Brexit -- Keep Calm and Carry On?!?!?!?

Intrepid readers of Black Falcon Market Morsels may've heard the news, but our friends Across the Pond voted last week on a small, insignificant, technical referendum dubbed 'Brexit'. Said referendum, of course, was to decide whether the (not so) United Kingdom should maintain its relationship with the European Union, or go it alone. Going into the vote, the 'smart' money (irony noted) had 'Remain' winning. In a result highlighting the hazards of democracy, the majority of Brits chose to 'Leave' the EU and forge ahead on their own. In the immediate aftermath of the result, global financial markets were, as they'd say, gob-smacked.
(*Ed note: many markets have stabilized over the past couple sessions. The US stock market is currently only down 1+% from pre-vote levels, but currencies and interest rates remain stressed. We continue to be vigilant assessing the risks and opportunities, but are wary of the current rally*)

For the purposes of this Morsel, I'll not opine on the arguments for/against Brexit. I do feel history will judge it to be a bit of biting off one's nose to spite the face. But perhaps the voters know something I don't. Maybe Admiral Horatio Nelson is poised to re-take the reins of British Navy and cobble back together the Empire of Yore.

Prior to the vote, we've been of the opinion global markets are vulnerable to correction -- potentially one of significance. In our view, headwinds greatly outnumber tailwinds (we'll use as many nautical terms as possible to stay in the good graces of Adm. Nelson -- hedging bets, you see). In the interest of brevity, we won't list them all, but the headwinds essentially distill down to an over-extended credit cycle, with the tailwinds being historically low interest rates serving as the Little Red Choo-Choo trying to get the economic train up that hill.

The Economic Effect of Brexit: We fear Brexit will ultimately result in diminished economic activity, particularly in the UK (5th largest economy) and the Euro Area (2nd largest when UK included, 3rd if excluded). Growth in neither the EU nor the UK was particularly robust pre-vote, and further slowdown may turn out to be the straw that breaks the back of the Chinese economy -- which has been trying to duct-tape its banking system, real estate market and currency for the past 12 months. The Brexit vote may be the first domino to fall that ultimately accelerates the progress of a global slowdown/recession history would suggest is coming due.

Brexit Effect on Global Markets: Uncertainty tends to upset the apple cart of global markets, and as mentioned, we've been of the opinion markets were vulnerable pre-Brexit. Hunts for yield in the (insanely?) low interest rate environment have distorted credit markets and arguably have resulted in an over-valued US stock market.

Over the summer, we anticipate the 'Risk-Off' trade to have asymmetric risk-reward, as in volatile markets investors tend to seek the 'Exit' door with a vengeance. Rates could go lower still (which may ultimately exacerbate issues), gold and the US$ should serve as a haven -- as equities and commodities come under pressure. As a direct result of Brexit, the heretofore global financial center of London should expect something of a shake-up. I wouldn't want to be long London real estate just now.

Expected Political Effects of Brexit: Both the Conservative and Labor parties in the UK appear to be in complete dis-array after the vote. The lack of political direction looks to result in protracted negotiations with the EU on extricating Britain out of the Union. Not helpful, many expectations from the 'Leavers' regarding the result of these negotiations seem, to this scribe, fanciful.

I'd expect the EU to negotiate with the posture of a spurned lover in a divorce proceeding. The legal wrangling of re-negotiating terms of trade and business contracts could be epic. As ever, lawyers win -- which I'm guessing was not a major plank of the Leave campaign.

In light of the fact that Scotland and Northern Ireland both voted overwhelmingly to Remain (in addition to the fact each has been a relatively reluctant member of UK in the most stable of times), the next referendums on the docket will be for Scotland to join the EU and Northern Ireland to unite with Ireland. The Great Britain we know and love may be on the cusp of becoming Pretty Darn Good England/Wales.

After that, look for more shoes to drop, possibly from France and the periphery of Europe. At minimum, we foresee years of _____ (fill-in-the-blank) -xit to be central to the geopolitical narrative.

