The coming EXITentialist crisis

Marko Papic | BCA Research | 27 June 2016

- Even alarmists like us have been surprised by the referendum outcome;

- The referendum is a major break in the 70 years of European integration;

- It will reinforced multipolarity and increase global geopolitcal risk;

- The UK, however, is an outlier in terms of Euroskepticism;

- No other EU country is likely to vote to leave the EU, although tail risks are up; and,

- Watch for the "Who is next" premium to be applied to European assets, and the "reflation trade" is likely over for the time being.

INTRODUCTION

> *"Since they will overload my shoulders," quoth John, "I shall throw down the burden with a squash amongst them, take it up who dares."*
>
> – John Arbuthnot, complaining about Europe's treatment of Britain, *The History of John Bull* (1712)

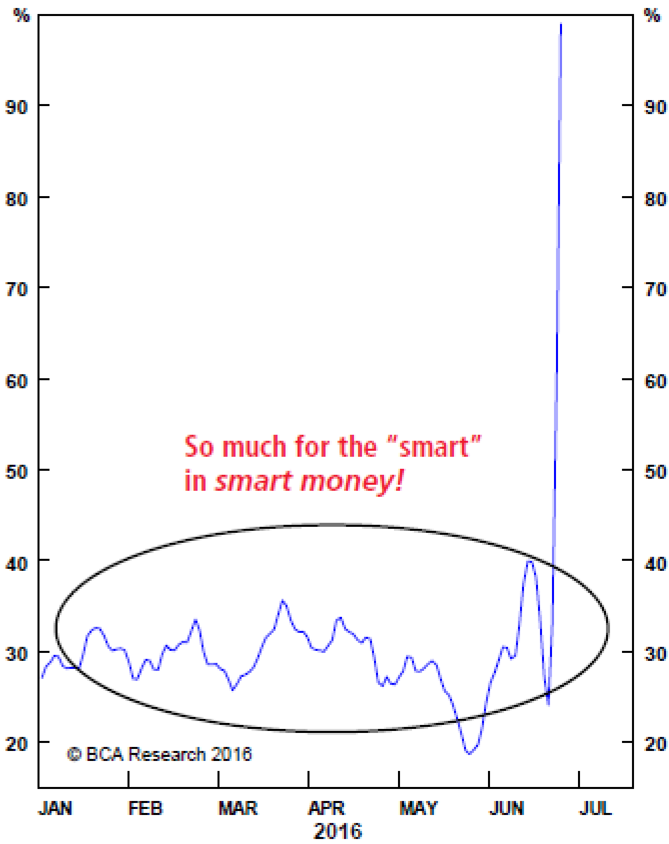
British voters have chosen to leave the European Union. The outcome caught most forecasters by surprise, including the "smart money" of the betting markets (refer Figure 1). We are not as surprised, since we raised the possibility that the conventional view was wrong as early as March and called the referendum "too close to call" in our last missive.[1] However, we also thought that the narrow polling would push voters towards the status quo in the last minute.

In this analysis, we offer our view on three questions:

1. What is next for the UK?
2. Who is next in the EU? Is a risk premium even appropriate?
3. What does this mean for broader global stability?

We conclude with investment implications.

Figure 1: So much for crowd wisdom
Probability of Brexit vote outcome "Leave"



Sources: BCA Research. Average of data from oddschecker.com and predictit.com

1. WHAT NEXT FOR THE UK?

In our report last week, "Break Glass To Brexit," we outlined some of the likeliest next steps after Brexit. These have not changed.

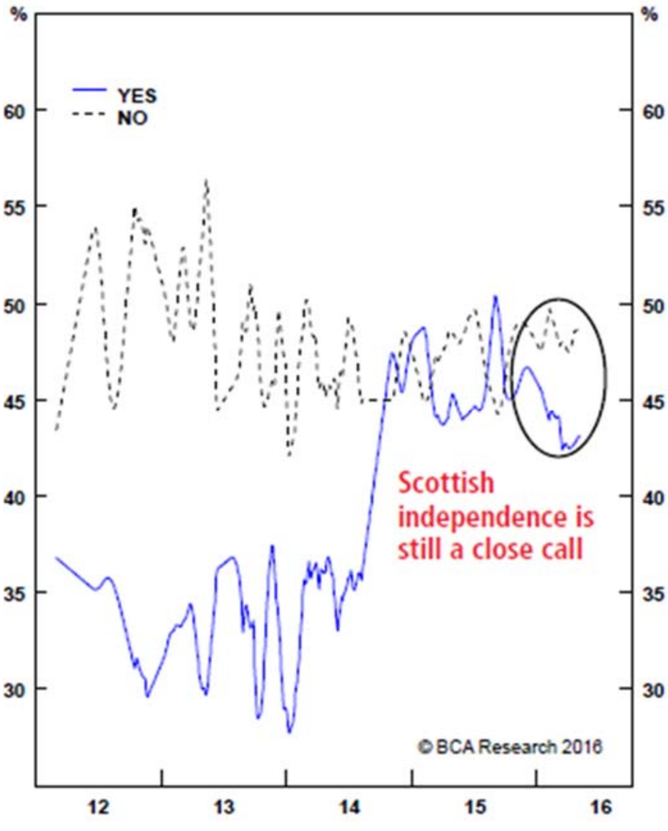
- **Cameron's fate and the Tories** – Leaders who stake their credibility on a referendum typically resign if they lose the vote, as with Jacques Parizeau in Quebec or Alex Salmond in Scotland. Cameron has similarly stated that he will resign by October. This introduces greater political risk into British politics. In particular, any economic risks emanating from the referendum will be blamed on the Tories. The Labour Party stands to benefit. Under Jeremy Corbyn, it has turned more left-wing than any opposition party since the 1980s. But Labour MPs could also ditch Corbyn in an effort to capitalise on Tory disintegration. British politics will be a rollercoaster for quite some time. The last time the Conservative Party imploded over Europe, a Tony Blair-led Labour waited in the wings. This is not the case today.

