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TOP DOWN INSIGHTS...BOTTOM LINE RESULTS

Buying Britain on Brexit

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Polls, betting odds, and most economists predicted otherwise, but yesterday the UK people voted 52-48% in favor of "Brexit" – that is, leaving the European Union (EU).[1] Tory Prime Minister David Cameron promptly agreed to step down and have an election next October to replace him. On news of the unexpected outcome the British pound and the euro dropped 10% and 3%, respectively, against the dollar. Gold surged 22%. Britain's FTSE 100 Index declined by 3% and other major equity indexes also fell 3-5%. Sovereign bonds jumped as yields fell. We expect all of this to *reverse* sharply over the coming weeks.

Cameron asked for this fallout; he opposed calls for Brexit yet foolishly agreed to put it to a vote to gain a governing edge over fellow Tories who've wanted Britain out of the EU. The latter faction (*aka*, euro-sceptics[2]) – has been right to oppose how the EU has imposed anti-market policies in Britain and other members, under the guise of policy "harmonization." The idea of harmonization was that tax rates, regulations, immigration and other public policies shouldn't differ much among EU members, otherwise people would move from higher-taxed, more-regulated member nations to lower-taxed, less-regulated ones. Yet the EU almost always required policy convergence to occur by lower-taxed, less-regulated members becoming more taxed and more regulated; the high-tax, high-regulation, fiscally-reckless states (like Greece) were spared needed reforms, with the result that the EU is now an economically stagnant swamp.

Britain joined the EU in 1973 and performed badly until Thatcher was elected UK prime minister in 1979. British equities declined at an annual rate of -1.3% from 1973 to 1979, under-performing Europe by 5% points, but then gained 11.0% per year under Thatcher's reign (1979-1995), out-performing Europe, because she implemented policies at odds with the EU's wishes, including privatizations, tax cuts, and deregulation.

Much like Reagan's pro-capitalist policies in America, Thatcher's policies in Britain were reviled by socialists and EU fans alike. Tragically, the successors of Reagan and Thatcher have become increasingly sympathetic with socialism with every passing decade. It shows. Since 1995 British equities have gained just 2.0% per year, half the returns of European equities. Industrial production in Britain increased 1.3% per year under Thatcher but since 1995 has declined -0.3% per year. Has the EU helped?

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[1] England and Wales each voted to leave the EU (53-47% 52-48%, respectively); Scotland and Northern Ireland voted to remain (62-38% and 56-44%, respectively). It's now more likely Scotland will vote to leave the UK; the last such referendum for independence occurred in September 2014 but lost, 55-45%.
[2] The most notable and intelligent is Daniel Hannan, EU Member of Parliament (for the UK) and author of *Doomed Marriage: Britain and Europe. London* (2012), *How We Invented Freedom & Why It Matters* (2013), and *Why Vote Leave* (2016).
[3] To facilitate trade, a European Economic Community (EEC) was formed in 1958 by Belgium, France, West Germany, Italy, Luxembourg and the Netherlands. In 1992 an 11-member EEC signed the Maastrict Treaty, changed its name to European Union (EU), included a timetable to replace their 11 national currencies with a single currency (the euro, implemented in 1999), established a European Central Bank (ECB), and set eligibility requirements to take in new members (including that they have a Deficit/GDP ratio no higher than 3% and a Debt/GDP ratio no higher than 60%). The EU now has 28 members, the most recent accessions being Croatia (2013), Romania (2007), and Bulgaria (2007).

Britain's Labour Party and political left have always wanted the UK to remain in the EU so the UK could more quickly become socialist, environmentalist, welfare statist and Islamic. That's not the result Cameron wished for the UK – at least not completely – but that's roughly what's been happening in the UK since the end of Thatcher's reign.