Solutions Available for Central Bankers: if economies and/or global markets crater as a result of Brexit and its aftershocks, the monetary policy tool-kit available to central bankers (the Fed, ECB, BOE, BOJ, primarily) is at best limited, at worst completely depleted. For the past 8 years, semi-coordinated moves of monetary accommodation -- graduating from zero official interest rates to Quantitative Easing to Negative official interest rates – have yielded merely sluggish growth (the US) to no growth and actual or feared deflation (Japan, Europe). Each successive policy move has been less effective than the previous.

Now, I was no Physics major in college, but I'm reasonably certain merely pushing harder on a string doesn't increase effectiveness. Central Bankers are trapped in a policy penalty box, with no rabbit to pull out of a hat to address a severe contraction. The best outcome, from our perch, is a garden-variety global recession.

Financial history is not kind to the end-game of distorted and/or manipulated markets. And, gazing at the current environment of zero to negative yields, it's becoming more and more difficult to envision a monetary un-wind resulting in a soft landing. The challenge is the timing and severity of the landing.

Lessons to be Learned From Brexit: From the Black Falcon Capital The Glass is Half-Full Department, perhaps the powers-what-be (recent events make it very difficult to refer to them as 'the Elites') will learn a lesson from the votes cast by the dis-enfranchised middle classes of the UK. Perhaps elected representatives will take it as a 'shot across the bow' (nautical term) and decide to change their governing ways.

In my view, the political class has cynically abandoned the responsibility of their jobs (I'll focus on the US, but I believe this ethos translates across borders), which presumably is to effect policy and improve living conditions for all of society. Abandoned in the interest of Petty Partisan Posturing. With apparent glee, they've exploited the media and the biases of their respective political bases in the interest of merely acquiring and retaining elected office. Compromise and a functioning government be damned.

The Fed has been the only policy game in town for roughly 7 years. In a perfect world, monetary policy would meld with smart fiscal policy to stimulate/maintain demand, working counter-cyclically to facilitate growth/employment while concurrently keeping price pressures at bay.

The US has had historically low interest rates for years now. It's also had a clear need for upgrades in infrastructure -- crumbling roads/bridges, the electricity grid (there was a complete blackout of the East Coast in 2003, and since then our mid-20th Century power grid has merely been tweaked), need for universal WiFi, etc, etc – and all the while the 'best-and-brightest' (again, irony noted) in DC squabble over the same, mind-numbing drivel.

The electorate is rightfully revolting against this nonsense. I'm unconvinced its collective focus is properly aimed, but I get it. In an era of US Treasury 10 year rates below 3% (currently 1.48%), there have been no significant, game-changing initiatives.

Here's one opportunity (thus far) missed. Seven years ago an initiative was proposed to set up a Private/Public Infrastructure Bank to address the rotting US infrastructure. Previous generations would've jumped at the opportunity to invest in the future. As it happens, the suggested infrastructure projects would've created exactly the types of jobs that've largely been lost through technology and globalization. You can't export bridge-buildin' to China. Yet, we can't get a vote on an Infrastructure Bank.

It's easier for pols to scare-monger, spin and make accusations against the other tribe on talk radio/cable news/social media than work together and address problems.

In the UK and Europe, it's going to be a long slog to dis-engage/re-entangle the Union. Political chaos will likely cross the Channel -- France, Italy, and the Netherlands seem to be queueing up for the next wave of political intrigue.

Perhaps the US electorate will take a lesson from the expected negative ramifications of Brexit. The lesson that allying and uniting with other nations is more effective than isolation. The lesson that the noise from electioneering is mostly just that -- noise. The lesson that perhaps those that are in DC for their own purposes -- and not their constituents' -- should look for another vocation.

Alas, I'm other than confident much will change on that front in November. It may be time to look for hedges against a 'Black Swan' type of market event.

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