The upcoming referendum on June 23rd in the United Kingdom (UK) on whether or not the country should leave the European Union (EU) looms as the biggest potential ‘known-unknown’ risk to global capital markets in the immediate future. Thanks to recent poll gains made by the Leave campaign, the prospect of ‘Brexit’ has emerged as a very real possibility.

Polling movement since September 2015. Source: Financial Times

The decision to leave the EU is a tremendous one for the British people. The UK accounts for 13% of the EU’s population and about 15% of its economic output. To put this into perspective, Brexit would be akin to the entire Northeast region of the United States, including the financial hub of New York, choosing to secede from the union because they pay a lot more in taxes to the center than the benefits they receive in return.

The key issue is that while the British people are aware of the pros and cons of being in the EU (at least on the face of it), there is considerable uncertainty about the counterfactual, i.e. what British life would look like outside the union. While it is impossible to fully discern all the ramifications of Brexit, some of which may become clear only over a decade or so, we believe it is worthwhile to try and unwrap some of the issues the UK will have to deal with in the event of a negative vote. Even if Remain wins, the Brexit genie is now out of the bottle and the central question - to leave or not to leave - will persist.

We begin with a brief history of UK - EU relations to shed some light on how the UK reached this point, and what that implies going forward.

How the UK got here

After a couple of attempts at membership in the European Economic Council (EEC) during the 1960s, both of which were vetoed down by France’s Charles DeGaulle, the UK eventually entered the club of European nations in 1973.

Membership in the EEC was in fact put to a referendum (the current Brexit vote is not the UK’s first official poll on EU membership) in 1975, and was overwhelmingly supported by 67% of the British public. However, it is important to understand that voters in 1975 were hoping that membership in the EEC would mitigate some of the problems faced by the UK during that decade, such as industrial decline, union strikes, power outages and high inflation amidst the oil crisis. A different, more economically powerful Britain exists today in the minds of the public, a point we will come back to.

Since the 1970s the UK has had an uneasy relationship with the EU. Prime Minister Margaret Thatcher negotiated a rebate on Britain’s EU contributions in 1984, making the argument that it received much less in agricultural subsidies than other members (France being the largest recipient). Yet, on February 7th 1992, UK Prime Minister John Major (also from Thatcher’s Conservative party), signed the Maastricht Treaty along with leaders of eleven other members of the European Council, essentially creating the European Union and the Euro currency (which Britain opted out of).

Crucially, the Maastricht treaty was never put to a referendum (the current Brexit vote is not the UK’s first official poll on EU membership) in 1975, and was overwhelmingly supported by 67% of the British public. However, it is important to understand that voters in 1975 were hoping that membership in the EEC would mitigate some of the problems faced by the UK during that decade, such as industrial decline, union strikes, power outages and high inflation amidst the oil crisis. A different, more economically powerful Britain exists today in the minds of the public, a point we will come back to.

The Maastricht treaty was eventually ratified by the British parliament in 1993, but just barely so, as members of the Prime Minister’s own party rebelled and put his government in serious danger of falling. At the time, former Prime Minister Thatcher was quoted as saying that John Major had ‘put his head in the fire’ by signing the treaty.
The intervening years between Maastricht and the upcoming referendum saw a pro-Europe Labor party in power, as well as the signing of the social chapter of the EU treaty (which governed employment) by Prime Minister Tony Blair.

The Brexit vote is a direct result of Prime Minister David Cameron’s promise in January 2013 that, if his Conservative party were re-elected in the May 2015 elections, he would renegotiate Britain’s membership in the EU and hold an in-out referendum by 2017. While Cameron did attempt the renegotiations after his re-election, a final deal was elusive, and on February 20th of 2016 he set June 23rd as the date for the referendum.

**Why Leave has gained momentum**

A confluence of factors has made the idea of Brexit more attractive to the British public over the past few years. Even people following the Brexit debate only marginally probably know that concerns over immigration have fueled support for the Leave campaign.

