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A comment on BREXIT

Dr Woody Brock | SED | 07 July 2016

We are as confused as everyone else is about the Brexit vote and what it implies. One reason why it is so difficult to hold any conviction about the future is that, despite a widely publicised referendum, nothing concrete has actually transpired to alter the Anglo-European status quo. It will be months if not years before changes in immigration and/or tariff policies actually are implemented, if they ever are.

The *unconditional* probability distribution over future possible outcomes is extremely "flat." That is, there is no meaningful "most likely" scenario to bet on. This is true for three main reasons.

1. No one knows who will be in charge either of Britain or of implementing Brexit, if it occurs. Today's power vacuum is quite astonishing. Hopefully, the next Prime Minister will be someone who is not a controversial drama queen, but rather a competent and boring politician focused on the art of compromise, both within the UK and in dealing with Brussels across the channel.

2. Regardless of who is next in charge, no one knows whether Parliament will vote for Article 50 or not during the next six months, and thus whether Brexit will occur. Keep in mind that the recent referendum is non-binding, having no direct policy implications. An act of Parliament is required to invoke Article 50, as we understand it.

3. Whatever Brexit politics are today and have been for the past few months, they will surely change significantly during the following few months before any actions are taken.

> More specifically, as more and more UK citizens learn about the true economic costs that Brexit will impose on the British economy, the percentage of UK citizens who would vote to "remain" in a second referendum will probably increase from the 48.1% who voted to remain in June to perhaps 55% by November.

Should this occur, then either new polling information alone or a second referendum could give Parliament the political cover needed *not* to proceed with invoking Article 50. This assumes that the new government (whether labor or conservative) is flexible and willing to backtrack on immigration. The latter will prove the great sticking point in dealing with Brussels – which simply cannot let the UK have its cake and eat it too when trading off immigration control against the economic benefits of full EU membership.

At present, the consensus is that the UK will not back down in demanding immigration control. However, it may well do so if enough citizens come to appreciate the *true* adverse economic impact of Brexit on their own livelihoods. They did not appreciate this prior to the 24 June referendum given the inflammatory nature of the LEAVE campaign. But a social learning process is now underway, and this will impact the future politics surrounding Brexit.

> There is an important bargaining reality that will guide negotiations during the months ahead. This is the reality that both the UK and the EU will lose a lot should Brexit occur. Thus there is a strong incentive for both sides to work out a "remain" compromise of some kind.

RELEVANCE OF BREXIT TO THE ECONOMY AND MARKETS

The Main Street reality is that Brexit will hurt everyone involved more than was admitted during the campaign. By October, a slate of new economic analyses will have been published that should convince more and more citizens that growth and corporate profits will both slow, and that unemployment will rise, should Brexit occur.

The most important impact on the financial markets will be a growing realisation that economic and profit growth will slow due to heightened uncertainty. The imposition of tariffs and the loss of many forms of cross-border efficiencies will be costly. The impact on inflation is ambiguous since higher operating costs will offset weakened demand for goods and services.

During the past few years, we have expressed the view that the era of great wealth growth in Europe and in the US during the past few decades is over. We have explained at length why wealth growth was so great between 1985 and 2015, and why wealth growth during the next few decades will be about one fifth of what it has been. Should Brexit occur, it will prove yet another nail in the coffin of both economic and wealth growth.

Perhaps most important to the markets if Brexit occurs will be a growing fear that several European nations under the sway of populist politicians will wish to renegotiate their own terms of EU membership. Indeed, should Brexit occur, it is very likely that the European project we have witnessed during the past 30 years will come to an end. We will witness a sequential Prisoner's Dilemma game, vast in magnitude and long in duration. As is well-known, the unique Nash equilibrium of such games is that everyone ends up worse off. This is the greatest risk at hand.

ENDOGENOUS RISK AND HEIGHTENED VOLATILITY

Given these realities, investors should expect heightened volatility, not only of stocks, but even of government bonds. The reason for this will stem from the increased magnitude of "Pricing Model Uncertainty" in global markets. Recall from past essays that PMU is a measure of the degree to which investors do NOT know the correct new price of an asset when they receive "news" impacting its price. That is, they do not know the correct new price of the asset that is consistent with the new news. One of the reasons why classical efficient markets models proved unable to explain some 80% of real-world observed volatility was that they assumed no PMU at all. When there is none, when news is announced traders immediately settle on a new price that they all know to be the right price. As a result, there is no overshoot or undershoot and hence there is little volatility.

The concept of PMU and an understanding of its impact on volatility is only a decade old. It is still not understood so that even today, virtually all models assume that all investors know the correct price given any news. This assumption applied pretty well to domestic US bond yields where, given the lack of any creditworthiness problems, news about inflation and the Fed would completely determine the correct new long-term yield. But this assumption did not apply at all to DOT-COM stocks where no one had a clue how to value, say, changes in earnings per share, assuming that there were any earnings! Was the correct P/E ratio 10 or 700 for Brock.com?

> What mattered was that everyone knew that no one knew the correct value. Invoking a deep theorem in the theory of games with incomplete information, the author showed a decade ago that this uncertainty will cause massive price overshoots and undershoots, in other words excess volatility. No assumption of investor irrationality was needed to arrive at this conclusion.

In the case of Brexit and the future of Europe and the euro, there will be heightened PMU even in the case of formerly credit-risk-free government securities. For no one will know how to interpret the impact of the peculiar and unprecedented news that lies ahead.

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Woody is a regular Faculty member at PortfolioConstruction Forum programs. This article is reproduced with permission.
