Mimosa Investment Management

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Brexit - The Known and Unknown

On June 24th the United Kingdom (UK) voted 52% to 48% to exit the European Union (EU). This result surprised most pundits and the London bookies, who had anticipated the majority would vote to remain in the EU. The British prime minister, David Cameron, resigned immediately, and the stock and bond markets reacted violently in the short term. The galvanizing issue, according to the polls, was the inability to control immigration into the UK from other EU members. There were significant numbers of Romanians, Poles, and other Eastern Europeans who had immigrated to Britain over the past 10 to 15 years. They changed the makeup of many towns and small cities. Those areas voted overwhelmingly to leave the EU.

Immediate Knowns

Since Britain has maintained its own currency, the Pound, this is an easier transition for them than it would be for almost any other EU member. The Pound did lose over 10% of its value vs. the US dollar, falling from $1.50 to $1.30 in the initial reaction.

The increased uncertainty in the Eurozone has and will continue to make US investments more attractive. Not to mention the negative interest rates in much of Europe and Japan, which is resulting in funds flowing to US bonds and driving our interest rates to record lows, below 1.35%

on a 10 year US government bond in early July.

The UK's sovereign credit rating was downgraded by at least two of the major ratings agencies. Both agencies also maintained negative outlooks on UK financial strength due to the likelihood of an abrupt slowdown in economic growth.

Unknowns

The question now is whether the EU can hold together, or will this be just the first domino to fall? The EU and in particular the Euro currency has been a grand experiment since day one. Never has a single currency been utilized by a group of countries who are governed so differently.

The new British prime minister, Theresa May, has agreed to enforce the Brexit vote and not propose a second referendum favored by many. The EU is anxious to remove the UK quickly to begin moving forward without the Brits. However, the Brits must negotiate new trade agreements with the EU, as well as all of its remaining major trading partners. This will undoubtedly take several years.

Scotland and Northern Ireland voted heavily in favor of staying in the EU. The Scots held a vote of their own in 2014 and narrowly voted to stay in the UK. Certainly, the Scots will be pressing London to hold another referendum in light of the Brexit decision.

London is a major financial center for Europe and the world. Business spending and investment will likely slow until the new order is established. The resulting economic slowdown will cause the Bank of England to reduce short term interest rates further. As ten year yields are already under 1% there, this may be the next major economy to experience negative 10 year yields.

The Vote

Overall the Brexit vote was a major surprise and illustrates the growing discontent among middle and lower class citizens in developed countries. They've lost significant jobs and had little to no increases in income over the past 10 to 15 years. They are frustrated with their governments, and have become disillusioned with globalization. This is evidenced in the US by the surprising success of Donald Trump's candidacy, and to some degree the campaign of Bernie Sanders. Over the next three to five years, we'll need to watch closely future developments, as the global economy has certainly benefitted from the free movement of goods and services over the past twenty years.