At the same time, it is important to point out that immigration by itself is not the only reason the Leave campaign has garnered wider support, especially among British elites. The desire for independence from a European Union hobbled by regulations and crises have come to the forefront as well, along with questions of national sovereignty. One hundred and fifty members of parliament, far from a fringe minority, support Leave as of this writing.

The concerns that drive the Leave campaign will not go away immediately, and hence, we believe it is worthwhile delving a little deeper into the issues that have sent the UK down this potential rabbit-hole.

**Immigration**

The key concern is that the current immigration regime allows an unfettered open door to other EU residents and only by leaving the EU can the UK regain control over its borders. The free movement of workers is one of the four fundamental freedoms guaranteed by Article 45 of the European Commission Treaty. Under these rules, any citizen from the other twenty-seven countries in the bloc can enter the UK without a visa to look for work or flee oppressive economic or political circumstances.

In recent years, net immigration into the UK has risen dramatically on the back of the country’s relatively strong economic recovery after the Financial Crisis of 2008, reaching a near record 330,000 individuals in 2015 according to the office of National Statistics. Leave campaigners claim that the EU’s free movement policy is chiefly responsible for this, and that stricter restrictions on migrant inflow would protect British jobs as well as boost stagnant wage growth.

On the other side, Remain activists contend that this is simply fear mongering, citing the fact that immigrants from the EU actually compose a smaller proportion of total inflow than those from non-EU states in South Asia and Canada. Further, they emphasize the boost to UK productivity, output and employment as a result of skilled and enterprising immigrant populations.

Currently, non-EU immigrants account for just over fifty percent of total net migration into the UK. Since 2010 however, inflows of immigrants from EU member countries have risen sharply. A significant portion of this recent influx has come from Bulgaria and Romania, causing a shift in immigrant population demographics.
These newer immigrants tend to be less skilled and more culturally separated, occupying rural areas and low-income urban neighborhoods. The apparent, unsubstantiated, causality between migrants taking advantage of open borders and domestic economic ills (like stagnant wages) has resulted in increasingly xenophobic public sentiment in Britain.

However, there is little evidence to support the hypothesis that immigration is solely responsible for slow wage growth. The UK has experienced tepid wage growth since 2008 (as has the U.S. we note), with wages not growing much above 2% annually. The movement of net migration correlates poorly with wage growth data, suggesting that the decline has more to do with sluggish global growth than with liberal immigration policies.

The central principle underlying the Leave campaign’s proposed model alternatives is the idea that Britain should be able to determine the size and composition of its immigrant population. They advocate a system wherein the UK can tailor their border policy to best suit the country’s economic needs. For instance, some have proposed a points based scheme that evaluates visa applicants based on their English language skills, employment, age and education. Only those applicants who secure a certain number of ‘points’ awarded on these criteria would be granted entry into the UK.

We should note that limiting the labor supply could be negative for an independent British economy. Rising wages and prices may satisfy political demands in the short-term, but they would almost certainly diminish the UK’s ability to compete effectively with manufacturers in Asia under an open trade agreement. In order to control labor costs, the government would have to increase the labor force participation rate through investments in education and skills training. Further, it must ensure that British workers are ready and willing to fill the vacuum left behind by immigrants at the lower end of the labor market. It is an open question as to whether the UK can manage this transition adroitly.

**Economic Independence**

Another argument being made is that the UK has reached a point of economic strength and confidence relative to the EU that makes it possible for it to thrive, let alone survive, unencumbered by EU institutions. In the mind of British voters, the UK of the 21st century is vastly different from the one that existed in the 1970s, when membership in the European community seemed like the obvious answer to a multitude of problems. That the UK will be able to move more nimbly in today’s world without being tied to a hobbled, crisis-ridden Europe has recently gained further currency.

Since the second quarter of 2009, after the Financial Crisis, growth in the UK has been comparable to growth in the US, and significantly higher than overall growth in a Euro area crippled by austerity and seemingly jumping from one crisis to the next.