- **Article 50 of the Lisbon Treaty** – The process of leaving the EU requires the departing member-state to invoke this article, which provides for a two-year period to negotiate an exit that should take account of the state's obligations and future relations with the union. No country has done this before so it is not clear how exactly it will happen. A coming meeting of the European Council provides an opportunity for Cameron to announce the country's intentions. But the government has an incentive to wait before initiating the two-year countdown process until it has formed a negotiation plan, since the EU is likely to take a hard line on the UK's access to the common market. It should be noted that the two-year negotiation timeframe is not firm. The UK could withdraw precipitously, or, with approval from all member states, it could negotiate for more than two years.
- **Another Referendum** – Yes, it is possible for another referendum to be held. In fact, the "Leave" vote champion, former Mayor of London Boris Johnson, raised the possibility of a second referendum when he announced his support for exit. Perhaps one could be held after the UK ends its negotiations with the EU. The problem is that we doubt the EU will concede much, since that could lead to a chain reaction in Europe. As such, it will depend on the UK's political circumstances whether a new referendum is held.
- **An Act of Parliament** – Formal withdrawal will require an act of parliament, since, for instance, the 1972 European Communities Act ensures that the UK automatically incorporates EU directives into law and has hitherto been interpreted as establishing the priority of EU law where it contradicts British law. That is a key motivation of the sovereignty argument behind Brexit. The law will have to be replaced if Britain leaves. Notably, the referendum itself does not have any legal consequences. It is a dead letter without a government decision to enact it. That decision should be forthcoming in a mature democracy where the result is clear and uncontested. However, the political aftermath could lead to a parliamentary dissolution, with some groups hoping to delay the country's exit or hold a second referendum.
- **Scottish Referendum** – Scots voted 62% to stay in the EU, versus England's 53% to leave, which throws into stark relief the differences in points of view between the two countries. The UK vote has reinvigorated calls for independence almost immediately, with the First Minister Nicola Sturgeon already calling for a new referendum. The failure of the Scottish independence referendum in 2014 has not extinguished the desire to leave (Figure 2 below), although we suspect the collapse of oil prices may at least raise the economic bar of independence. The Scottish National Party has swept into almost total control of the Scots parliament since the referendum failed. Scotland, by comparison with the UK, is a disproportionate beneficiary of EU transfers. During the 2014 referendum, the EU pushed against Scots independence, but it may not do so the second time. The loss of Scotland would jeopardise British

energy and naval advantages as well as create various internal political risks across the British Isles for the future.

- **Tensions in Ireland** – Northern Ireland, like Scotland, benefits from EU funds (like farm subsidies) and voted 56% to remain. It too has groups aggravated by England's vote carrying the day. Any separation of Scotland would motivate forces both in Northern Ireland and in the Republic of Ireland to push for a unified Irish island state. That will aggravate political and sectarian tensions that have only quieted down since 1998 and were even showing a few signs of heating back up before Brexit. Thus, Brexit will force Westminster to devote greater attention and resources to re-establishing the UK's compact with its constituent countries.

Figure 2: Scottish Independence – a yearning not yet laid to rest
Scottish Independence Referendum



Source: BCA Research. UK polling report, YouGov and whatscotlandthinks.org

The Bottom Line

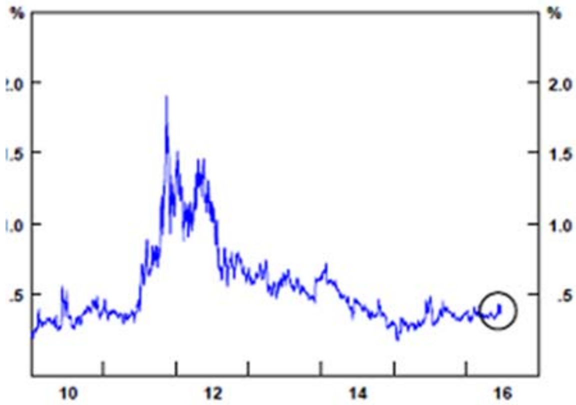
Political uncertainty will rise across the UK due to Brexit. If the decision to leave the EU stays, we believe that the UK may cease to exist as a unitary state. However, the referendum may not be the last word on EU membership.

2. WHO IS NEXT?

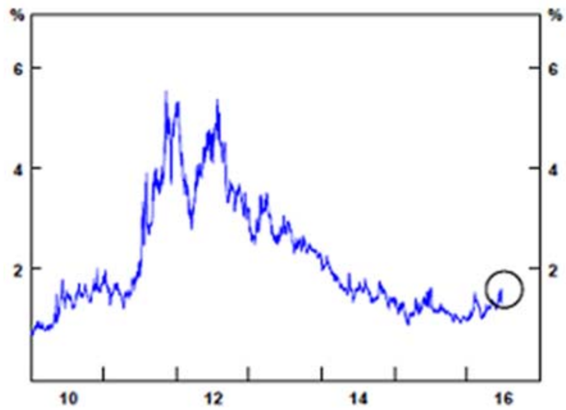
The immediate question investors are asking is, "Who is next to try to leave the EU?" Already, the "Who Is Next Premium" is infecting Mediterranean European bond markets, with peripheral spreads up across the board (Figure 3).

