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Brexit and its Implications

The Brexit referendum was important for the long-term functioning of the United Kingdom. The Parliament could not arbitrarily decide whether to stay or leave. The voting public did their duty in the democracy that exists. The majority decided to leave the European Union. Sunday's march was a waste of time and effort. There cannot be a second referendum and Parliament should not override the will of the people considering they govern at the will of those same people.

The outcome, I believe, was to be expected. The European Union officials are not elected to their positions and they do not bear the obligation of responsibility for decisions handed down to member countries. Remember that the EU was initially invented to be a trading group. These days, it makes laws and rules on how a country governs itself. The EU, in many people's minds, has over-stepped the boundaries. The UK has existed within the EU for forty years and I believe that most of those that voted to remain were younger voters that had not experienced an independent United Kingdom. Older voters want to regain control over the economy, migration and policy-making functions. Further, to give up the Pound for the Euro relinquishes control over some of the levers of the economy; using the Euro limits the central bank's efforts to stimulate the economy.

So, what does this mean for the UK and the rest of the world? I believe that Prime Minister Cameron is correct in abdicating to a Brexit believer. This person will be able to negotiate the UK's exit in an orderly fashion. The next step is whether 'Article 50' will be triggered. The first part of 'Article 50' is simple;

"Any member state may decide to withdraw from the union in accordance with its own constitutional requirements."

However, the second part states that the Member State will inform the EU and then negotiate a withdrawal agreement that provides details of its future relationship with the EU. This agreement must then be ratified by achieving a majority vote of EU states and then obtaining consent by the European Parliament. If this clause is triggered then the UK has 2 years to conclude new arrangements but failing to do so only means that the UK will fall out of the EU. Many have argued that there is no time pressure in acting on the referendum and I believe that this is true. The UK must settle down and think about the terms of trade between themselves and their European neighbours. It is a chance to work out how to do business in a manner that benefits the UK.

The German foreign minister, Frank-Walter Steinmeier led a cry with five other members that the “process must start as soon as possible”.

The EU commission president Jean-Claude Juncker said that “It doesn’t make any sense to wait until October to try to negotiate the terms of their departure. I would like to get it started immediately.”

My opinion is that this suits France and Germany because they dislike the disruption to their process. There is a large degree of uncertainty which causes fear. Since the Brexit vote, several countries have come out in favour of revisiting their EU relationship due to concerns over their country’s lack of control and voter opinion. As elections draw closer in France and Germany, in May 2017 and August 2017 respectively, more uncertainty is likely. Both countries are likely to blame the UK for whatever ills are bedeviling their economies at that time!

So, will the UK cope? Initially, as we have seen, there was a massive reaction in the markets, but the long-term result depends on how the economy is managed and whether confidence is encouraged. Growth may slow in Q3 and Q4 but it is likely that the Bank of England will cut rates. The gilts market that trades fixed instruments appears not to be concerned at the moment because rates are low and the debt burden is easy to fund at present. The big question is that of more quantitative easing and bank margins in the UK. In the meantime, the pound has fallen by at least 15% which is positive for exporters.

Equity markets are more easily spooked and some corporates will look to move their headquarters to European cities; a major plus for those centres. Some listed companies have voiced concerns that business confidence may fall on the expectation that doing business in Europe will be more difficult. Generally though, there is more of a concern about what is happening in the US and China and, in truth, this is a more appropriate focus.

The US is registering patchy growth and Federal Reserve Chairman Janet Yellen has been cautious to raise rates and stall it. The Bureau of Economic Analysis released data showing that the US Economy expanded by 1.1% (q-o-q) in the first 3 months of 2016, better than the 0.8% that was forecast but the trend is still softening.

China is the axis of economic growth for many countries and whilst China's growth has been slowing, it still outpaces most other countries. The major impetus was their focus on infrastructure, but now China has switched focus to creating a consumer driven economy. In doing so, the government has moved approximately 400 million people from rural areas to urban developments. Now those people are spending to live so, it is consumer discretionary money that is in the economy and the government lacks control over it. At this point, growth is now around 5% to 7% and the Chinese government has a vested interest in ensuring the success of the transition. Bear in mind that the Chinese economy is worth around 10 trillion dollars!

So, back to the EU…According to the European Commission data the EU does not do a significant amount of trade with the UK. Importantly, the US and China are the EU's major partners and, therefore, the status quo should remain the same.

Client and Supplier Countries of the EU28 in Merchandise Trade (value %)
(2015, excluding intra-EU trade)

Source: Eurostat (Comext, statistical regime 4) Updated 14-Apr-2016

N°	Total EU Trade with...	million euro	share (%)	EU Imports from...	million euro	share (%)	EU Exports to...	million euro	share (%)	EU trade balance with...	million euro
	Extra EU28	**3,518,659**	**100.0**	**Extra EU28**	**1,727,125**	**100.0**	**Extra EU28**	**1,791,534**	**100.0**	**Extra EU28**	**64,410**
1	USA	619,660	17.6	China	350,424	20.3	USA	371,223	20.7	USA	122,786
2	China	520,909	14.8	USA	248,437	14.4	China	170,484	9.5	Switzerland	48,552
3	Switzerland	253,199	7.2	Russia	135,711	7.9	Switzerland	150,875	8.4	United Arab Emirates	39,133
4	Russia	209,622	6.0	Switzerland	102,323	5.9	Turkey	79,107	4.4	Australia	22,094
5	Turkey	140,714	4.0	Norway	74,260	4.3	Russia	73,911	4.1	Hong Kong	21,130
6	Norway	123,128	3.5	Turkey	61,607	3.6	Japan	56,550	3.2	Saudi Arabia	18,708
7	Japan	116,318	3.3	Japan	59,768	3.5	Norway	48,869	2.7	Turkey	17,499
8	South Korea	90,248	2.6	South Korea	42,347	2.5	United Arab Emirates	48,512	2.7	Mexico	13,977
9	India	77,589	2.2	India	39,448	2.3	South Korea	47,901	2.7	Stores and provisions -	13,315
10	Brazil	65,666	1.9	Brazil	31,067	1.8	Saudi Arabia	40,260	2.2	Egypt	13,194

