The Absolute Return Letter

April 2016
A Different Take on Brexit

"Brexit would see the UK return to its status as a cake-filled misery-laden grey old island."

Emma Thompson, Actress

As political manifestos go, this will likely go over in history as the most useless ever. When I married my wife many moons ago, she asked me to make two promises, one of which was never to become a politician. *Never!* Once you have read the next few pages, you will probably agree that I did the right thing by never pursuing a career in politics.

Having said that, the Brexit debate here in the UK is rather silly, and it is about time that (some of) the more meaningful issues are raised. I can understand why politicians bring the discussion down to a level that the average person in the street can understand. I would certainly put well over 90% of the electorate to sleep with the points I raise in the following, but to make it a referendum about kettles and toasters (see here) is perhaps to underestimate the IQ of the average voter.

Little time has, at least so far, been allocated to the bigger picture; to things that really matter. Instead the media thrive on stories that sell newspapers. I cannot possibly cover all the pros and cons in a single Absolute Return Letter, and have therefore decided to focus on issues that are likely never to be thoroughly covered in the mainstream media.

My aim is to make this letter as factual as possible, but emotions do run high on this subject, and I am no exception. I will look at the pros as well as the cons because, as is almost always the case, this is not a choice between black and white. And because I cannot vote (as I am not a British citizen), I am sort of neutral. That said, of course I have an opinion, which I will spell out later in this letter.

One final note before I begin. We have had a substantial number of new subscribers in the last few weeks (thanks to John Mauldin), some of whom I may lose over the next few pages, as this month's topic is very UK-centric in nature. All I can say in my own defence is that this month's letter is very atypical in nature, so don't give up. I have no plans of becoming a political activist. I just get *loads* of questions on the subject.

A brief record of how the EU was born

The beast we have all come to know as the European Union, was born in the immediate aftermath of World War II. In 1950 the then French foreign minister proposed for a European governing body to be established, which saw the first light of day in 1951-52. It was governed by the so-called Paris treaties and became known as the European Coal and Steel Community ('ECSC'). Six European countries founded the ECSC – France, Germany, Italy and the three Benelux countries.

Fast forward to 1957-58, and the Rome treaties were signed, which became the foundation of the European Economic Community ('EEC'). The U.K. became a member in 1973. The EEC replaced the ECSC, and ultimately turned into the EU.

All this is important for one very good reason. When the ECSC was established in the early 1950s, World War II had ended only a handful of years earlier, and Europe was still licking its wounds. Most young (and some older) people wouldn't know today, but the ECSC was as much a political project as it was an economic one. '*Never more war in Europe*' was the message and, back then, it wasn't difficult to gain popular support for the idea, following such an ugly chapter in Europe's colourful history.

Long live the bureaucracy

The political leadership in Europe have, since day one, been a step or two ahead of ordinary people, and such vision has been absolutely necessary in order to get so many different nations and cultures to function as one. Having said that, more recently, near fatal mistakes have been made, which have caused many people to lose faith in the whole idea.

The biggest mistake of them all – at least from a timing point of view - was the introduction of the euro. Europe simply wasn't ready for that project, and now the EU runs the risk of the first ever member nation leaving the club again, because political leaders in Europe have been overly ambitious and perhaps even a bit arrogant.

Here in the UK, the debate leading up to the referendum is in danger of turning outright silly. Far too much time is spent on the colour of toilet paper and not enough time on issues that really matter at the end of the day. Entire websites are dedicated to weird and crazy EU laws, and the UK media love it. Having said that, most of the issues brought up by the British media do no harm other than to the British pride.

Here in the UK, it is widely perceived that Brexit would make the UK more competitive. Back in February, I wrote a piece on wealth-to-GDP; how the ratio exceeds historic averages at present levels, and why it is likely to mean-revert in the years to come. If you didn't read it, you really should (see here).