Figure 3: The "Who is Next? Premium"
10-year government bond yields

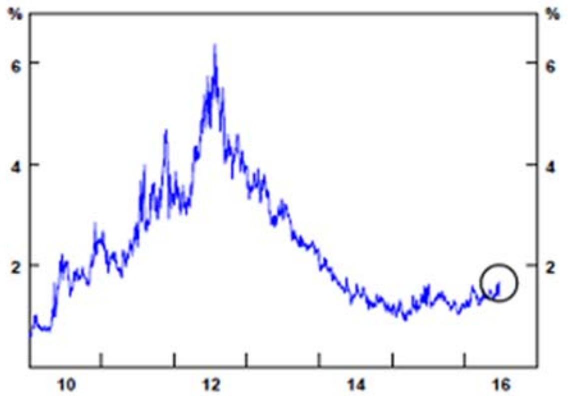
France minus Germany



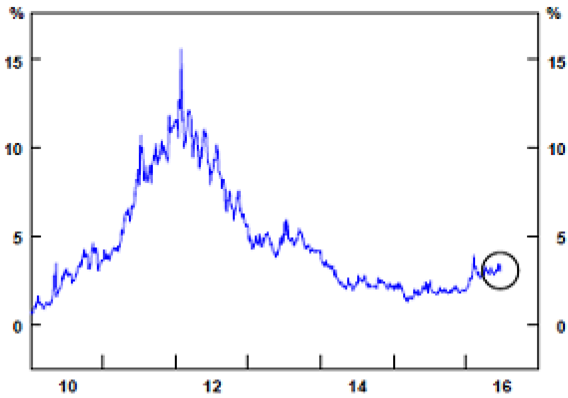
Italy minus Germany



Spain minus Germany



Portugal minus Germany

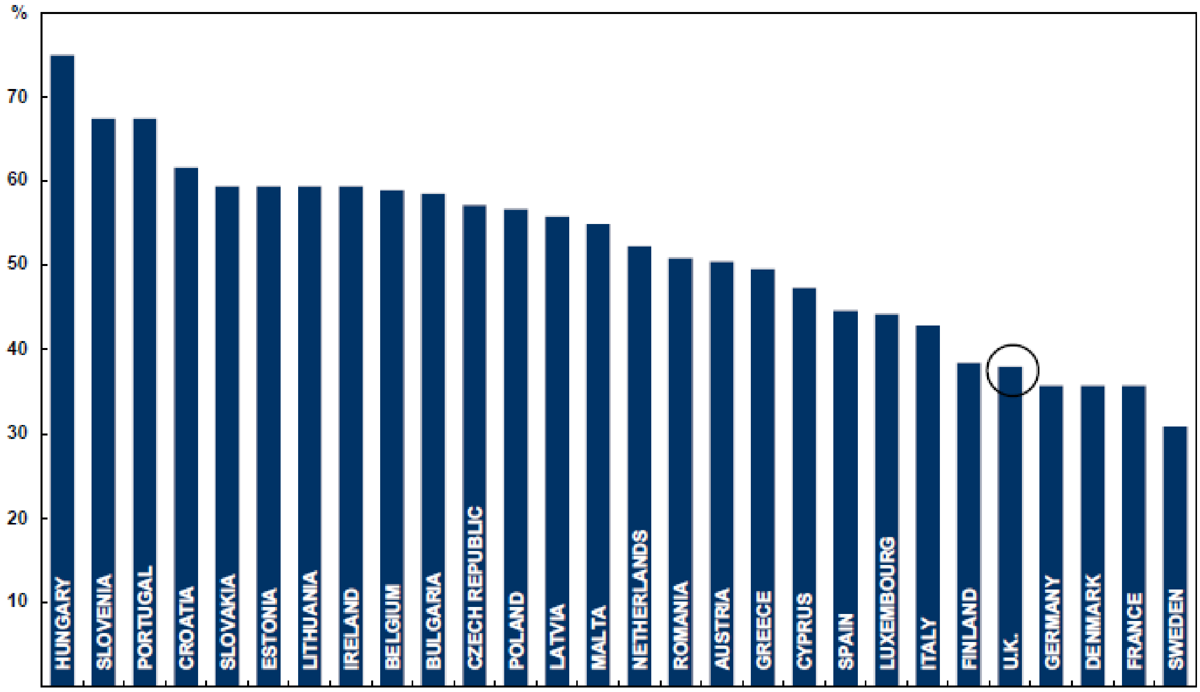


Source: BCA Research

To simplify the answer to this forecasting challenge, we developed an EU Dependency Index (Figure 4).[2] It combines six economic and financial factors to determine which member states have a high bar to clear in order to leave the EU.

