Brexit Sends the World into a Tizz

This article is an extract taken from the upcoming Forager June 2016 Quarterly Report.

Three times in the past 12 months financial markets have been in a tizz. We went close to a bear market in August 2015, officially entered one in February of this year and then saw frantic currency and equity selloffs after the Brits voted to leave the European Union in the final week of June.

The first two of those were buying opportunities. There didn't seem to be a lot of rational logic behind some of the selling, and we were able to pick up businesses like **Alphabet** and **South32** at very attractive prices.

It may yet become irrational, but so far the response to the latter, Brexit, has been orderly and appropriate. This is not jumping at shadows. Brexit has the potential to have a very serious impact on the wider UK economy and many of the companies operating within it.

Irrespective of your view on the politics (I have some sympathy for a country wanting less political interference from a supra-national body), the economics of Brexit range between not great and bad.

The optimists' argument goes that, while the EU allows free trade within its borders, it is actually quite protectionist against the rest of the world. This is true, as any Australian farmer can tell you (some 70% of European farm receipts are government subsidies, compared with just 4% in Australia). Freed from those shackles, the UK will become a rich bastion of free trade with the rest of the world.

The world these people live in, where countries run around signing free-trade agreements willy-nilly, is not the one I have been living in for the past four decades. Domestic politics and self-interest make individual free-trade deals almost impossible to negotiate. The Trans-Pacific Partnership between 12 Pacific Ring counties including Australia, Japan and the US has been seven years in the making, has been dramatically watered down from original expectations and still hasn't been ratified by respective governments. The proposed Transatlantic Trade and Investment Partnership between the US and Europe was first proposed in 1990 and is still no chance of being finalised. While Canada's agreement with the EU, often proposed as the template for the UK, took seven years to negotiate and also still hasn't been ratified. Even in Britain, I'm not sure unfettered free trade is what the average person is in favour of – particularly those who voted in favour of Brexit.

The argument the UK will be better off outside the EU is nonsense. The UK has been one of the largest beneficiaries since joining the European Economic Community in 1973. According to a recent article in the Financial Times, the UK has gone from being the "sick man of Europe", where GDP per head had previously grown roughly half as quickly as it had in Germany, France and Italy to a point in 2013 where Britain became "more prosperous than the average of the three other large European economies for the first time since 1965".

From an economic perspective at least, open access to one third of the global economy, which the UK has with its current membership of the EU, is about as good as it gets.

For all of these reasons, I still think the most likely post-Brexit outcome is something that looks largely similar to the current arrangements. Some commentators have even suggested a precedent for a second referendum if new arrangements can be negotiated that allow Britain to stay in the EU with some restrictions on immigration. Or an arrangement similar to that which Norway has where, in exchange for unfettered access to export markets, it agrees to be bound by most EU rules, contributes to the EU budget and accepts unlimited immigration from other EU countries.

All of that is still highly uncertain. Both the governing Tory party and the main opposition Labour Party are in complete disarray in the UK, so no one even knows who is going to be doing the negotiating. And European leaders have expressed contempt for any agreement which might incentivise other countries to go down a similar path.

Even if the ultimate outcome is a positive one, the route from today's disarray to a happy place is going to be tumultuous. The prospect of exit is going to have an immediate impact on consumer spending, business investment and (probably) house prices. How much is anyone's guess, but these risks are real and worth treading carefully around.

Hence we have been giving a lot of thought to these risks as we assess our portfolio exposures to the UK economy and the opportunities that are thrown up as stock prices fall. We have direct exposure in the International Shares Fund and indirect exposure through **GBST** and **Enero** in the Australian Shares Fund. But we are also concerned about the broader implications of a general trend towards rising protectionism around the world.

A hit to global trade has been one of the key factors in our risk exposure analysis for the past few years, but we have generally focused on exposure to the overall level of trade. This is obviously a heightened risk with Britain leaving the EU, but there are potential further consequences of a rise in global nationalism that need to be contemplated.

We own a lot of European businesses that are predominantly focused on international exports (**El.En.**, **Kapsch**, **Rosenbauer**, **B&C Speakers**, **Rolls Royce**). These companies - particularly the first four - are massive beneficiaries of the EU project. How did a Linz-based fire truck manufacturer, or a medical device manufacturer based in Florence, become global leaders in their fields?

The answer is that, despite being from small cities, they have free and unfettered access to 500 million potential customers and the world's largest economy in the EU. The EU also has the ability to use its leverage to negotiate access to other large markets like the US, and these companies become immediate beneficiaries. What chance is tiny Austria of negotiating an equivalent deal with dozens of other countries? The much-derided rules of the EU also govern things like public tenders, ensuring the process is open, transparent and less susceptible to vested interests. What chance is Kapsch of winning a toll road contract in Bulgaria in a world without these rules?

I'm not for a moment pretending the EU is perfect and there are fundamental flaws that need to be fixed. Hopefully Brexit is the wake-up call needed to remedy some of those flaws. But on balance the European project has been an extraordinary economic success story over the past 50 years and some of the companies we own are specific beneficiaries.

A far right candidate, Norbert Hofer, came within a whisker of winning the presidency of Austria in May this year and National Front's Marine Le Pen is expected to be prominent in next year's French presidential election. Both are keen on putting up physical and economic borders. From an investment perspective, their desire to unravel Europe's integration, and the public's desire to support them, is something we need to be contemplating.

As I have pointed out many times in the past, there is no correlation between economic growth and stock market returns. Our job is to build portfolios that are resilient to a wide range of potential outcomes. And the best opportunities always arise when the fellow investors are at their most pessimistic. So do not think such turmoil would not be without opportunity. But we have some very interesting years ahead of us and it would seem we are going to earn our keep.