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BREXIT – The Prospect of Britain's Withdrawal (Exit) from the European Union

Less than one year ago, Greece faced expulsion from the European Union (commonly called "Grexit"). This was big news – a potential existential crisis for the European Union. Alexis Tsipras, the firebrand leader of the populist Syriza party, had recently been elected Prime Minister of Greece. He vowed to end austerity, and to demand debt relief from European and international "bureaucrats." Mr. Tsipras' game of brinkmanship ended in the final hour, as he reluctantly agreed to a deal that included significant austerity measures and no debt relief. Greece and the European Union ("EU") were on the brink of the unknown, and of a potential disaster. No country has ever left the European Union (of 28 countries), and procedures for doing so do not even exist.

Bo Bennett, PhD and author of Year to Success, once said that "Diplomacy is more than saying or doing the right things at the right time, it is avoiding saying or doing the wrong things at any time." Mr. Tsipras would have done well to heed this advice. On alternating days, Mr. Tsipras would lambast the leaders of the so called "Troika," and then negotiate with them, requesting relief from existing debt and previously agreed upon austerity measures. It's fair to say that Mr. Tsipras' grandstanding likely worked against him during these negotiations.

The same might also be said about David Cameron, Britain's otherwise diplomatically-skilled Prime Minister. During the period of the Grexit crisis, and upon growing impatient with complaints from within and outside his own party, Mr. Cameron agreed to call a referendum on EU membership if re-elected. "Euro-sceptics" believe Britain is being held back by the EU. They believe the EU imposes too many rules, and that membership is very expensive and offers little in return. While Mr. Cameron supports EU membership, he has at times criticized the ruling European Commission. He also promised to negotiate significant concessions from the European Union ahead of the referendum.

Mr. Cameron was taking a calculated, political gamble at the time. After all, polls consistently showed that the majority of voters wanted to remain in the EU. Most believe that EU membership provides an economic boost to Britain. Mr. Cameron believed that this referendum was an opportunity to silence the "Leave Campaign" once and for all, and to potentially negotiate even better terms from the EU in the process. In fact, Mr. Cameron was able to negotiate some concessions from the EU.

Mr. Cameron did not see the European immigration crisis coming. All member countries are now being pushed to accept large numbers of refugees and migrants fleeing Syria, Iraq, Afghanistan and other troubled countries. A majority of voters in Britain is against this mass immigration of poor, mostly unskilled immigrants, and especially resent being told to take them. The Leave Campaign is exploiting this sentiment. The polls have narrowed significantly.

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The referendum is currently scheduled for June 23rd. Big business, with few exceptions, is in favor of staying in the EU. This is no surprise since the EU was founded on the premise of promoting the free movement of money, people and products within the union. David Cameron and most in his party are also on the Remain side, although a number of high profile politicians have voiced their support to leave the EU. While we are very interested in how this works out politically, we are especially interested in how markets will react. Markets do not like uncertainty. Markets were choppy as the Greek Debt Crisis unfolded, and we would not be surprised to see the same effect, and then some, as Britain's referendum approaches. Note that Britain's economy (2015 GDP of $2,476bn) is nearly ten times the size of Greece's economy.[1]

Both pro- and anti-EU voices agree that the short-term impact of a Leave vote on Britain's economy (and its markets) is likely to be negative. Significant uncertainly surrounds international trade agreements, which would need to be individually negotiated, country by country. Most believe that other European countries would be loath to strike a good deal with Britain, which could potentially motivate others to leave the union. And Britain alone has less to offer international partners than that offered by the European Union as a whole.

Long term, the impact on Britain's economy is up for debate. A number of economic entities have weighed in, and their forecasts on the long-term effects on the economy range from a negative 5.50% to a positive 1.55%.[2] We are more inclined to believe that Brexit would serve as a drag on Britain's economy, negatively impacting corporate earnings and, as a result, the financial markets. While we expect that Britain will vote to remain in the union, and most of the recent polls do show the Remain side ahead, we cannot ignore the risk that it may not.

We are keeping a close eye on Britain's polls and the European markets. We have made modest reductions to our targeted European allocation, and we have been implementing this change over the past few months. We will continue to monitor the situation, and we will be in touch if we feel further changes are warranted. As always, please feel free to contact us with any questions or concerns.

1) The Economist, Pocket World in Figures (2015 Edition)
2) The Economist, Brexit Brief (April 9th-15th, 2016 Edition)

Sincerely,

Steven Criscuolo, CPA
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