As with all indexes, one should take its conclusions with a grain of salt. But, generally speaking, the results are helpful. For instance, Hungary is more constrained in leaving the EU than Sweden. Hungary's trade is almost exclusively with EU member states, its interest payments as a percent of GDP are high (and would become higher post-EU exit), and it benefits the most from structural funds from the EU. Leaving the bloc would be a painful decision for Budapest that would undoubtedly leave the country worse off.

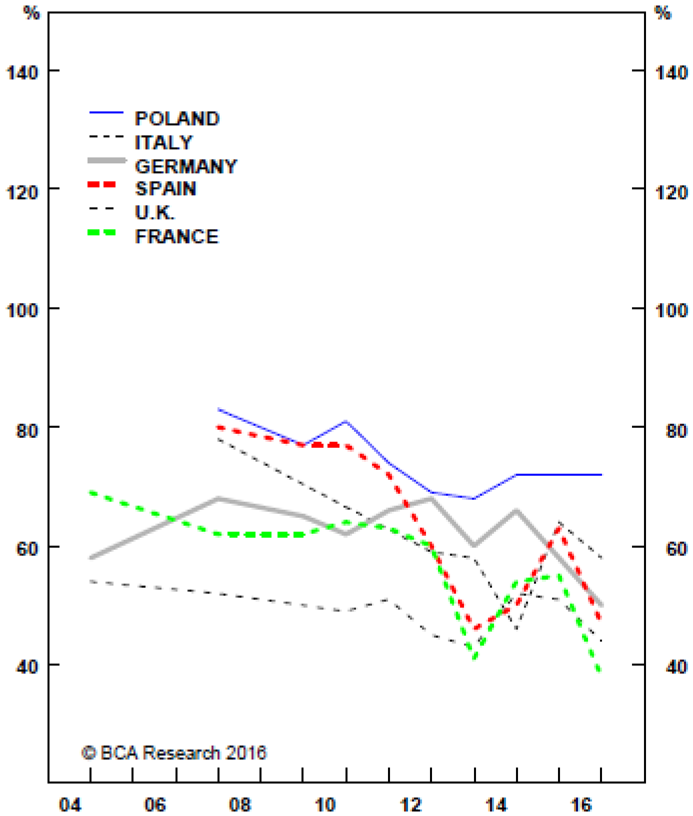
Figure 4: Constraints to leaving the EU
EU dependency ratio



Source: BCA Research
Notes: In order to measure each country's dependence on the EU, a ranking system was compiled based on six factors (all as a percent of GDP): 1. trade balance with the EU; 2. total exports; 3. debt interest payments; 4. gross government debt; 5. foreign direct investment; and, 6. net transfers to the EU. For each factor, a ranking of 1 indicates the least dependence, and a ranking of 28 indicates the most dependence. All the rankings are then added up across the factors to gauge the aggregate dependence of each country (taken as a percent of the maximum dependence).

One set of factors that our index does not measure is geopolitics. Central and Eastern Europe, as well as Cyprus, are members of the EU for more than just economic benefits. In the case of countries like Romania and Poland, the EU is seen as another layer – on top of NATO membership – of security guarantees vis-à-vis Russia. (For Cyprus, the EU is a form of security arrangement against Turkey.) In the oft-cited 2016 Pew Research poll showing a decline of support for the EU, Poland remains the most supportive with a 72% favorable rate (Figure 5). Hungary is not far behind. Both countries are led by rhetorically Euroskeptic right-of-center parties, but the reality is that they will not contemplate exit.

Figure 5: Falling support for the EU
Percent of respondents with a favorable view of the EU



Source: "Euroskepticism beyond Brexit", The Pew Research Center.

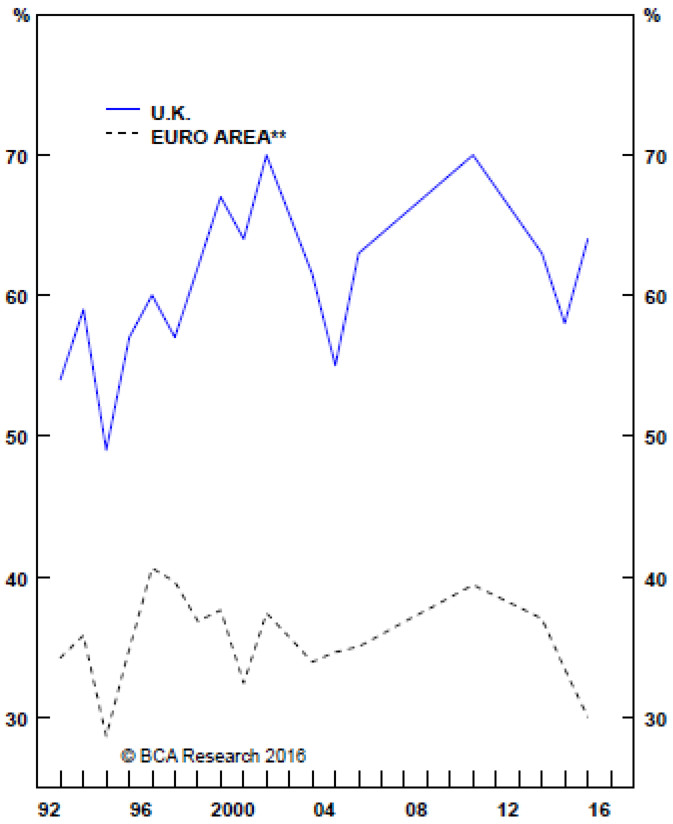
By focusing on the lower end of the dependency index, we can isolate the countries that are the least constrained economically in pursuing a break with the union. We will therefore focus on the Netherlands, Austria, Greece, Spain, Italy, Finland, Germany, Denmark, France, and Sweden. This is not to say that the other countries on the index do not have Euroskeptic movements, but only that we do not take them seriously.