**National Sovereignty**

The third argument, perhaps even more important, is the idea of restoring full national sovereignty to Britain as opposed to living under the auspices of a supranational European council - especially one that cannot directly be removed by the British electorate if they so desired, unlike in a more democratic system. By leaving the EU, the UK would regain control over various aspects of social and economic policy that were ceded to the European Union under the terms of the Maastricht Treaty.

We believe it is this argument that has helped Leave gain supporters across the political spectrum, and most importantly, it is this idea that will probably continue to resurrect the possibility of Brexit in the future, even if Remain wins this round. What we are seeing now may only be the beginning of a protracted, perhaps even decades-long, campaign to wean Britain off the EU.

In the next section we discuss the potential impact of Leave coming out on top. While this question is impossible to answer in its entirety, we can certainly get a sense of the scale and scope of the issues Britain will face in the event of Brexit.
Brexit Impact

Trade and the Economy

The United States is the UK’s single largest trading partner, accounting for 11% of total exports in 2014. Collectively, however, EU countries remain the chief export destination of British goods, absorbing about 51% of the UK’s export volume. Note that exports made up about 28% of UK GDP as of 2014.

Since 1973, the UK has benefited greatly from membership in the European single market. Under its rules, goods can move freely between any of the twenty-eight member states, unhindered by tariffs and other barriers. By proxy, the UK also profits from the fifty trade agreements the EU has signed with nations outside Europe. In the event of an exit, the UK must either negotiate a comprehensive Free Trade agreement (FTA) with the EU, or engage with the single market under WTO rules. If Britain is unable to secure a deal with the EU, it will be forced to rebalance its exports away from Europe and towards the United States and other large markets like India and China.

Thus, the future of the UK economy heavily depends on the adoption of a liberal, post-exit trade policy, as well as on reaching some sort of an agreement with the EU. Given that Britain imports more from the EU than it exports to them, one imagines that the EU would have some incentive to expedite this.

Yet the political fallout from a potential Brexit cannot be ignored. Germany’s hawkish finance minister Wolfgang Schaubel employed some harsh rhetoric recently, reminiscent of his attitude during the Greek debt crisis in 2015, saying “In is in - out is out”. The UK should not expect any good will or compromises (again, as in the case of Greece), if they choose to leave.

The idea is that Britain, or any other member state, entertaining the notion of leaving the EU sets a dangerous precedent and must be made an example of with devastating consequences. Germany, and perhaps even France, it seems, will have no qualms about employing the EU's set of economic weapons to 'punish' Brexit. At the same time, this is exactly the sort of rhetoric that will continue to push the UK further away - if not now, then at some point in the future.

If the UK were unable to strike a deal with the EU, they would find themselves facing an incredibly uncertain economic future. Under such a scenario, there would be even more pressure to pursue free trade agreements and deregulate extensively. Of course, this would be a struggle. In a recent visit, President Obama of the United States (US) urged the British to remain in the union, remarking that an independent Britain would be 'at the back of the queue' when it came to negotiating a free trade agreement with the US.

While the US is the single largest domestic market for British goods, its own consumption-oriented economy is hardly reliant on the UK, accounting for just 3% of its total export volume. Further, the export sector contributes just a little more than 13% of American GDP.

All of this points to an alarming truth about the British economy. If cut off from the EU’s single market, it possesses very little bargaining power in the international trade environment, and will need to undertake substantial reform in order to be competitive. The Economist Intelligence Unit (EIU) estimate that the economy would experience at least a 1% reduction in 2017 if the public voted to leave, and that by 2020 the nation’s GDP would be 6% smaller than it would have been had it remained in the EU.
So how likely is this bleak economic scenario? This depends on the kind of deal the UK can finally negotiate with the EU. The graphic on top of this page details three models for a potential partnership between Britain and the EU.

It is important to note that in the event of Brexit, the UK would continue to retain the benefits of membership for two years to hash out the terms of a divorce. This prevents the possibility of an abrupt, hard restructuring of the economy, mitigating adverse economic effects as firms, households and markets adjust their expectations over the interim period.