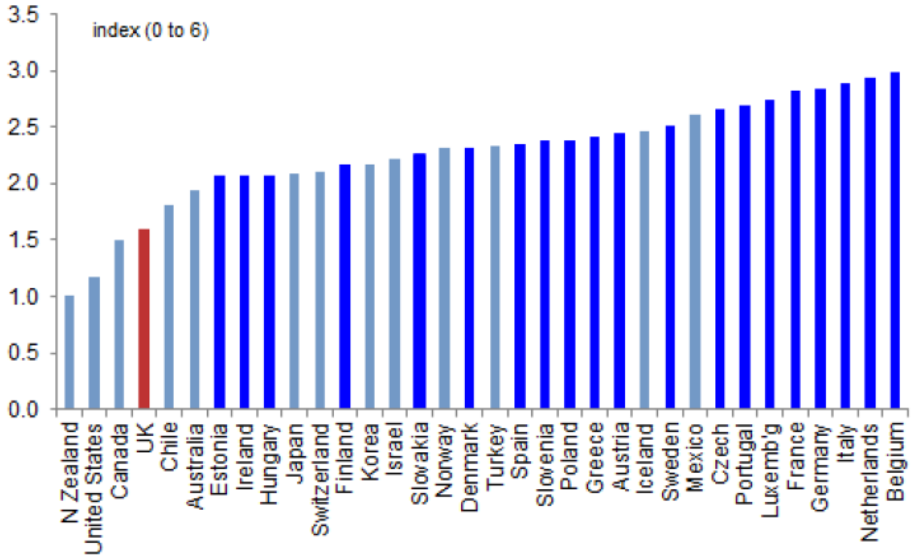
To cut a long story short, wealth-to-GDP is a measure of the efficiency of capital; i.e. how much capital it takes to grow total output by $1. As the wealth-to-GDP ratio is much higher in Europe than it is in the US, I concluded that capital is utilized less efficiently in Europe, and that is absolutely correct.

I then began to wonder – could Brexit possibly fix that problem? Could we leave the bureaucracy of the EU behind by exiting? There is little doubt that bureaucracy holds back innovation, which is one of the strongest drivers of productivity growth and hence of GDP growth.

As regular readers of the Absolute Return Letter will know, in the years to come, I expect little or no economic growth in Europe, unless productivity improves, as the other basic driver of economic growth - workforce growth - will on average have a negative impact on GDP growth over the next many years. All this becomes relevant, as far as Brexit is concerned, because bureaucracy in the EU is often accused of destroying innovation and hence productivity growth. Now, if one assumes that Brexit would lead to less bureaucracy and more innovation, it is not entirely unthinkable to expect it to lead to higher productivity and hence accelerating economic growth.

Here is the problem I have with that argument. EU bureaucracy is not nearly as bad as generally perceived. Yes, the MEPs in Strasbourg do make some silly decisions every now and then, which have a habit of hitting the front pages of UK newspapers, but what really matters re economic growth is not whether the European parliament decide that kettles for our 5 o'clock tea should be banned.

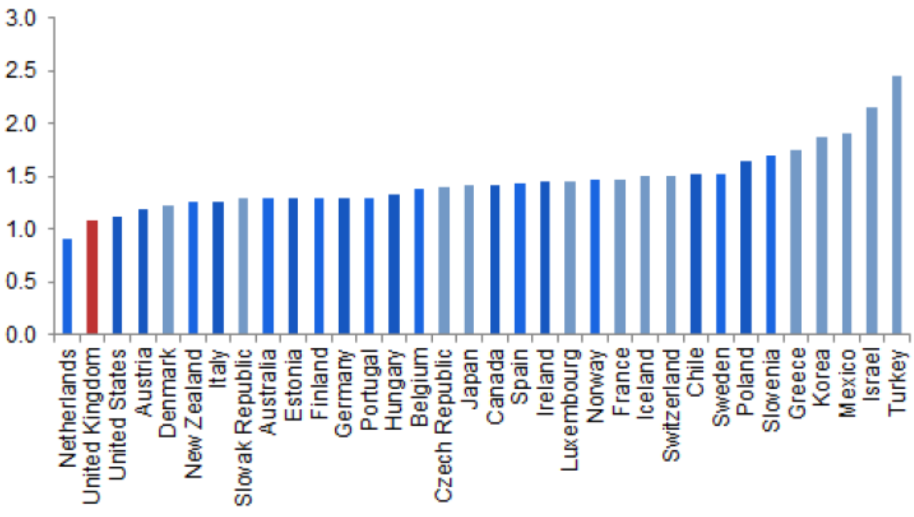
Chart 1: Level of employment protection in various countries