How do our selected EU member states stack up against the UK?

First, as we argued earlier this year, the UK stands out for Euroskepticism. In our view, it has the lowest political, economic, financial, and geographic constraints to exiting the bloc. This is born out in data. In particular:

- **Identity** – The British have never felt comfortable defining themselves as European (Figure 6). Meanwhile, the sense of "Europeanness" has actually risen in the rest of Europe since 2010.

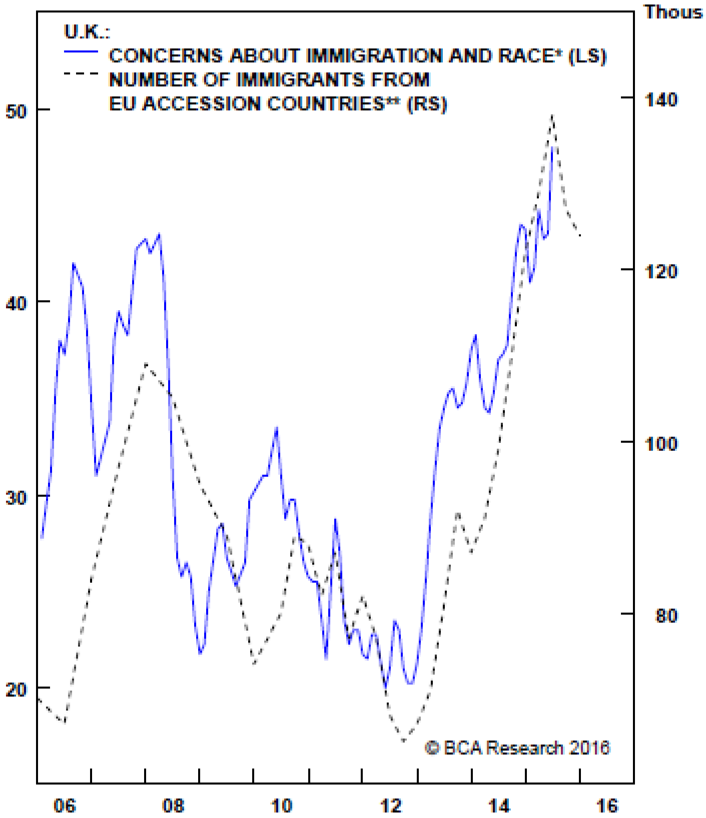
Figure 6: British identity has always stood apart
% of respondents identifying only with their nationality and not also as "European"



Source: Eurobarometer. Includes Germany, France, Italy, Spain, and The Netherlands.

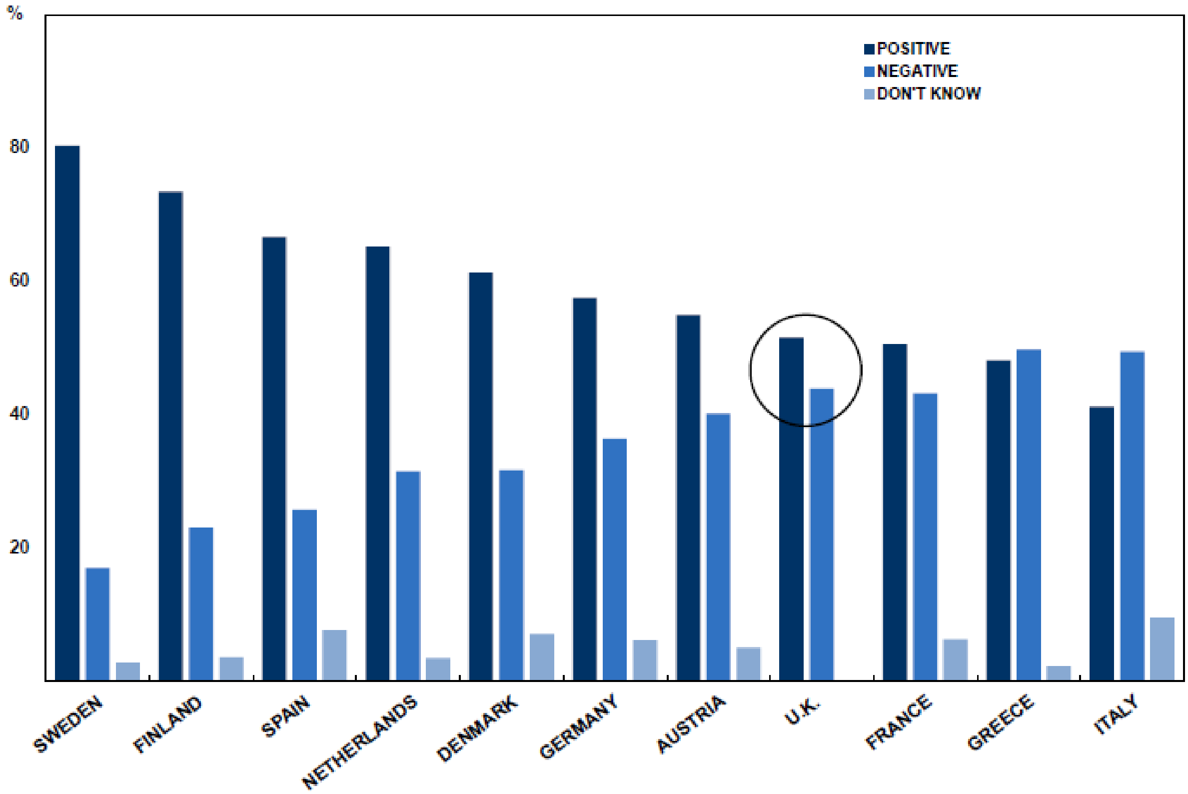
- **EU Immigration** – In our view, the issue of intra-EU immigration carried the day for "Leave" on 23 June. Polling data revealed that this issue, perhaps more than any other, was a source of consternation among UK voters (Figure 7). The feeling is not mutual across Europe (Figure 8), although France and Italy are similarly split on the issue.