At the same time, as we explained earlier, members of the EU will be reluctant to make things easy for Britain. They will in all likelihood reject any proposal to allow the UK to remain in the single market without continuing to maintain an open door pass for EU citizens. This will obviously create political havoc in the UK, especially since a prime motivator for Brexit is closure of the very same door.

Not having access to the single market will also have dire consequences for London’s status as a financial center. This is a key reason as to why business services and the finance sector are most in favor of Remain amongst industries, while construction, agriculture, forestry and fishing are most in favor of leaving.

**Capital Markets**

Global capital markets have become increasingly jittery as Leave swung into the lead, with currency markets experiencing significantly higher volatility. In February, after the date of the referendum was announced, the pound fell to a seven-year low against the dollar. Since then, the currency has rallied on market expectations that Britain would vote to remain in the EU, but recent poll gains by the Leave campaign have induced a further drop in the pound.

Equity markets have not been completely immune either. UK’s FTSE 100 saw a drawdown of more than 7% between April 20th and June 14th, a period in which Leave gained significant momentum. We should point out that only about 25% of companies listed on the FTSE 100 come from within the UK. The rest are multinationals that will benefit from a devalued pound.

The tension has carried over to global equity markets as well. The European equity index basket, Euro Stoxx 50, fell more than 10% over the same period. U.S. equity markets were less directly impacted, with drawdowns close to 3%, but there has been a spike in volatility. The CBOE volatility index (VIX) jumped more than 40% over the first two weeks of June, as odds grew that Leave could win.

At the same time, bond yields across the world have continued to plunge, as investors look for safe assets amid increasingly pessimistic views on the global economy and the ability, or rather inablility, of Central Banks to provide sufficient and/or effective monetary stimulus. We do note that UK bond (Gilt) yields have also fallen almost 50 basis points since the end of April (to 1.15 as of June 17th). This does suggest that while investors are worried about the implications of Brexit on the UK economy and trade relations,
these concerns do not extend to the full faith and credit of the UK government to repay its bondholders.

**Monetary Policy**

The Bank of England issued a fresh warning on Thursday, June 16th, saying that Brexit could result in the UK sliding into a recession. The central bank said that spending has already reduced over the threat of the UK leaving the EU. Lower spending can subsequently lead to lower demand for labor and raise the unemployment rate (currently at 5.1%). Governor Mark Carney warned that Brexit could send the pound sharply lower, raising inflation and unemployment.

The Bank of England is already in the process of implementing contingency measures in the event of Brexit. The central bank plans to hold additional auctions of sterling to ensure that the banking system has enough funds to operate under that scenario.

The UK is also facing its largest current account deficit in peacetime since 1772, standing at 7% of GDP at the end of the first quarter of 2016, versus 5.2% for all of 2015. A deficit this large should lead to a fall in the currency, irrespective of the outcome of the Brexit vote.

In theory, a cheaper currency would help rebalance the economy by making British exports cheaper on the global market, and imports more expensive - narrowing the deficit. Then again, imports becoming more expensive could lead to higher inflation, even as UK exporters who use imported raw materials for their products face higher costs. So some of the competitive advantage of a cheaper currency would be lost.

A combination of influences on demand, supply and the exchange rate could potentially lead to a materially lower path for growth and a higher path for inflation. All of this could potentially put the central bank in a precarious position, having to choose between stabilizing inflation and employment.

**Political Impact**

Five out of twenty-one cabinet members (other than the Prime Minister himself) have openly campaigned for Leave, against the stated position of the Prime Minister, which is quite unprecedented. If the vote goes against Remain, we may well see David Cameron announce his intention to step down on Friday morning after the vote. It is highly unlikely that he will stick around to negotiate the terms of Britain’s exit from the EU over the next two years.