But the European Commission website also shows the following:

United Kingdom

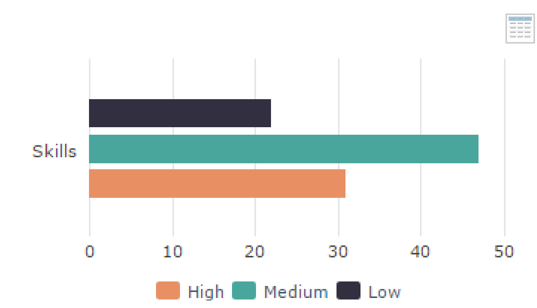
Exports from the UK to countries outside the EU support 3,250,000 jobs in the UK.

Another 722,000 Brits are in jobs linked to exports from other EU countries to countries outside the EU.

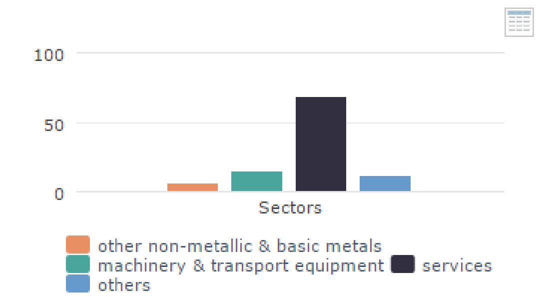
This means 1 in 8 jobs in the UK depends on EU exports.

British exports to countries outside the EU also support over 335,000 jobs in the rest of the EU.

In the UK, most people in export-related jobs are medium-skilled workers.



68% of export-related jobs in the UK are in services.



Apart from 1 in 8 jobs in the UK being dependent on the EU, what else does it receive for its membership? The cost of membership is worth considering… According to The Telegraph (UK), the UK's full membership fee in 2015 would have been 17.8bn GBP (Pounds) but Margaret Thatcher negotiated a rebate in 1984. In 2014, the total contribution paid to the EU was 12.9bn GBP. I cannot find any details for 2016 but I believe that the Brexit campaigners will be focusing on the 34 billion GBP that has been demanded recently by Brussels.

Since none of the politicians want to lead the UK through the exit it will be left largely to the long-term bureaucrats to navigate. A guide as to how the UK will progress in continuing their relationships with both the US and EU will become evident in the forthcoming round of the Transatlantic Trade Partnership (TTIP) talks next week. Another opportunity will be the G20 to be held in Hangzhou, China, in September.

Australia has an EU delegation based in Brussels and the EU has a post in Canberra so there is already a reciprocal arrangement. The Australian Department of Foreign Affairs and Trade (DFAT) have been working on a Free Trade Agreement (FTA) since November 2015. According to the DFAT website "the EU is Australia's largest source of foreign investment and second largest trading partner. In 2014, the EU's foreign direct investment in Australia was valued at $169.6 billion and Australian foreign direct investment in the EU was valued at $83.5 billion. Total two-way merchandise and services trade between Australia and the EU was worth $83.9 billion.

The EU is Australia's largest services export market, valued at nearly $10 billion in 2014. Services account for 19.7 per cent of Australia's total trade in goods and services and will be an important component of any future free trade agreement."

I presume that DFAT and interested parties will continue to pursue an FTA with positive outcomes for Australian businesses.

In looking at the implications for Australia, I found that we export merchandise of gold, alcoholic beverages, lead and jewellery (pearls and gems) to the UK worth A$3,686m. Gold will continue to be priced in US$ but the cross rate of GBP to AUD will play a part in the other trades. Australia stands to benefit from a weaker GBP on our imports of passenger cars, medicines and pharmaceuticals plus books and magazines which amount to A$6,333m. The service sector accounts for A$4,899m of exports (mostly personal travel) and A$6,226m of imports which includes travel and professional, technical and business services. Given the likelihood of a negative response from EU member nations, Australia has the opportunity to improve its trading relationship with the UK and I believe that the High Commissions need to work out an each-way trade visit to capitalise on the situation. At present, the only forthcoming event is the European Association of International Education Conference that is to be held in Liverpool on the 13th of September. Companies that already do business in the UK may be able to grab more market-share if they act quickly. Here I am thinking of CSL Limited, Sonic Health, the big-4 banks, Treasury Wine Estates and Computershare. However, margins may be skimmed due to the weakening GBP.

From a market perspective we will continue to see volatility and the range will probably be more pronounced as investors jump to conclusions and markets over-react. We have seen some selling out of the GBP and Euro into 'safe haven currencies' such as the yen, Swiss franc, US Dollar and even the little Aussie Battler A$. In general, my advice is to focus on companies that have consistent earnings, so the miners, consumer staples, healthcare and domestically focused companies should be good targets but it depends very much on price. Now is the time to look for value and I mean real earnings, based on solid sales not an historic price-to-earnings ratio. Remember, globally investors will be looking for growth and yield too and may find their way to ASX listed companies. I've just seen that the London Stock Exchange listed Aussie miners BHP and RIO were performing well on the opening…

Now is the time to research so that you can buy quality assets on the dips for the long-term. Patience will be the key because global growth will be slow. You will also need some courage to weather the volatility to come.

It's going to be a bumpy ride…

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