Source: Goldman Sachs, OECD, March 2016

Forgetting access to growth capital for a moment, in reality, economic growth is largely dictated by labour market and product market regulations and, on that account, the EU isn't doing too badly. Take labour market regulations. The seven most protective countries in a recent OECD study are indeed all members of the EU but, if the EU was as over-regulated as generally perceived, the UK wouldn't come out as the fourth least regulated market in the study (chart 1). It is tempting to conclude that it is the countries in question that are over-regulated – not the EU.

Chart 2: Level of product market regulations in various countries



Source: Goldman Sachs, OECD, March 2016

Another example – product market regulations. Although EU countries do not fare nearly as badly as they do with respect to labour market regulations, most EU member countries do significantly worse than the UK. Again – the EU cannot possibly be the culprit (chart 2).

Consequently, UK voters are likely to be disappointed, if they expect Brexit to lead to stronger economic growth. UK labour and product markets are already exceedingly competitive, and Brexit is not likely to meaningfully improve British competitiveness.

The cost of EU membership

Let's jump from one of the biggest potential disappointments to possibly one of the biggest winners, should the UK decide to leave the EU. UK net contributions to the EU amount to approx. £10 billion a year (chart 3). As you can see, the number has risen significantly in recent years, but that is largely because the UK economy has done comparatively well relative to most other EU countries over that period, and contributions vary according to underlying economic performance of the member states.

Chart 3: UK contributions to the EU

£ million

	2008 Outturn	2009 Outturn	2010 Outturn	2011 Outturn	2012 Outturn	2013 Outturn	2014 Estimated Outturn[1]
Gross Payments[2]	12,653	14,129	15,197	15,357	15,746	18,135	19,234
Less: UK rebate	-4,862	-5,392	-3,047	-3,143	-3,110	-3,674	-4,888
Less: Public sector receipts	-4,497	-4,401	-4,768	-4,132	-4,169	-3,996	-4,539
Net contributions to EU Budget[3]	**3,294**	**4,336**	**7,382**	**8,082**	**8,467**	**10,465**	**9,807[4]**

[1] The figures for 2014 are derived from the Office for Budget Responsibility forecast. Those for earlier years are outturn.
[2] Gross payment figures include TOR payments at 75%. The remaining 25% is retained by the UK to cover the costs of administering collection on behalf of the EU.
[3] Due to rounding, totals may not exactly correspond to the sum of individual items.
[4] The 2014 estimated outturn figure is derived from the Office for Budget Responsibility's December 2014 forecast.

Source: Office for Budget Responsibility and HM Treasury

Source: UK government paper on EU membership, December 2014

The all-important question is, how much of the £10 billion per year can the UK expect to save, should it decide to leave the EU? In reality nobody knows the answer, as it will come down to subsequent negotiations, but take Norway and Switzerland – the two largest Western European countries that are not members of the EU.

Government by fax

The two countries have very different agreements in place with the EU, which may have something to do with the fact that Norway runs a significant trade surplus vis-à-vis the EU, whereas Switzerland runs a trade deficit.

Norway is a member of the European Economic Area (EEA); Switzerland is not. The practical implication of that is that Norway has to apply a large number of EU laws and directives in order to fulfil its obligations under the EEA treaty, whereas Switzerland does not. Norwegian critics of that arrangement say that Norway is governed by fax. The country has no say whatsoever as to how EU laws and directives are drafted, but it is still required to implement them.

Switzerland obviously has to meet EU standards when exporting to the EU, but that is no different from having to meet Japanese standards when exporting to Japan. When the British vote on the 23rd June, I am sure the vast majority of voters won't understand this subtle but very important difference. In practice, if the Norwegian model is followed (i.e. the UK leave the EU but remain a member of the EEA), Brexit won't really make that much of a difference. For all intents and purposes, the UK will remain a member of the EU.

