CROSSBRIDGE CAPITAL

Market Viewpoints

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Everything you want is on the other side of fear.

- Jack Canfield

Rebellious Demos

Winston Churchill once said - "Each time we have to choose between Europe and the open sea, we shall always choose the open sea."

Consider, for one moment, the magnitude of what happened last week. Never has there been a greater coalition of the establishment in the UK's history of universal suffrage, to persuade its people to vote a certain way: The Prime Minister and the majority of his cabinet, three-quarters of Westminster Parliamentarians, the Bank of England (BoE), foreign leaders, economists, historians,….and the list goes on. Almost everyone with power and influence said Britain should not leave the European Union (EU) and take a leap into the unknown. Yet, last Thursday, the British people said No to the EU. They rebelled and have chosen the open sea. You don't have to be on the Leave side to admire this (although it helps). You just have to be in favour of democracy. Liberty and democracy matter, and leaders will be well advised to not ignore this.

The UK has been raising the issue of a "democracy deficit" in the EU for some time. Earlier this year, UK Prime Minister David Cameron regaled German Chancellor Angela Merkel with a pre-dinner presentation to explain his referendum idea. Public support for keeping the UK within the EU was collapsing, he warned, but a renegotiation of its terms would prevent Britain from voting to leave. Merkel was not persuaded, and Cameron was sent home with little to show in the way of concessions. The EU took a gamble: The Brits were bluffing and would never vote to leave. A more generous deal, particularly one that would have allowed the UK more control over immigration, would probably have stopped a *Brexit*. The absence of a deal however, sent a clear message to voters: The EU isn't interested in reforming, so it's time to get out. With no deal, all that Cameron could do was use the "fear" card about the risks of leaving the EU and he overplayed his hand. Instead of fear, he seemed to have stoked a mood of defiance and patriotism. It was not the "Little England" that *Brexiteers* were seeking but the escape from the anti-democratic and excessively bureaucratic "Little Europe."

The result should send a clear warning to politicians and bureaucrats alike in every corner of the world: Do not take the people for granted; do not presume that they think the same way as you do; do not underestimate their capacity to think and make their own decision and to throw away political ideas and systems they have come to dislike. In the aftermath of the *Brexit* vote, the US elections in November and the Italian constitutional referendum in October become very significant risk events. Financial markets, bureaucrats and politicians seem to think trade and globalization will do it for everyone. They have placed little or no value on freedom, self-determination, and decentralization, yet, these are the necessary ingredients that encourage wealth creation, prosperity and peace. The referendum's key takeaway is that sovereignty and nationalism now rival economics as drivers of voter sentiment.

What's next for investments?

With Cameron's decision to resign, Article 50 will not be triggered until a new Prime Minister (PM) is in place. Pressure has abated on the UK to serve swift notice of its intention to leave the EU after last week's referendum. In her approach, Merkel is heeding calls from her country's business community. Research indicates that 5.5 million jobs in the EU depend on trade with the UK. The UK has been the fastest-growing major car market in Europe and now accounts for nearly 20% of new-car sales in the EU. It is definitely in the EU's interest for the UK to remain in the Union. Furthermore, The UK is the third-largest contributor to the budget after Germany and France, providing about an eighth of its resources.

Therefore what is likely to happen, is that the UK will seek and obtain a deal that is being called "Norway-minus" in diplomatic circles - less close to the EU than Norway. Norway is outside the EU bloc, but accepts free movement of workers within the EU as the price for being in the bloc's single market. *Brexiteers* will not get a generous deal for fear that it encourages other EU nations to follow the same path. However, the UK will get more than Cameron got in his negotiations in February, or the UK will have no option but to leave the EU. If the UK gets a new deal, it will likely be put to referendum by the new PM and, one hopes, the UK will then vote to stay.

In the meantime, it is clearly a risk-off scenario for investments now, as uncertainly looms. Gold and Bonds will continue to do well in such a scenario as will USD, CHF and JPY, particularly the latter two. GBP/USD still have a risk to the downside. UK GDP growth in the second half of the year will be severely impacted if investments are delayed as multinational companies look to the "Leave" leaders for clarity as to next steps. S&P, the ratings agency, could strip the UK of its AAA rating and the Bank of England stands ready to cut interest rates if there is even a hint of a recession. This will only weaken the GBP. If things get worse, GBP/USD could trade at a level below 1.20 over the next three months. That is a further -9% drop from today's levels. Any benefit that the UK derives from leaving the EU will accrue only in the medium to long term. The short term impact will be mostly negative.

Of course it goes without saying that the *Brexit* vote, and the uncertainty it has brought, will make the US Federal Reserve (Fed) hold off on an interest rate increase for longer. Under the Chairship of Janet Yellen, the Fed seems to focus particularly on the downside risks. The increased volatility will also see systematic funds and "volatility target" funds de-lever, i.e. there will be additional selling in equity markets over the next few weeks. It would be best to wait, for now, before putting new money into equity investments. There will likely be an opportunity to buy stocks later this summer. However, since we are now purely into a political realm, expect a sharp rally in GBP/USD and European equities, should we see signs of a deal between the EU and the UK.

Best wishes,

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