The other issue is that of Scotland, which is significantly more pro-European than the rest of the country. We may well see another push for independence should Brexit occur. The last referendum for Scottish independence, held on September 18th 2014, ended with 55.3% voting against it. However, the result may be different if Britain chooses to sever ties with Europe.

In any case, the political turmoil promises to be considerable if Leave wins, along with a not insignificant likelihood of the United Kingdom itself breaking up, with Scotland eventually choosing to go its own way.

**The Big Question: How does Britain Navigate the Legislative Complexities?**

European Union laws course through several veins of British law currently, including immigration, asylum, employment, agriculture, competition, regulation and environmental laws and standards, amongst others. These laws touch every facet of life in the UK. A Brexit vote will not instantly extricate the UK from this web of influence. In a recent report on Brexit, Lord Bosewell, chair of the House of Lords EU committee said:

“You cannot just cut through them - practically every one of the thousands of EU laws that apply in the UK would need to be reviewed, and then assessed on the merits, before the government would decide whether or not to leave it on the statute book.”

All this would have to be done without creating a slew of new legal vacuums. EU provisions, including standards and regulations, will have to individually reviewed and subsequently retained, amended, or repealed. All the while keeping in mind that Britain’s largest trading partner would continue to be the EU, at least in the short to medium-term.

For example, if Jaguar wanted to sell UK made cars in continental Europe, they would still need to meet EU emission standards, in which case these would have to bow directly be put into domestic law. Similarly, EU based consumer protection laws, say to prevent credit card fraud, would have to be enshrined into UK domestic statutes, or else they would disappear upon withdrawal from the Union.

Another example: Agriculture and fisheries, which cannot be ignored even though they account for less than 1% of domestic output in the UK, would require creation of an entirely new regulatory framework.

The Leave campaign has been supported by sides that have traditionally found themselves diametrically opposite each other. One side is anti-immigration, anti-globalization, and for national sovereignty while the other supports even more economic liberalization, small government and opposition to subsidies. Presumably, all of these disparate forces would have to come together and decide on the best course of action regarding practically every single statute.
**Conclusion**

Britain leaving the EU may well emerge as one of the most consequential events in recent history. As the vote looms closer, political tensions have reached an all-time high in the UK, peaking with the tragic murder of Pro-EU Member of Parliament Jo Cox. This has shocked the country and led to more subdued campaigning in the days leading up to the vote.

While most forecasts expect the crop of undecided voters to break toward Remain over the last few days, the final margin may be fairly slim. Thus, irrespective of the outcome, Britain is sure to experience divided public opinion in the years ahead. As we mentioned earlier, the issues that propel the Leave side, such as immigration, economic independence and national sovereignty, will not simply disappear if Remain wins. Campaigners pushing to sever ties with Europe are likely to push for more referendums on specific EU treaties going forward, even if they cannot get another shot at a Brexit referendum in the short term. The rise of populism combined with the cloud of an ambivalent Britain remaining within the EU will create much uncertainty over the next decade or so, hampering overall growth.

In an effort to understand the dynamics of the conflict, this paper has placed the upcoming referendum within the historical context of relations between the United Kingdom and Europe. We have outlined several immediate, as well as long-term, implications of Brexit on the UK economy. Post-withdrawal, Britain is likely to experience difficult structural transformations that may contract economic growth in the short-term. The labor market may well face significant constraints if a new immigration policy that is more restrictive is enacted. Trade relations will also have to be rebalanced, causing considerable chaos and uncertainty for business in the UK, and for Europe as well. We discussed scenarios that lay out the multiple routes Britain’s political economy could take with respect to their relationship with the EU and the rest of the world.

It is impossible to unpack all the potential complexities of Brexit, but our goal was to gain a better understanding of the size and scope of the issues involved. Much of this work is speculative, far more dependent on the political cross-currents in London and Brussels than on economic theory. Come June 23rd, Britain will have an answer to the immediate question of separation, but it is far from likely that this will be the last time the question is asked. So irrespective of the outcome, expect turbulent times ahead for Britain and the European Union.

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