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Brexit, Top Google Searches, and Sub Zero Interest Rates Around the Globe

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It seems nobody was looking for the Brexit vote to go the way it did last week. Immediately following the vote, we were shocked to read (or were we?) the most searched phrases on Google in the U.K. were: "What is the EU?" and "What does it mean to leave the EU?" So even after the votes were counted, it seems many weren't quite aware what they may have voted for in the first place! With that in mind, and with a lengthy conversation one of us just had with our father about Britain and the European Union in general, we thought it might be appropriate to step back and review what exactly it was, what just changed across the pond, and how it might affect us.

A brief history lesson:

What is the U.K.?

The name United Kingdom refers to the union of what were once four separate countries: England, Scotland, Wales, and Northern Ireland. The term "England" is sometimes wrongly used in reference to the whole United Kingdom, the entire island of Great Britain or simply Britain. This is not only incorrect but can cause offense to people from other parts of the U.K.

What did Britain vote on?

The referendum question asked voters whether the country should "remain a member of the European Union" or "leave the European Union."

What is the European Union?

The European Union - often known as the EU - is an economic and political partnership involving 28 European countries. It began after World War II to foster economic cooperation, with the idea that countries which trade together are more likely to avoid going to war with each other. It has since grown to become a "single market" allowing goods and people to move around, basically as if the member states were one country. It has its own currency, the euro, which is used by 19 of the member countries, its own parliament and it now sets rules in a wide range of areas - including the environment, transport, consumer rights and even things such as mobile phone charges.

What would it mean to leave the EU?

This is an essential and divisive question. The economic effect of an exit would depend on what settlement was negotiated, especially on whether Britain would retain access to the single market for duty-free trade and financial services. But that would probably require accepting freedom of movement and labor for European Union citizens, which is one of the main complaints the "Leave" camp has about bloc membership. Most economists favored remaining in the bloc and say an exit would cut growth, weaken the pound and hurt the City of London, Britain's financial center. Even economists who favor an exit say growth would be affected in the short and medium terms, though they also say Britain would be better off by 2030. You can see how complicated it is.

Our view at Corda is that the United Kingdom's move to extract itself from the European Union could take a lot longer than people are saying it will. A simple divorce from the EU is designed to happen two years after the article that addresses the breakup is invoked. This is called Article 50, which outlines what happens next and how ties are to be officially severed exactly two years later.

According to Fergus McCormick, head of ratings group DBRS, the actual unwinding of EU trade and financial agreements to which Britain is bound will take years as agreements are phased out as opposed to terminated. "The problem is we are in unchartered territory. In addition to extracting itself from all the contracts that it has with European businesses, and to extract itself from the very complex treaties of the European Union…Britain has to renegotiate 60 trade agreements outside of the ones it has negotiated through the years through the EU. That's going to take a long time."

Our friends at First Trust in Chicago speak of uncertainty as not exactly a bad thing. We quote; "If you really want certainty you couldn't get much more of it in the old Soviet Union or present day North Korea. Those economies minimize flexibility, choice, freedom, while maximizing certainty. By contrast, free-market capitalism is the opposite of a system built on certainty. No one knows what will be invented or discovered next – otherwise it already would have been invented or discovered – or how consumer appetites will change in the future. In free-market capitalism, uncertainty is a feature, not a bug."

Regardless, global markets lost anywhere between $2-3 Trillion between June 24th – 27th. That's a record amount, more so than Black Monday, October 19, 1987. Of course the sheer size of the capital markets are much larger today than in 1987.

We do not consider Brexit to be a cataclysmic event like the collapse of Lehman Brothers or Bear Stearns in 2008. However, we do think the long exit process will be complex and difficult over the next few years, all the while prolonging political turmoil in the U.K. and elsewhere in Europe. In addition, most economists we are tracking suggest declines in trade and foreign investment in the U.K. as well as the potential to slow growth in Europe. However, the U.K. is less than 4% of the world economy, so overall, some are predicting a modest 0.2% reduction in global GDP over the next 12 months. It will be some time before the impact of this historic change becomes evident.

Another point to consider is how the U.K. could position itself relative to the EU much like Switzerland and Norway do. Those countries voted not to be members of the EU, so the EU created a "social" membership in the European Economic Area which gave them free trade and easier border crossings but a buffer from the political whims of the Union. German Chancellor Angela Merkel may take a hard stance against this, but again, there will be months of posturing and negotiations while you and I and the rest of the world goes about our business.

So, despite the turmoil and expectation for a drawn out process in the U.K. over the next decade, we believe the U.S. will continue to experience moderate economic growth coupled with low inflation and low interest rates. We have been on this path for quite some time and do not see anything to suggest that will change anytime soon.

Now switching gears for a minute from Brexit to something we believe will have greater ramifications in the years ahead. It is the level of interest rates at home and abroad. The 10-Year U.S. Treasury bond is now yielding ~1.5%. The record low for the 10-Year Treasury was 1.38% in July 2012. Low interest rates may be good for borrowers, but you'll be hard pressed to find anyone else benefitting from such a low yield. As much as most investors have been counting on (or even betting on) higher interest rates, it is possible our rates continue to decline. 1.5% might sound like a low number, but did you know that there is $11.7 Trillion of negative yielding debt across the globe, with Japan leading the way with about two-thirds of the global total? In Switzerland, nearly all government debt is negative. So the possible repercussions of an extended time period of zero producing debt and how some investors might view the stock or real estate markets as TINA – There Is No Alternative – might cause prices of those assets classes to gyrate suddenly in both directions dependent upon monetary, fiscal, and other economic changes that are bound to present themselves in the future, both good and bad! For instance, it is possible for a melt up in financial and real assets if there is a sudden urge to own businesses yielding 2%, 3%, and 4% or more if the alternatives are either close to zero or less than zero! But that doesn't necessarily make them a must buy, as one must still be careful about the quality and potential for future gains, or even worse, the potential for loss. It's quite a balancing act. We assure you, this is what keeps us up at night worrying on your behalf.

So, as the Brexit news dissipates or other items hit the front pages, we will continue to look dispassionately across the globe and ultimately the markets will return to focusing on earnings, cash flow, balance sheets, dividends, valuations, and total return potential. Heightened uncertainties will certainly cause volatility, but we will use that to our advantage to buy and/or sell. As the tides of protectionism ebb and flow, especially with a U.S. presidential election about four months way, markets may be pressured one day and rebounding the next. We will continue to carefully monitor our businesses and you can be confident we will stay on top of how these events might impact your portfolio.

We are here to answer any questions that you might have.

Best Regards,

The Corda Team