Considering the substantial UK trade deficit vis-à-vis the rest of the EU, the UK government could choose to pursue a very cynical approach and not seek a free trade agreement at all. That would result in the UK being subjected to general WTO rules when trading with the EU, but it would probably also mean the end of the City of London as a financial centre, so the government is not likely to walk down that road.

Brexit, should it happen, is more likely to result in some sort of negotiated solution, which will probably be some kind of mix between the Norwegian and the Swiss model. I am fully aware that Brexit supporters much prefer the Swiss model to the Norwegian one, but certain compromises will have to be made in order to protect the City.

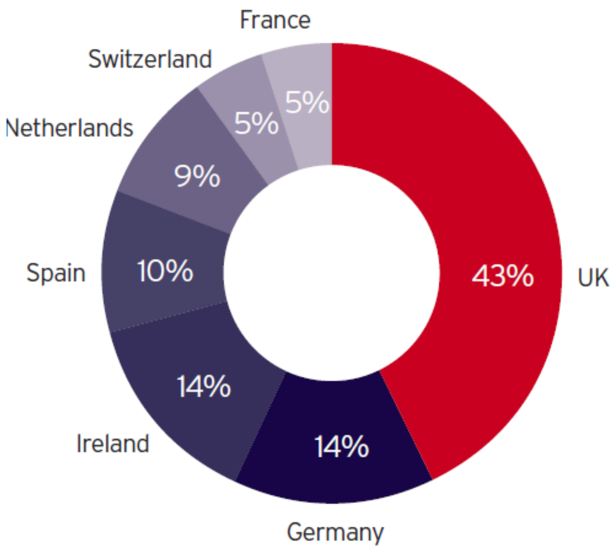
Job losses to be expected

Free trade agreement or not, Brexit is likely to lead to significant job losses in the UK. In the short term, investments, which account for roughly 10% of UK GDP, will be negatively affected. The uncertainty surrounding the implications of Brexit is likely to drive many UK companies to postpone a significant part of their investment programme until there is more clarity.

How long those investments will be postponed for, is not entirely clear to me. As EU laws will continue to apply for 24 months after the referendum, it is possible that the negative impact on investments, and therefore also on economic growth, could last for 3-4 years.

Longer term, the risk to UK jobs will come from elsewhere, though. The UK economy has benefitted enormously from a large number of multi-national companies choosing to base their European headquarters in the UK (chart 4). Should we decide to leave the EU, some of those multi-nationals will move their European HQ elsewhere, as they would wish for it to be inside the EU.

Chart 4: Location of European HQ for multi-national companies



Source: UK Trade & Investment, May 2013

Precisely how many will do that, nobody knows, but it is a significant risk that surprisingly few talk about. Much will depend on the trade negotiations that will take place following the referendum (if we leave). An attractive deal that will result in most multi-nationals staying in the UK is likely to come at a price, though, which will most likely result in the UK continuing to make substantial financial contributions to the EU. You can't have the cake and eat it.

Other important aspects of life that may change

In addition to these largely fiscal implications, other important aspects of life could also change, should the British opt for Brexit. Scotland would almost certainly push for another referendum on independence, and Brexit could quite possibly tip the balance, as the majority of Scottish voters are pro-EU. As a tax payer in England, I would actually benefit significantly from Scottish independence, as the British government sends vast sums of money up north every year.

I also suspect that the migration crisis could get worse (if that is possible). If the UK is no longer a member of the EU, would the French do anything to stop the migrants in Calais and surrounding areas from getting on the first lorry to the UK? I don't think so, unless a deal is negotiated with the French, and such a deal will come at a price.

Contagion risk is probably the biggest concern though - at least from an EU point-of-view. Anti-EU parties in other EU countries are likely to gain much momentum from a British exit, and it is not unthinkable that we will see similar referendums in other countries. This could possibly be the beginning of the end for the EU, but I am not prepared to go that far in my conclusion yet, as it is still way too early.

