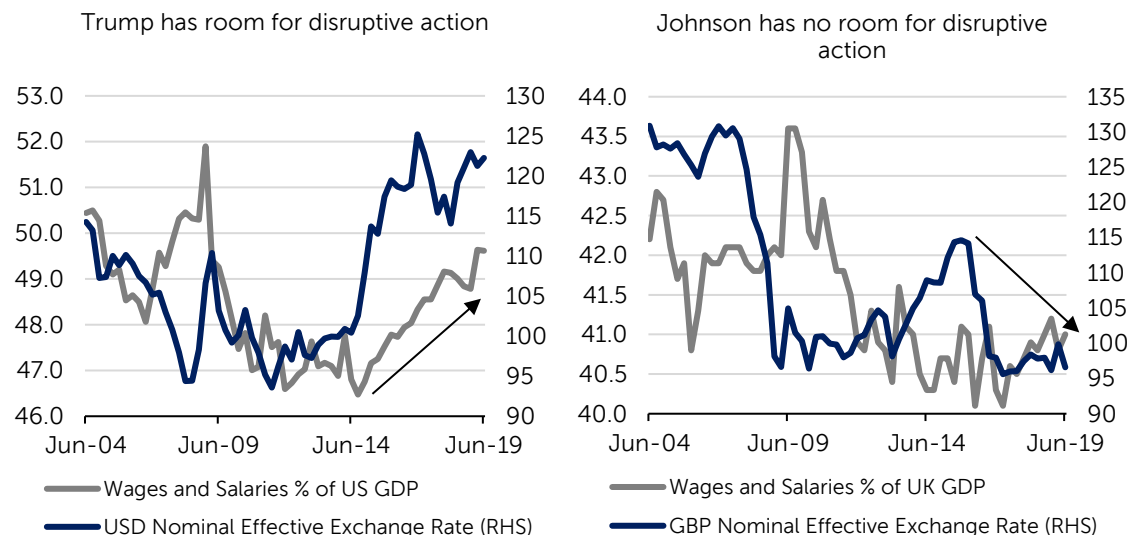


Boris Johnson and the Brexit delusion

A hard look at the economic and financial impact of Brexit



Source: Bloomberg

As we write this short note, the UK parliament is trying to freeze (the government's) Brexit (policy) and the country is heading towards elections that could be held on October 15, but will more likely be held at a later stage in October or November. The country remains locked in a major political and constitutional crisis. Nobody really knows whether the final outcome of this saga will be Brexit with or without deal, or even no Brexit. The mere purpose of this note is to a) outline the key economic and investment implications under all possible short-term scenarios; b) reflect on the likely long-term re-orientation of the UK towards the EU.

Some basic economic facts regarding a no deal Brexit

- The loss of access to the EU single market would likely lead to a further correction of the pound sterling;
- The UK is not the US. Its global economic weight is small and the pound sterling is not a major reserve currency, such that the prospect of a no-deal scenario cannot but lead to currency devaluation.
- Currency devaluations are always bad for wage earners, not necessarily bad for investors. Above charts illustrate Mr. Johnson's basic economic policy constraint versus Mr. Trump's optionality. The latter's fiscal profligacy and trade war have determined an increase in the wage share of US GDP. Johnson's fiscal profligacy and Brexit would determine a continuing correction of the wage share of UK GDP (something perhaps acceptable when aggregate growth was booming, but unbearable in today's world of shallow growth);
- It is the *capacity to disrupt "globalist" policies without disrupting one's own disenfranchised working class electoral base* that confers credibility upon a "populist" leader;
- Brexit is much less of a risk for global markets not only because the UK is too small to significantly impact global GDP, but also because Brexit is already touching the limits of what the UK electorate can bear.

