Everything Just Changed

Anatole Kaletsky
akaletsky@gavekal.com

The outcome of the referendum is a shock fully comparable to the Lehman moment

There are moments in history when the impossible becomes inevitable without ever passing through improbable. The period after the Lehman Brothers bankruptcy was such a time. Last night's unexpected repudiation by British voters of 40 years of European Union membership is another. The outcome of the referendum is a shock fully comparable to the Lehman collapse. Rarely, if ever, has a G7 currency fallen by -10% in a single trading session, as the pound did last night in Asia, ending up at its lowest level against the US dollar since 1985.

Whether markets will rebound or plunge further will depend on a host of political developments in Britain and elsewhere

Whether the pound or other assets will enjoy some kind of technical rebound or plunge further, and the longer term impact on financial markets and the world economy, will depend on a host of political developments in Britain, the rest of Europe and other countries. By definition these political events will be as unpredictable as the referendum itself. Rather than trying to base a strategic response to this earthquake on purely speculative assumptions about British or European politics, trade negotiations or monetary policy, this is a time to behave tactically. As in the immediate aftermath of the Lehman bust, the priority must be to protect positions, raise cash and retain optionality to respond to whatever opportunities or disasters may emerge in the coming weeks and months.

After maintaining ever since 2009 that economic fundamentals around the world were gradually improving and therefore that more risk-on positioning was justified, I have been arguing for the past two months that 2016 was turning into a year when politics, rather than economic data or corporate results, would set the course for financial markets. This became obvious in the past few weeks as markets around the world started to follow the gyrations of British opinion polls. What never seriously occurred to me was that the populist revolt was in reality even bigger than

Checking The Boxes
Our short take on the latest news

Fact	Consensus belief	Our reaction
US new home sales fell -6% MoM to 551k in May, from 586k in Apr	Lower than 560k expected	Strong demand supports home sales; but construction to stay weak due to tight loan standards
US Markit manufacturing PMI rose to 51.4 in Jun, from 50.7 in May	Higher than 50.9 expected	Inventory & strong USD remain issues for manufacturers; expect mfg sector to remain weak
UK votes to leave European Union	Unexpected; probability of Brexit was less than 30% according to bookmakers ahead of vote	Near term bearish but could create conditions to break EU out of malaise longer term
Eurozone flash composite PMI fell to 52.8 in Jun, from 53.1 in May	Below 53.0 expected; Ger 54.1 (from 54.5), Fra 49.4 (50.9)	Points to muddle through growth but Brexit vote changes EZ economic outlook

the opinion polls suggested and would acquire enough momentum to overthrow the entire political structure of the world's most stable and generally moderate democracy. For better or worse, that is what happened last night—and as a result all the assumptions behind the risk-on thesis must, at the very least, be temporarily suspended, and possibly turned upside down.

Charles's *Ursus Magnus* is, at least in the months ahead, the most likely scenario

What this means in practice is that Charles's longstanding expectation of an *Ursus Magnus* bear market must now be considered the most likely scenario, at least for the months ahead. There are four reasons to jump straight to this dismal conclusion, even if many of my previously bullish economic and financial arguments were valid before last night's Brexit vote.

Though the UK makes up a small share of global GDP, financial market interconnectedness means a clear risk of contagion

First, the UK is a significant part of the global economy and the prospects for trade, investment, asset prices and banking stability in Britain will be gravely damaged—at least for the next few months—by the unprecedented policy uncertainty that begins this morning. While Britain's share of global GDP may only be 2.5% to 4% (depending on market or purchasing power parity exchange rates) its weight in global finance is much greater. More importantly, as we learned from the subprime crisis, and again from Greece and Ireland, serious disruptions in a small part of the global economy can be magnified many times over by global interconnections—and this amplification process is much more powerful and much faster when it works through financial markets and investor expectations, and not just through the interconnections in trade and manufacturing that dominate conventional economic models. Given Britain's very large current account deficit and the exposure of the British banking system to property values, the potential for a financial crisis and then contagion to the rest of the Europe is a clear and present danger.

The credibility of the EU and ECB's efforts to prevent another euro crisis outbreak will be severely tested

Secondly, the political impact of British withdrawal on other EU countries is potentially huge but also totally unpredictable. Whether this will mean a tightening or a loosening of ties among the other EU countries or even perhaps the total breakup of the EU or the eurozone will emerge only gradually in the months ahead. But what can be said for certain is that the credibility of the EU and European Central Bank's efforts to prevent another outbreak of the euro crisis and to keep Spain, Greece and Italy within the euro will be severely tested and questioned by the markets—and even more importantly by the citizens of all these countries.

Financial markets and pundits are now forced to take the prospect of a Trump presidency much more seriously

Thirdly, the Brexit vote will surely encourage similar political upheavals in other countries. In the rest of Europe direct imitation is highly probable. In the US, the connection will be subtler but powerful nonetheless. Although US voters will not be inspired to support Donald Trump by the British example, financial markets and political pundits will be forced to take the Trump phenomenon much more seriously because expert opinion and prediction markets turned out to be so misguided in the British referendum result. That means that Trump will acquire greater credibility and financial support—and it also increases the risk that political uncertainty ahead of the presidential election will trigger a US financial crisis or recession, which in turn would give Donald Trump a much more plausible route to the White House than seemed likely 24 hours ago.

Britain is now a society split along lines of age and education…

Finally, and perhaps most disturbingly, the British referendum has produced an extremely fractured and polarized society—with huge majorities for Brexit among elderly and poor voters and in relatively under-developed rural regions vehemently opposed by almost equal majorities that supported EU membership among young and highly educated voters and in the prosperous cities—not only London, but also Manchester, Bristol, Newcastle and the whole of Scotland. This extreme polarization on a national issue of existential importance would raise risks of social and political tension even in benign economic conditions. If, as is likely, Britain now suffers some kind of financial crisis and recession, the people who voted for Brexit will discover that leaving the EU has not resolved any of the economic problems and social grievances that provoked their protest against the political establishment. If this happens, public anger will presumably intensify, rather than calm down. A similar disillusionment is likely in other countries whose voters decide simply to overthrow political elites and dismiss the analysis of economic "experts", without having any serious alternatives to put in their place.

...and what happens when Brexit voters discover that last night did not solve their grievances?

One cannot be sure of the long term outcome—raise cash and reduce risk

At some point, these political and economic tensions will presumably stabilize and the popular revolts could ultimately have positive outcomes if new political leaders and economic policymakers come forward with constructive ideas for reform. That is what happened after the crisis of the 1970s with the rise of Reagan and Thatcher and in the 1930s in America under Roosevelt. But the 1930s should remind us that there could be much less benign outcomes. And even in the 1980s, the benefits for investors only became apparent after several years of big losses and extreme turbulence. When a society and an economic system is turned upside down, which is what voters have now decided to do to Britain and perhaps the whole of Europe, one can never be sure about the long-term outcome. The rational first response is to raise cash and reduce risk.