Investment implications

Under normal circumstances, you would expect equities to fall and interest rates to rise, given the uncertainties associated with the upcoming referendum; however, interest rates are 'managed' (due to QE), and equities are struggling almost everywhere, meaning that it is hard to distinguish between the Brexit referendum and general uncertainty, when trying to establish the root cause behind the wobbly equity markets at present.

What's left then in terms of taking the temperature on the patient? The answer is foreign exchange markets, and the fall in the value of sterling over the past few months suggests to me that markets assign a relatively high probability to Brexit – a conclusion which is in line with opinion polls.

An age old axiom goes something like this: *Buy on rumours, sell on facts*. I still believe that the British will stay in the EU but only after a long and exhausting battle. Should I be wrong, though, I still think much of the damage to sterling will be behind us when we wake up on the 24th June.

This doesn't mean that sterling cannot fall further between now and the 23rd June. I think the British currency will be the main adjustment mechanism in financial markets in terms of how the prevailing view is reflected in financial asset prices. Short term, I am a bear. Longer term, should the British vote against Brexit, as I expect, I can only be bullish.

One additional comment on currencies: The exchange rate likely to weaken the least is GBP/EUR, and the reason is simple. Brexit would not only be negative for UK GDP growth; it wouldn't be good news for the Eurozone either. Using FX to hedge against Brexit, USD appears to be a much better choice than EUR.

Final remarks

The problem with a referendum of this kind is that most people struggle to get to the bottom of such a complex issue. *What would it really mean to me, should we decide to leave the EU?* People ask this question all the time but, in reality, nobody knows the answer, which is why the debate is at risk of becoming so superficial and so driven by emotions. No other country has ever left the EU, so we can't even learn from those who have chosen to do so previously.

As I pointed out earlier, this is not a choice between black and white, though. I find it impossible to reach any conclusion as to precisely what Brexit would mean, financially or otherwise. Too many questions are still up in the air, and there are very clearly both pros and cons, even if most campaigners (on either side) pretend for it to be a relatively simple question.

You have probably figured it out already, but I would prefer for the UK to stay in the EU; not because I have figured it all out, because I haven't. That said, there are two very good reasons not to exit (I think):

1. *Fear of the unknown:* The whole issue is so complex that nobody really knows what an exit would imply, and I prefer to be inside trying to make what we already have work better. After all, it is a decision that cannot be reversed.

2. *Take down borders – don't put them up:* 55 years after the ECSC was first established we are at risk of destroying what has taken so many years to establish, and that is not the way forward.

I would never suggest that the EU is perfect (it is certainly not), and neither would I suggest that leaving the EU could lead to war in Europe. I can think of many things that should be changed, and I would begin by urging our political leaders to be less ambitious. By nature, politics only works well, if there is some level of vision amongst the people we elect; however, in recent years, the gap between the political leadership and the electorate has simply grown too big. Slow down!

Niels C. Jensen
1 April 2016

Important Notice

Absolute Return Partners

Absolute Return Partners LLP is a London based client-driven, alternative investment boutique. We provide independent asset management and investment advisory services globally to institutional investors.

We are a company with a simple mission – delivering superior risk-adjusted returns to our clients. We believe that we can achieve this through a disciplined risk management approach and an investment process based on our open architecture platform.

Our focus is strictly on absolute returns and our thinking, product development, asset allocation and portfolio construction are all driven by a series of long-term macro themes, some of which we express in the Absolute Return Letter.

We have eliminated all conflicts of interest with our transparent business model and we offer flexible solutions, tailored to match specific needs.

We are authorised and regulated by the Financial Conduct Authority in the UK.

Visit www.arpinvestments.com to learn more about us.

Absolute Return Letter contributors:

Niels C. Jensen	nj@arpinvestments.com	Tel +44 20 8939 2901
Gerard Ifill-Williams	giw@arpinvestments.com	Tel +44 20 8939 2902
Nick Rees	nr@arpinvestments.com	Tel +44 20 8939 2903
Tricia Ward	tw@arpinvestments.com	Tel +44 20 8939 2906
Alison Major Lépine	aml@arpinvestments.com	Tel: +44 20 8939 2910