Figure 7: EU emigration: A concern in Britain



Sources: IPSOS MORI, ONS.

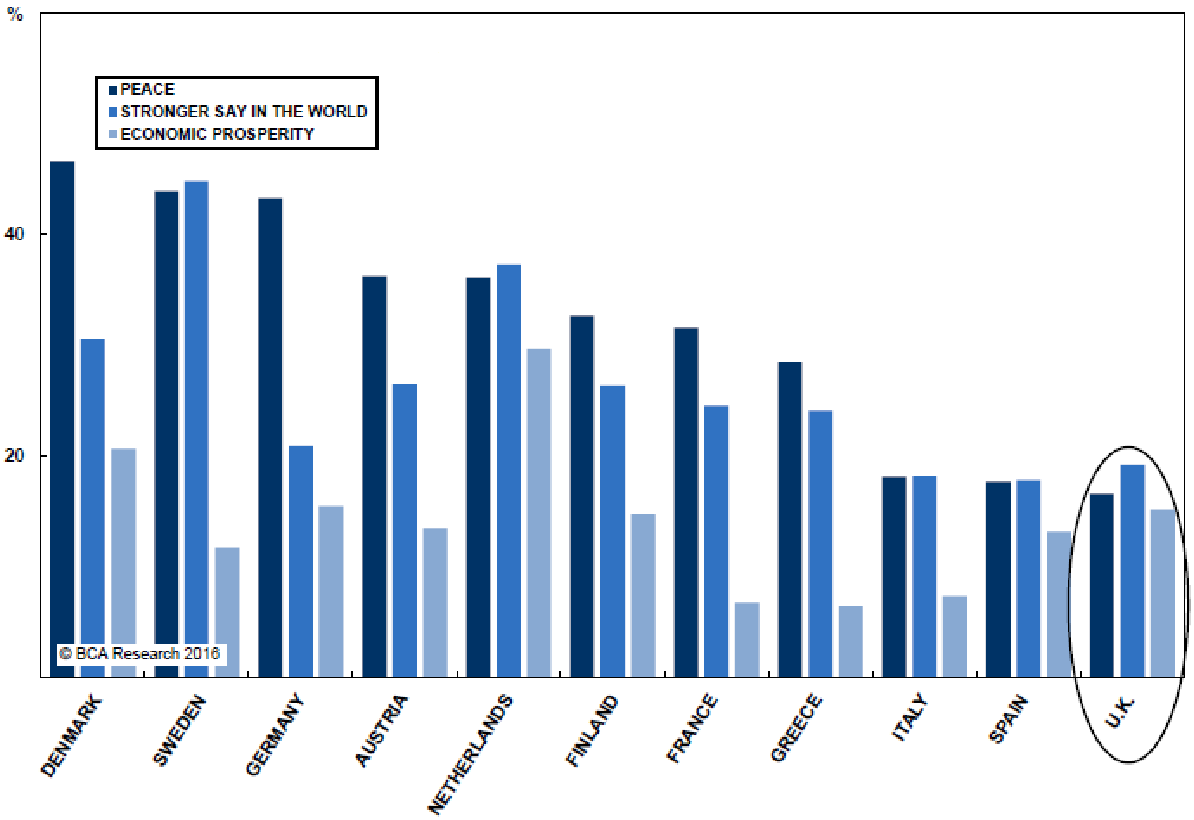
Figure 8: Not everyone in Europe is concerned about EU emigration
Feeling towards immigration of people from other EU member states



Source: Eurobarometer (2015), European Commission.

- **Geopolitics** – Europeans do not see the EU as a vehicle towards "economic prosperity" but rather a project for "peace" and a "stronger say in the world" (Figure 9). Therefore, for much of the EU, the bloc has a geopolitical component that gives the EU a "geopolitical imperative for integration," as we argued in 2011.[3] This is not the case in the UK, which is the world's fifth largest economy, a nuclear power, a permanent UN Security Council member, and a geographically isolated island. It needs the EU the least in the geopolitical sense.

