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Brexit Aftershocks

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Wow, what just happened? Reactions to the Brexit

That the UK actually voted to leave the European Union was a surprise to many people throughout the world. This surprise has been reflected perhaps nowhere clearer than the financial markets. As the saying goes, the market hates uncertainty. And the “Brexit” sure causes a lot of uncertainty. Here are some preliminary thoughts about this:

Who wanted to Leave?

The coalition who made up the “Leave” voters are by no means a homogenous group. There are, as I understand it, two main factions within the Leave group. And aside from a desire to smash the mold, these factions share very little other political views in common. These two groups could be described as the *Nationalists/Xenophobes* and the *Freedom from Oversight* people.

- **Nationalists/Xenophobes** – Perturbed by increases in immigration, a group of voters saw the Brexit as a chance to stop immigration.
- **Freedom from Oversight** – This group wants to set up a Britain that is free from regulatory oversight by Brussels and the EU. They hope that their free market vision will lead to prosperity. The overwhelming majority of economists who weighed in on the Brexit campaign didn’t feel as optimistic.

Does this boost the xenophobes?

This has all sorts of ugly social implications (i.e., overt racism) but is also problematic because it’s not likely that the Brexit will reduce immigration. Leave leadership has already said as much. The realization that their anti-immigration vote will be ineffective will surely cause further rancor. So is this a boost to the xenophobes?

- **Yes** – This is probably a boost to the morale and ire of the white nationalists because they can march around claiming they’re taking their country back. So in the immediate term (as in, now) they can feel like they’ve won something big.
- **No** – The very day after the vote, Brexit campaign leaders began walking back their campaign promise on immigration, saying there’s no intention of pulling up the drawbridge. This won’t play well with the xenophobes, because they will view this as promises broken... at least on this point, they are correct. They were played, lied to in order to influence their votes. Also, the net economic impact of immigration to the UK was shown to be positive, meaning that immigration has been good for the economy in terms of taxes and economic contribution.

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Will the Brexit be a Benefit for the Freedom from Oversight Proponents?

- **Yes** – If Britain can now make its own way without needing to coordinate with Brussels and the EU, then they'll get to experience the joys of the free market: free floating currency, free flow of resources and trade, etc. It's a lovely fantasy.
- **No** – It's sort of preposterous from my view that people would expect this to be good for them in a free market sense. First, they better be careful what they wish for. The currency markets have emphatically voted *against* the Brexit as the pound and financial markets have plummeted. The free market is rewarding the Leave voters by shifting billions of dollars in wealth *out* of the UK and into other, safer place (such as the US). Secondly, the Leave voters are totally naïve to think that they'll have anything close to free markets in resources (labor is a primary resource and the other half other Leave coalition hates immigrants); and trade will not be free because they just voted to walk away from open access to the European market, meaning they'll now need to make individual trade deals with each and every remaining EU member.

What are Some of the Economic Impacts?

Exports for US firms. American companies that sell to the UK and Europe would be negatively impacted if those countries go into pullback or recession.

- **UK** – I read that the UK only accounts for some 3% of US exports¹. If this amount declines by 10%-20%, the net impact wouldn't seem to be drastic for total US exports.
- **Members of the EU** – The EU as a whole represents a larger trading partner. Depending upon how you measure it, the EU represents some 17% of US exports. While large, the impact has to be kept in perspective: even a 20% decline in EU buying from the US isn't, when taken alone, catastrophic.
- **Follow-on impact: ripple or butterfly effect** – If the Brexit causes problems beyond the UK and Europe to their trading partners, we could see a multiplier effect that could cause far-reaching problems. Whether this effect erodes in impact the farther it gets from the source (like ripples from a stone dropped into a pond) or is amplified (like the butterfly beating its wings in China which leads to a typhoon in Hawaii) remains to be seen. But it's probably the impact of these follow-on effects that should be watched the closest.

What About the Impact on Currency?

The British pound and Euro have declined steeply from the Brexit. The best way to understand this is to consider the rise and fall in a country's currency represents global confidence or lack thereof in that country. The US is seen as strong – there's relative confidence in the strength of our economy. Foreign investors move money into American investments (of all sorts) which drives up the value of the dollar and causes the value of their domestic currency to fall. The opposite is happening right now to the UK. Investors are moving money by the truckload out of UK investments, causing the value of these investments and the value of the British pound to fall.

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Whether this is a good or bad thing depends upon where you sit. If you're an American buying anything British, you can now buy more with your US dollars. But if you're British, you now earn less US dollars than you did just a short time ago. This could be bad for you, especially because you now probably want to own more dollars (because the US dollar is a safer currency). And most importantly, all of their imports are much more expensive. So in the midst of social and political turmoil in the UK, they now also get to have higher prices. Sounds like a fun summer.

Commodities Are Impacted Too, Right?

