU. There was much speculation prior to the event and both the "Remain" and "Leave" supporters campaigned passionately. In the days leading up to the referendum, public opinion polls indicated that Britain would ultimately vote to remain in the EU, and global stock markets were pricing in a "Remain" victory. The risk of a "Leave" victory was seemingly underestimated by the markets and BREXIT followers around the globe were shocked when the final results indicated that Britain had voted to leave the EU with a majority of 52%.

Following the results, a clear repricing in the markets occurred as the British pound (£) plunged to a three-decade low, global financial markets sold off, and investors fled to safe haven assets such as the US dollar, Japanese yen, gold, and sovereign bonds. Prime Minister David Cameron also announced that he will step down from his post by October and let his successor navigate the waters out of the EU.

WHAT HAPPENS NEXT?

Over the coming days, weeks, and months you will be bombarded with headlines, opinions, and predictions in regards to what the BREXIT means going forward. However, the fact of the matter is that nobody really knows what will happen – we are in unchartered waters. As of right now, it is generally expected that:

- Britain will wait until a new prime minister is elected to invoke Article 50 of the Lisbon Treaty – the formal request to leave the EU. Once this process starts, Britain will have two years to negotiate withdrawal terms and form a new trade relationship. There is a lot of uncertainty around how these negotiations will play out. If Britain exits on favourable terms it may prompt other countries in the EU to follow suit, which could lead to a collapse of the EU altogether. Negotiations may be bitter and drawn out to set an example for other EU members contemplating exit.
- Britain may try and model a new relationship with the EU based on Switzerland and Norway, which are both outside of the EU but retain deep ties with Europe in terms of trade. This model would free Britain from unwanted EU bureaucracy while still allowing access to the single market structure. However, it should be noted that Switzerland and Norway still adhere to the four principles of the single market: free movement of goods, capital, services, and people. Many supporters of "Leave" voted on the assumption that border control would be stronger and that Britain would no longer have to adhere to the "free movement of people" rule.
- Short term economic performance in Britain may be affected by reduced foreign investment, delayed consumer and business spending, and reduced hiring. This has already been present in the months leading up to the vote and will likely persist due to the long stretch of uncertainty surrounding exit negotiations. Longer term, global banks in Britain may relocate operations to other countries in the EU due to lighter regulation.
- The possibility of Britain entering a recession combined with jittery financial markets will likely influence global central banks to hold off on rate hikes in the near future.
- Scotland and Northern Ireland, which heavily supported remaining in the EU, may attempt to leave the United Kingdom and rejoin the EU independently.
- Financial markets will likely be more volatile in the short term.

At the end of the day, most of the BREXIT risk is longer term and political in nature. In the meantime, the majority of businesses in Europe will continue on as normal and any impact on the real economy in North America should be minimal. Investors with a longer term time horizon and diversified portfolio should not fret over short term market movements.

As always, QAM remains diligent and disciplined in the management of client portfolios. Furthermore, our external managers continue to manage risk through active security selection, sector allocation, and diversification.