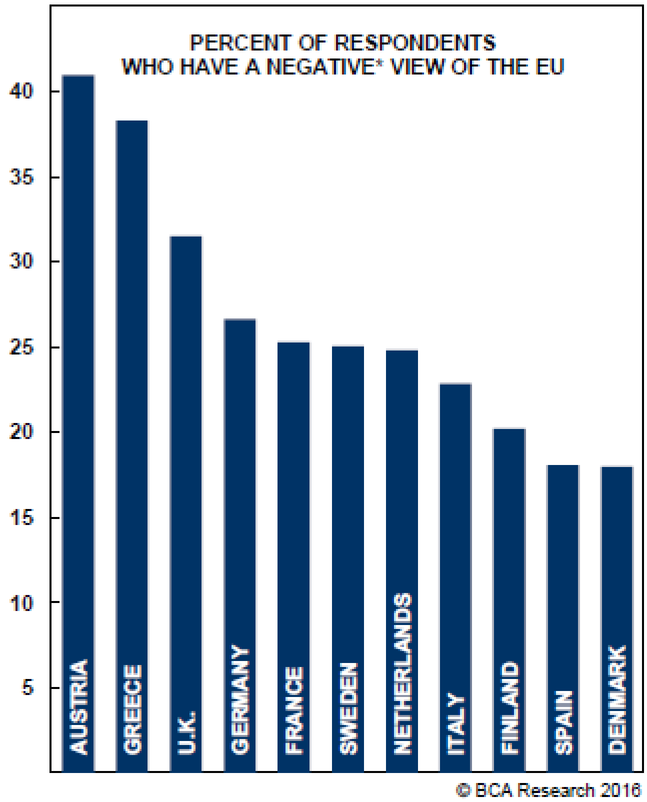
Figure 9: The UK does not perceive the EU as a geopolitical project
What does the EU mean to you personally?



Source: Eurobarometer (2015), European Commission. Respondents can have multiple answers.

- **Confidence** – British voters do not see a life outside the EU as a big threat, perhaps revealing why the "Stay" campaign strategy of emphasising the economic costs of exit was a mistake. When asked whether they thought "their country could better face the future outside the EU" British respondents have consistently answered in the affirmative (Source: Eurobarometer, 2015, European Commission). This is not the case for any other country in Europe. It is an important point because holding a negative view of the EU is not the same as wanting to leave it. Greece is a good example. While 38% of Greeks see the EU in a negative light, 56% do not think the country would do better outside of it (Figure 10). Denmark, Sweden, Finland, and the Netherlands – all frequently cited as "Euroskeptic" candidates for a future EU-exit – also score surprisingly low on confidence that they would be successful outside of the EU. However, Italian confidence in a future sans Europe appears to be growing, and Austrian confidence has always been high.

Figure 10: Not everyone who is angry wants a divorce
Percentage of respondents who have a negative* view of the EU



Source: Eurobarometer (2015), European Commission. * Respondents who have a fairly negative or very negative view of the EU.

- **Currency** – The UK is not a member of the euro area and therefore does not have to deal with the redenomination risk of exit. For countries in the Mediterranean, such a risk would see household wealth redenominated into *pesetas*, *lira*, and *francs*. For Germany, it would mean a 20% to 30% *deutschmark* appreciation and a devastating blow to its export-driven economy. Support for membership in the euro area remains surprisingly high in the countries that are members of the currency union (Source: Eurobarometer, 2015, European Commission). In fact, support for the euro is at or near its highest levels ever in Finland, France, Germany, the Netherlands, Spain, and even Greece! Again, Italy stands as a dangerous outlier.

From the polling data, we can conclude that the UK stands alone in consistently lying on the Euroskeptic side of each political category. However, we can also make five general observations:

- Italy has clearly seen a significant rise in Euroskepticism over the past decade;

- Austria has always lacked enthusiasm for the EU, although its support of the euro remains high;
- Concerns over the Nordic countries are overstated. There is no evidence that they are Euroskeptics;
- France is mixed, scoring high on Euroskepticism when it comes to immigration, but low on other issues; and,
- Germany is committed to European institutions.

So, who is next? With great respect to the history made on 23 June and to the growing anti-establishment sentiment around the world, we suspect that nobody will follow in the UK's footsteps and actually vote to leave. In fact, European policymakers are likely to push against the 23 June vote with a new treaty that takes into account many of the grievances of Euroskeptics around the continent. But the point is that the economic, financial, political, and geopolitical costs of exit are much higher for every other EU member state.

Nevertheless, given the success of the UK's referendum, the probability that another vote on EU membership will be held has increased. That alone will be enough for the markets to apply a "Who is Next" premium to European assets, which explains the European asset sell-off the day after the referendum.

The Bottom Line

A "Who is Next" premium will undoubtedly be applied to European assets now that the UK has voted to leave the EU. However, it will likely overstate the risks of other countries following suit. The UK has the least political, economic, financial, and geopolitical constraints to exiting the bloc.

The Goldilocks era for investors - in terms of the economic policy consensus - is over. When combined with the hegemonic instability of a multipolar order, Brexit means that politics and geopolitics will become an ever more relevant analytical lens for investors. The apex of globalisation has come and gone.[4]

3. BROAD POLITICAL AND GEOPOLITICAL IMPLICATIONS

The decision by the UK electorate to leave the EU is going to increase both political and geopolitical volatility. It strikes at the stability of the European Union, which is one of the core post-World War Two institutions that have kept peace in the Western world for the past seventy years. As such, its implications - if London goes ahead with Brexit - will be profound.