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Economic and financial scenario analysis

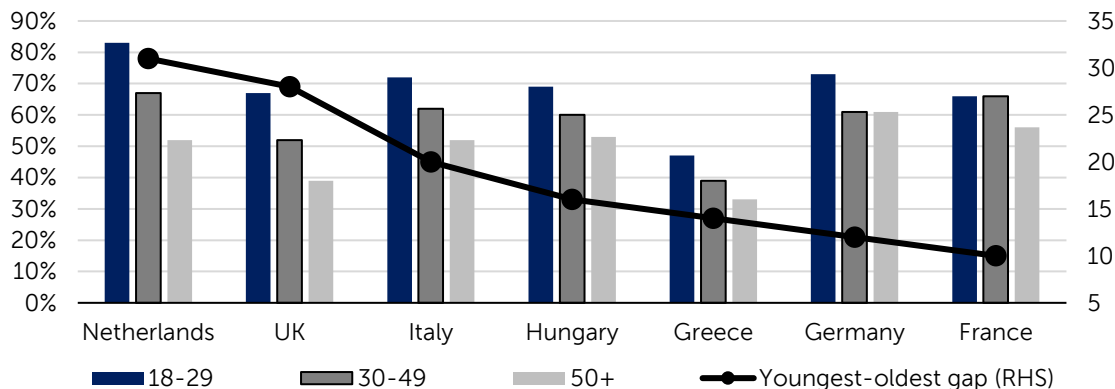
The above considerations do not mean that Johnson will lose his battle for a no-deal Brexit, whether it be on October 31 or on another date in the not too distant future. But they allow us to draw some conclusions about the possible implications for the many possible scenarios

1. A Johnson electoral victory would likely lead to a no-deal outcome, if no longer on October 31, then on any other date to be granted by the EU in case an extension would be requested on October 17.
 - It would thus trigger a further devaluation of the pound sterling which, thanks to an increase in foreign demand and earnings, would lead to an appreciation in local prices of UK blue chips and premium real estate, but also to a reduction of domestic real wages and salaries;
 - Lower real wages and salaries would likely depress earnings of small domestic stocks;
 - The recessive impact would last for a long period because no-deal would not result in the so-called "clean break". The negotiation of a trade deal with the country's most important trading partner, the EU, will still first require a divorce bill settlement, as well as a solution for the Irish border issue. In addition, the negotiation of free-trade deals with other large economies will be difficult (also in consideration of the lower external value of the pound) and unlikely compensate for the lost access to the EU single market.
2. A Corbyn electoral victory, or a hung parliament, would either lead to second referendum or to a negotiated Brexit, i.e. a permanent customs union or a deal very similar to the one negotiated by the May government.
 - A second referendum would bring us entirely back to the current state of uncertainty;
 - A negotiated Brexit would have a positive impact on the pound sterling, trigger a mild correction of blue chip stocks but boost smaller domestic stocks
 - In the case of a Corbyn electoral victory (as opposed to a hung parliament), however, over time both the value of the pound sterling and UK equities would remain hostage to speculation about redistributive socialist policies, a completely new type of political uncertainty.

Long run considerations

In the short-term, a negotiated Brexit that would preserve as much access as possible to the EU single market would be economically better than a no-deal Brexit, and politically better than a revocation of article 50. Indeed, the only viable "clean break" strategy would be an international offshore center model, possibly enhanced by free zones and - ports. Such model might lead to further UK asset appreciation, not protection of workers' income, which – as can be seen from the above charts – has remained under pressure since the 2008 Global Financial Crisis. It is therefore unsustainable in the long run. Ultimately, the UK is not only bound to further re-approach the EU, but indeed to re-enter it, simply because the membership solution is geopolitically much more valuable than any other type of association. Is that surprising? Not really. First of all, as can be seen from charts A.1., A.2., and A.3. in the appendix, following the end of the immigration crisis (a key factor is anti-EU sentiment during the 2016 referendum), pro-European attitudes have risen across the continent, including in the United Kingdom and Italy. And those attitudes have risen in spite of the economic slowdown! More importantly, the Brits are, above all, a nation of skilled and gifted pragmatists. This characteristic has been passed on to the youngest generations which, as can be seen from the below chart, are not significantly less pro-European than other young Europeans, and even more pro-European than their French generational cohort! Over time, it will be the millennials to undo the economic, political and constitutional damage inflicted by the Brexit delusion.