Yes, commodities, often called *hard goods*, are impacted directly. Commodities are often volatile. And with the Brexit there are some winners and a lot of losers.

- **Gold** – This is where people put their money when disaster strikes. Gold tends to rise in times of fear and cynicism. Many people see gold as a kind of original currency, so perhaps the safest of all. I don't so much agree. It's hard to buy other goods and services with gold and it would be highly regulated and hoarded by governments and tycoons if other currencies declined too far. Finally, gold is often mined in countries with poor regulations by people whose lives are akin to slavery. That's a hard sector for me to admire as a long term investment. Though as a cyclical hedge, it's certainly looking strong at the moment.
- **Other commodities** – Consider the raw materials used to make up the things we eat, build, consume. These raw goods are the starting point in the processes that give us the goods and services we need. If there's a global recession and we're going to need much less of them, then their demand (and value) can fall quickly. Also, currency fluctuation can wreak havoc on commodities, which is another factor here. Right now, both the fear of recession and the impact of currency fluctuation are causing havoc in basic materials or commodities.

With So Many Negative Impacts, What Does this Brexit Resolve, Anyway?

I have to say I don't think the Brexit resolves much; and it causes a lot more problems than solutions. It seems that voters wanted to register dissatisfaction with the powers that be (or that *were*). The xenophobes (should I just call them the racists?) were sick of losing their jobs to people who weren't British enough and wanted someone to do something about it. The free marketers were sick of all that cumbersome coordination with the EU and want to be left alone to operate in an unencumbered marketplace. But they were I think actually duped by their leaders. Leave leadership is pledging that immigration will continue. And I read today that Leave leadership is hoping to maintain access to European markets (in fact they must retain access to the EU consumers!). This will require trade deals, which will require coordination and oversight, which is what they already have. Maybe they think that this will bring them better trade deals with every single trading partner in the EU than they already enjoy as part of the EU, but that sounds kind of backwards.

Another area in which Leave voters seem duped is in promises that were made to them around a national health care system. Some 250 million pounds per week is being sent to the EU as a sort of tax² and Leave voters were promised (in speeches, TV advertisements, etc.) that this money would be redirected towards national health care. This apparently sounded intriguing to many voters and influenced their decision

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making. Too bad it's not true. Leave coalition politicians have no intention of following through on that. In a Washington Post article I read this morning, Nigel Farage leader of UK Independence Party says that people "made a mistake doing that," meaning they made a mistake if they believed the promise about funding national health care.

There seems to be a great deal of voter remorse in the UK right now. People got swept up in their protest vote and now have an absolute mess on their hands. It's like they wanted to be able to say they registered their displeasure with their vote, but didn't want a majority to agree with them.

It's enough of a mess that it makes me wonder whether the Brexit will actually even happen anyway. The market hates this, the economists and politicians hate it, the corporate community hates it. Pretty soon I suspect many of the Brexit supporters will hate it (as they realize the broken promises they fell for). Anarchists might like it. Racists might like it. Let's hope they don't represent a voting majority in the UK (they don't).

What's the Impact for Investors

For UK investors, that this is so bad is perhaps the only good news. Maybe the actual implementation will in some way not be as bad as it looks right now. That's not a lot to hang your hat on... they screwed up. Royally.

For the US, this is generally not a good thing, though some positive feedback loops aren't hard to envision. First the bad: turmoil in Europe is not good for the world or the US. The turmoil could worsen as Leave proponents grow more angry and disillusioned over how this vote doesn't resolve their problems. In the immediate term, the impact is negative in most quarters (except gold and doomsday survivalists). But the larger structural impacts will take many years to fully play out. A great deal of money will leave the EU and flow into safer markets. The US will be the biggest recipient of these flows. The impact on US capital markets may be hard to sift out. Stocks will fall as investors digest the impact of reduced growth projections. Some of the negative impact on stocks will be offset by the increased cash inflows. There are many sectors in the US that used to see UK firms as their biggest competitors (such as banks, IT firms, and aerospace). Big contracts that may have gone to British firms are now much more likely to go to the more stable US counterparts. This is definitely good for US corporations.

Finally, much has been written about the lessons US voters might learn from this situation. Be careful of getting what you wish for seems to be the common theme. Who knows how much domestic US voters will be affected. Ardent supporters of their candidate will probably see in this a reason to strengthen their resolve (confirmation bias). Those on the fence may well be moved to make a safer (more conservative with a small "c") vote. Spain just saw this in their own elections where fans of Venezuela's disastrous policies were gaining strength, only to see that dissipate after the Brexit vote came through.

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One of my favorite (or should I say favourite) Winston Churchill quotes about the US goes something like this: “Americans will eventually do the right thing, after they’ve exhausted all other options.” Looks like the same cannot be said for his countrymen.

¹ <http://atlas.media.mit.edu/en/profile/country/usa/>

² <https://fullfact.org/europe/our-eu-membership-fee-55-million/>

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