The UK referendum will have implications for multipolarity, a major theme of BCA's *Geopolitical Strategy*. The world lacks global leadership as the US wanes in relative geopolitical power. From an investor's perspective, this is a negative process as multipolarity is empirically and theoretically proven to be a harbinger of interstate conflict. Today, this process has largely been assuaged by the existence of Cold War-era institutions that allow the US to amplify its power. The EU, NATO, and financial institutions such as the IMF and the World Bank are such entities.

By leaving the EU, the UK does not necessarily undermine this global order, but it does show that a 43 year-old geopolitical relationship can end. It will weaken the EU as a global player, given the UK's obvious hard power, and aid Europe's geopolitical rivals. And if it further leads to disintegration of the EU, which is not our base case, it will massively increase global geopolitical risk. We suspect our clients will have to brush up on obscure geographical references - such as Alsace-Lorraine, Silesia, and South Tyrol - by the time this process is over, if it ever begins.

This is a profoundly negative outcome, if it were to occur. Generations that thought they would never see another armed conflict on the European Peninsula may be in for a surprise.

On the domestic political front, the rise of the anti-establishment - particularly in the US and UK - has been one of the most talked-about themes in the financial community in 2016. However, it is unclear how to price the risk, if any, of non-centrists coming to power. In part, the reason is that investors have had widespread disbelief that populism could win any major election in any major economy. That has now changed with the UK choosing to exit the EU.

We suspect that the focus over the next several months - in terms of assigning risk premia - will remain on Europe. However, the reality is that middle class malaise may be the most advanced in the laissez-faire economies of the US and the UK, especially now that the debt supercycle is no longer available to assuage the pain of decade-long stagnant wages.

In a way, anti-globalisation policies are merely the politically right-of-center approach to redistributing income. The last three decades of free trade and laissez-faire policies have led to growing income inequality as winners of globalisation captured most of the gains and losers were left to face the consequences, and the painful adjustment, without much redistribution. Take the vote on EU membership, which saw ALL of England vote to leave except for the financial capital of the world, London.

For Bernie Sanders and Jeremy Corbyn - as well as Podemos in Spain and SYRIZA in Greece - the answer is to dial up the redistribution. For Donald Trump, UKIP, and Marine Le Pen in France, the answer is to wall off their economies and hope to stave off redistribution by shifting the blame for tepid growth to the outside world. Both policies will be equally bad for equity markets and risk assets, as they will erode profit margins one way or another.

The 1990s consensus on deregulation, privatisation, low taxes, budgetary discipline, and free trade is over. The median voter is shifting to the left-of-center and demanding economic policies that are in contravention of the 1990s "Third Way" consensus. According to the median voter theory, policymakers will shift with the median voter to a new center and will not shift back to the old center once they capture power. Thus, even if the establishment wins in the US this year and France and Germany next year, it will have moved away from the laissez-faire and globalisation consensus.

This is bad news for emerging markets. It is also bad news for the shares of global companies who have benefited tremendously from the steady dismantling of barriers to the free flow of goods, capital, and labor. In the long run, the decline of globalisation will also usher in higher inflation. Globalisation has effectively produced the largest supply-side shock in the history of mankind. As such, it is a major deflationary force. But if policymakers respond to populism with protectionism and fiscal expenditure, then the deflationary forces of globalisation will reverse - perhaps sooner than the market expects.

The Bottom Line

The Goldilocks era for investors - in terms of the economic policy consensus - is over. When combined with the hegemonic instability of a multipolar order, Brexit means that politics and geopolitics will become an ever more relevant analytical lens for investors. The apex of globalisation has come and gone.

INVESTMENT IMPLICATIONS

We have long maintained that at times such as this, it makes sense to take a cold shower and resist making any rushed investment decision. Brexit, if it were to go ahead as currently planned, has the potential to change the world, but it is not clear precisely how.

The current market sell-off offers a buying opportunity, at least in the short term. Policymakers are already responding with renewed stimulus. The G7 communique issued on the heels of the referendum has essentially given a green light to Japan and Europe to intervene in the currency markets. The Fed funds rate futures are now pricing in a 15% probability of a US rate cut by the end of the year, whereas the probability was zero just one day ago. Nevertheless, the damage has been done. Peter Berezin, Chief Strategist of BCA's *Global Investment Strategy*, fears that the "reflation trade" that began in February may be over. Certainly the data out of China is becoming more difficult to square, with declining credit growth and leading indicators (like excavator sales) taking a plunge.

Reflation by policymakers may eventually combine with the pervasive "search for yield" to buoy risk assets. At the moment, however, all eyes will be turned to Europe and the "Who is Next" premium likely to creep into assets. We suspect that global assets will take cues not from the Fed or China in the short term, but Europe and the usual bellwether of the continent's future - Mediterranean economies.

ENDNOTES

1. See BCA Special Report, "Break Glass To Brexit: A Fact Sheet," dated 17 June 2016, and BCA Geopolitical Strategy and European Investment Strategy Special Report, "With Or Without You: The U.K. And The EU," dated 17 March 2016, available at gps.bcaresearch.com.

2. The six factors are trade balance with the EU, exports as percent of GDP, debt interest payments, gross government debt, foreign direct investment, and net transfers to the EU.

3. See BCA's The Bank Credit Analyst, "Europe's Geopolitical Gambit: Relevance Through Integration," dated 19 October 2011, available at bca.bcaresearch.com.

4. See BCA Geopolitical Strategy Special Report, "The Apex Of Globalization – All Downhill From Here," dated 12 November 2014, available at gps.bcaresearch.com.

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