Celebrating 15 Years!

THE LINNEMAN LETTER

Volume 16, Issue 2 Summer 2016

Brexit Shocks the Political Elite

In a resounding repudiation of the political class, on June 23, 2016, the citizens of the U.K. overwhelmingly voted to leave the European Union by a margin of 52% (17.4 million voters) to 48% (16.1 million). The 'British exit', commonly known as "Brexit", was opposed by all 5 U.K. political parties, as well as President Obama, Chancellor Merkel, and almost every political leader around the globe. The vote was framed as a choice between maintaining economic and political stability (the "stay" camp) versus national sovereignty (the "leave" camp).

The EU was established to be a powerful force for economic liberalization, with the objective of breaking down trade barriers and boosting European economies in the wake of World War II. However, over the past 10-15 years, the EU ceased being an economic liberalizing force. Instead, it burdened member countries with increased regulation, red tape, and bureaucracy, resulting in stifled growth throughout the region. The EU has become obsessed with resource redistribution across members, rather than economic liberalization, transferring wealth from financially strong countries such as the U.K. and Germany to struggling countries, such as Greece and Spain to be largely used on local "pork" projects. Beyond the issue of redistribution, those favoring Brexit are also frustrated with growing levels of immigration from EU member states created by the Middle East refugee crisis. Those favoring remaining in the EU argue that it maintains the certainty of the status quo, avoiding the unknown consequences of Brexit. For what it is worth, we would have voted to exit, as U.K. domestic policy cannot flourish when subjected to influence by French, Greek, and Italian politicians and bureaucrats. And we believe that sensible trade agreements will evolve over time. In addition, we believe that anything so broadly supported by the political class must be wrong!

Based on global stock market reaction, the Brexit vote caught financial markets off guard. On June 23rd, while the vote was occurring, the Dow rose by about 300 points, but when the results were announced the next morning, the Dow lost 3.4% or 610 points (the 8th largest 1-day point loss) on June 24th. Meanwhile, the U.K.'s FTSE 100 fell by as much as 8% on June 24th, closing with a loss of 3.2% after a partial recovery. In addition, the dollar/pound exchange rate has fluctuated wildly, dropping to a 7-year low of 0.73 the day after the vote. In the face of uncertainty, investors over-reacted, fleeing to safety. With Treasury yields already low, spreads will widen as investors move to safe assets.

What should you do in the aftermath of the Brexit referendum? Not much! However, since global stock markets took huge hits, it is a great time to buy low 'beta' assets – even if the outlook is negative in the short term. That is, all post-Brexit asset price betas temporarily converged on "1.0". Therefore, investors should invest in assets with historically low betas, as such assets will recover the most as conditions revert to norm. Theoretically, if an asset normally has a low beta with the market, say 0.75, it will lose more as short-term betas move to 1. In contrast, if an asset has a high beta, say 1.25, and its beta goes to 1, then the asset will lose less than under normal conditions. As a result, investors should take advantage of the assets which have temporarily fallen the most in value, as normalcy will eventually return.

Markets will return to close to normal in the long run, provided that nationalist tendencies do not override common sense. We predict that the U.K. will establish new trade agreements, which will be beneficial to all parties. With this in mind, we predict that the impact of the referendum will be negligible in the medium to long term. In the near term, investors will retreat to U.S. financial markets.

While the U.K. and the U.S. will likely weather the storm well, the future of the EU is at risk. First, without continued U.K. funding to poorer countries, either other wealthy EU countries will be required to make larger transfer payments to offset the loss of Britain's contribution, or lower transfers. Either scenario will increase anti-EU sentiments, creating the possibility of further EU exits. Further, since the EU is already highly unpopular in most every member nation, other citizenry will demand similar referenda, which will yield similar outcomes.

Editorial Staff: Peter Linneman, Ph.D., Deborah Moy, Nicholas DeLuna, and Diana Zhou