EU origins. Launched in 1958 by six nations,[3] it had a decent aim: to prevent another world war by unifying states that historically had been perpetually and mutually antagonistic. The introduction of the euro in 1999 also was a good idea, creating economic efficiencies. But European peace since WWII has had more to do with NATO than with the EU. With a lesser need to fund military budgets, EU members irresponsibly ballooned public spending on "social insurance" and welfare schemes. Now many EU members risk national insolvency, having steadily taxed, regulated and socialized their economies into submission and stagnation.

Some say Cameron was "courageous" for allowing the Brexit referendum, but a real statesman would have openly and courageously defied popular will had he thought it bad for the nation he leads. Instead he and the Tories did what every craven politician does these days: pander in the usual democratic manner and take a definitive poll to see what largely uneducated masses might wish to happen on some political-economic policy beyond their comprehension. Fortunately, in this case the right choice was made, although probably not because the British people are especially pro-capitalist; more likely they've become more nationalistic, worried that immigrants will take their jobs or their lives.

So what to make of Brexit? Bearish? Bullish? Innocuous? For who, what and how long? Obviously it's near-term bearish for the British pound, euro and many equity markets, bullish for gold, and bullish for many sovereign bonds.[4] But on *every count* we expect a *reversal* over the coming weeks and return to prior trends. That's another way of saying Brexit is largely an innocuous politico-economic event, that today's big price changes reflect people wrongly forecasting and being surprised about the result, not some likely material diminution in Britain's economic-financial performance due alone to non-EU membership. If anything it'll do better by not kowtowing as much to EU socialists; if it needs to cut trade deals with the EU it can do so. Leaving the EU also doesn't necessarily hurt London's preeminence as a global financial center. Best of all for British would be policy that becomes more pro-capitalist. Of course, Britain is not without its own socialists and they aren't going away just because Britain is now going away from EU membership; if anything they'll fight to get back in, starting with the October elections. If the Labour Party loses, it'll confirm peoples' preference for Brexit.

Pessimists right but wrong. Most economists predicted that Brexit wouldn't pass, but if it did, it would be bearish for Britain. Speaking on Brexit today ex-Fed head Alan Greenspan said "this is the worst," "the tip of the iceberg," because what's "causing the British problem is a widespread problem," or "a massive slowing in the rate of [growth of] real incomes across the whole European spectrum, caused essentially by output per hour in virtually every country slowing to a halt."[5]

Greenspan and the Brexit pessimists are right – but only up to a (superficial) point. The problem in fact goes far deeper than economics. Its bad politics, making it difficult to make efficient, rational and profitable economic decisions. Deeper still, modern politics is being driven by envy of the successful and the desire to punish and expropriate them. What Greenspan and the Brexit pessimists fail to explain is that the deeper cause of the economic stagnation around the world is old-style, burgeoning, deficit-spending welfare states. In these "entitlement states" everyone is supposedly "entitled" to what everyone else has, on the grounds of "social justice," especially if the others are "haves" and the "entitled" are "have-nots." People then wonder why, after decades of such politicized envy and redistribution, they're stagnating economically. They *deserve* it.

Sound familiar? Think socialism. Think Bernie Sanders. Think the EU. Everything's for free, allegedly – as if real producers will keep on producing regardless of how much they're taxed, regulated, and reviled. Stagnation is the fault of socialist elements in public policy. Didn't socialism lose its appeal after the fall of the Soviet Union in 1991? Not really. Since then millions of people globally have vote for it "democratically."[6] For many years now university students have universally embraced socialism and despised capitalism, attributing to the latter the failures of the former. Blame parents and professors. That's the future – and it isn't bullish.

[4] 10-year benchmark government yields declined 31 basis points for the U.S. (to 1.45%), 30 basis points for Britain (to 1.05%), 20 basis points for Canada (to 1.70%), 20 basis points for Germany (to -0.10%), 15 basis points for France (to 0.30%), and 6 basis points for Japan (to -0.19%).
[5] "'This is the worst,' Alan Greenspan says of British Break from EU," *CNBC.com*, June 24, 2016.
[6] "A Generation after Socialism's Collapse, Resentment Persists Towards . . . Capitalism," *The Capitalist Advisor*, November 9, 2009.

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