Young Brits have more favourable view of EU than young French



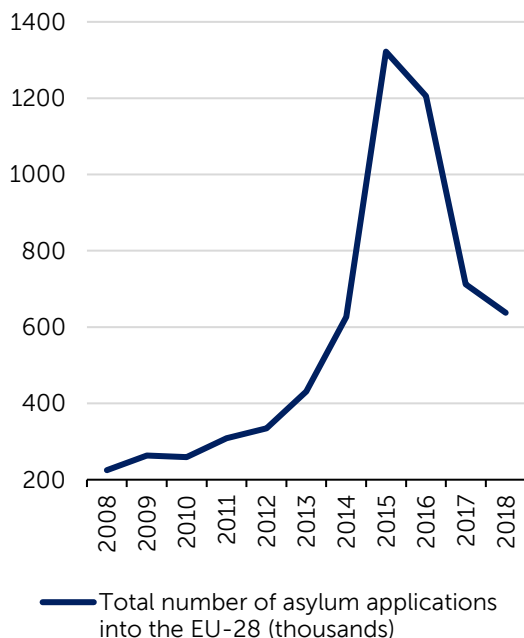
Source: PEW Research Center

Investment implications

- The next months are extremely unpredictable, but the implied volatility levels (chart A.4. in the appendix) make any combined long put-call strategy (straddle) too expensive;
- Assuming that the British political system will find a pragmatic solution to the Brexit earthquake, we would buy into pound sterling and small domestic stocks following their correction in a no deal scenario.
- We would however be more careful if a Corbyn government would emerge since the long-term implications of distributional policies might constitute a bigger dent to asset valuations than the disruption of a hard Brexit which, by its very nature, would be politically not sustainable.

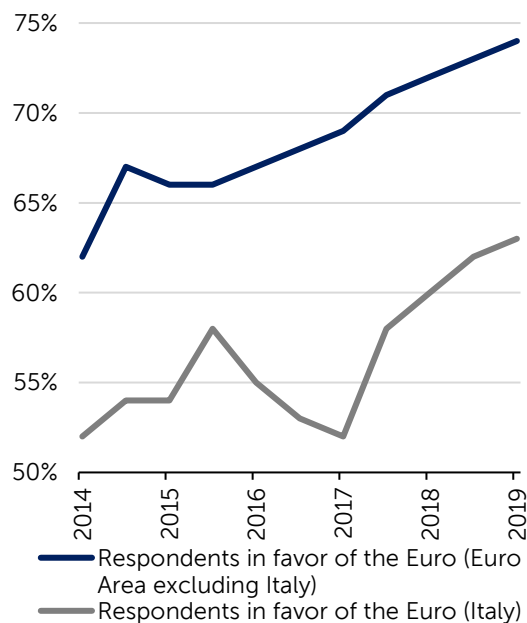
Appendix

A.1. Europe's migrant crisis has peaked



Source: Eurostat

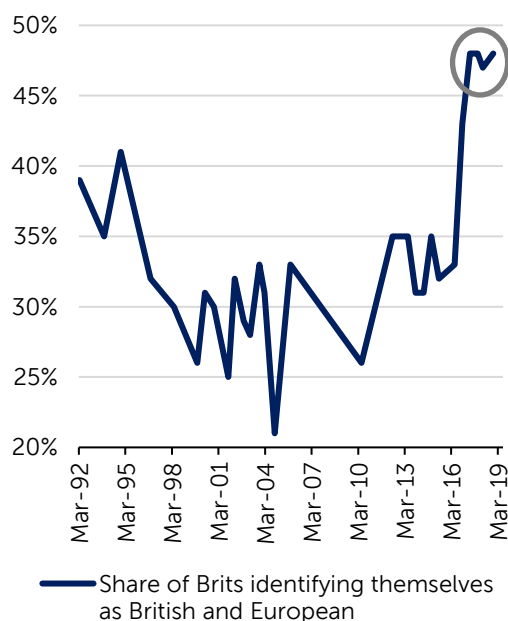
A.2. Pro-European sentiment rising across the continent



Source: Eurobarometer

Notes: Euro area is equally-weighted average of Greece, Germany, Spain, France, Portugal, Belgium, The Netherlands, Austria, Finland and Ireland

A.3. Brits identifying themselves also as European have never been more



Source: Eurobarometer

A.4. Most currency uncertainty appears to be priced in



Source: Bloomberg

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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