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SPECIAL MESSAGE: Thoughts on "The Brexit"

"The endless threats about trade deals and GDP per capita from the EU and the IMF and the World Bank and the OECD, instead of cowing the British people, seem merely to have excited their bloody-mindedness. They recognize that they might indeed take a short-term financial hit, but there are some things more important than money."

- ***Andrew Roberts, British historian, in his Bradley Prize speech at the Kennedy Center, June 15***

If there was ever an event that established the futility of crystal ball prognostication, it was the Brexit. The polls, the betting markets, the leading financial pundits and the world markets all suggested the UK would vote to remain in the EU. Yet, it did not.

Countless newspaper headlines throughout the world led with something like: "The Unthinkable Has Happened."

Not exactly. As one of my favorite industry commentators, Nick Murray, observed:

"**The eminently thinkable has happened.** A free people has risen up against a government headquartered in another country -- which made 60% of its laws (with foreign judges deciding if those laws were legitimate) -- and declared their independence."

No, he was NOT celebrating July 4, 1776 a week early. Mr. Murray was opining about June 23, 2016, a day on which the British people voted by a convincing majority to leave the European Union. It seems they became transfixed, finally, by the antic notion that they ought to have the right to make their own laws and to have their own judges decide on them.

In their own manic-depressive way, investment markets saw a lot of turbulence in the last 3-trading sessions. The past eight years of sluggish nominal growth, combined with a highly levered global environment, led to less predictable geopolitical forces and more political populism. These forces really asserted themselves last week in the Brexit vote.

I would describe Friday's market sell-off and today's down morning as *more of a surprised environment than a truly distressed one*.

Market risk perception is certainly up, but it is not extreme. The VIX index of implied volatility has risen to slightly over 20%. This is a little above average but well below the 40%+ implied

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volatility that we see in real market crises. The S&P 500 Index was down 3.6% Friday, but it is still within 5% of its all-time high. The Barclay's High Yield Index was soft, but it edged down less than 2%. And while gold is strong, it's still well below the highs of a few years ago.

It will take some time for us to get a clear read on the long-term impact of the Brexit. UK Prime Minister David Cameron has resigned, but we won't know his successor for some time. In fact, it's likely to be a few months before his successor is appointed.

Candidates for his position are quite different in character, and the choice the Conservative Party makes will no doubt have a bearing on the UK's negotiating posture as it withdraws from the EU. This process is likely to take a couple of years. The key area of focus here will be the UK's access to the single EU market, as this represents nearly half of UK exports. The EU heads of state are not meeting until Tuesday, so we won't have a preliminary read on their intent until then.

We simply don't know if the UK will negotiate a position close to what it already has, along the lines of Norway, for example, which maintains full access to the single market in exchange for labor mobility, fiscal transfers, and willingness to accept most EU legislative directives. It's also uncertain whether Germany and France will want to make the divorce painful enough to dissuade other EU members from considering this path forward.

In the short-term, this uncertainty is likely to weigh heavily on the UK's economic performance. Longer-term, the combination of a weak currency and perhaps a more flexible legal and regulatory regime could be a positive for the supply-side of the UK economy, but we'll simply have to wait to see how policies unfold.

The UK itself is small in a global context, so the question of contagion is actually more important. There are elections this weekend in Spain, an Italian constitutional referendum in October, and support for euro-skeptic politicians like Le Pen in France is increasing. There's also the potential for renewed talk of a Scottish referendum on independence.

There are many paths that both markets and the political economy can go down, given the propensity of central banks to rush to the rescue whenever a danger seems to lurk. Central banks have already stated their willingness to provide liquidity if required. Futures markets now predict that a rate hike in the US is all but off the table this year. Having said that, the ammunition that the central banks of the world have is somewhat more limited today, unless they choose to engage in increasingly unconventional policy which could add to exceptional uncertainty at some point.

Personally -and I've said this several times in Bodnar White Papers- I never felt comfortable with the idea of a unified Europe with a common currency. I could never figure out how it could sustain itself when certain countries overspent, then used inflation to debase their currencies. I believed it was inevitable that the system would unwind. Maybe it will…. maybe it won't. Stay tuned.

In the meantime, the hardy British people can get ready once again to be masters of their own political -- and especially economic -- fates. Being the most outward-facing of the major European economies (the UK, not China, is the largest foreign investor in the U.S.) I can't imagine it won't thrive on its own.

For example, it will no longer be forced to live under the EU's crushing external tariff, which deters African farmers from exporting their produce to Europe, perpetuating poverty there and raising consumer prices in Europe.

And it will once again be free to innovate -something the European Union, claiming to need 28 countries to agree on anything, is incapable. Markus Breyer, director general of BusinessEurope, a confederation of industry groups, has said, "Technological progress is often hindered or almost impossible in Europe." There is no European Google, Amazon or Apple, and for good reason.

For those of you disappointed…. don't be.

June 23rd was a great day for Britain, and for its "Special Relationship" with the USA. It was a great day for human liberty, and one of the worst days ever for stultifying European collectivism.

Appropriately, the 4th of July this year will be a four-day weekend. Fire up the grill, hang your flags a few days early and rejoice. All will be well…regardless of what the stock market says.

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