# The EU Membership Referendum: Bigger Than Brexit

June 23, 2016

CEDAR ROWE
PARTNERS

Dear Partners,

In our Q4 2015 Capital Markets Update, we identified political polarization in Europe as a key risk coming into 2016. On February 20th of this year, UK Prime Minister David Cameron announced plans for a referendum on the country's membership in the European Union, which is being held today. Throughout the past four months, raucous campaigns for and against the UK's membership in the European Union have been waged, and politicians, central bankers, multinational corporations, and prominent investors have aired their views regarding the economic and ideological implications of the vote. While the referendum has been portrayed by the media as a binary and culminating event, we believe it's more appropriately thought of as the latest installment in a series of mini-crises, precipitated by deeply rooted economic and political problems facing Europe. While a full survey of Europe's problems is beyond the scope of this commentary, we'd like to offer a high level summary of the circumstances surrounding the UK referendum including the basics of EU membership, the UK's reasons for considering a withdrawal from the EU, the legal and political contours of the UK referendum, and investing implications.

## EU Basics

The basic premise of the European Union is that its members benefit from "pooling" aspects of their national sovereignty—delegating certain decision making powers to EU institutions in order to attain the benefits of size and integration. The major tenets of EU membership are freedom of movement for workers, tariff-free trade within a single European market for goods and services, and, for 19 of the EU's 28 members, a common currency. While the original impetus for many of the EU's predecessor treaties (of which there are too many to list) was to foster economic cooperation after WWII, it's important to recognize that the EU is not simply an economic union or a trade zone. The EU's scope has gradually expanded to areas such as public health, security, human rights, and environment policy. EU institutions have the power to draft rules and make decisions, some of which are universally binding across all member states without ratification at the national level. Thus, there are significant vested interests in maintaining the integrity of the European Union—and grievances against it—that extend well beyond the realm of economics and finance.

## The Case For Leaving

The EU principles of open borders and free trade are relatively easy to uphold during periods when jobs are plentiful and wages are rising. However, the period of economic malaise following the 2007-08 financial crisis has created numerous strains and divisions within and among EU member states and given rise to nationalistic sentiments. In the UK, those favoring a "leave" vote argue that withdrawing from the EU would liberate the UK from the overbearing and misguided regulation of the EU as well as the economic and social burden of the EU's liberal immigration policies, which allow EU citizens to live and work anywhere within the 28-member bloc while requiring host countries to offer migrants the same social welfare benefits as their own citizens.

In recent years, the UK has absorbed thousands of economic migrants, as its relatively strong economic performance has drawn workers from places like Bulgaria, Poland, Romania, and Lithuania where conditions are less favorable. More recently, the rise of ISIS and the corresponding European refugee crisis have exacerbated concerns regarding the EU's freedom of movement principle, as terrorist attacks in Paris and Brussels have evidenced major failures of EU security, border control, and intelligence sharing measures. Apart from security concerns, some Brits also fear an erosion of national identity, tradition, and values due to mass immigration. In the words of Boris Johnson, Brexit advocate and former mayor of London, "immigration is a powerful symbol of our lack of control".

While the outcome of the UK referendum is important, the broader issue at hand is the economic and political future of Europe. Despite a multi-decade movement toward integration, ideological fault lines are becoming increasingly evident. Several EU member states harbor populist, nationalist, and euroskeptic political parties whose platforms resemble that of the Brexit campaign; weaker ties to the EU, a tougher stance on immigration, and a policy agenda that favors domestic interests above all else. Examples include the National Front in France, Podemos in Spain, the Freedom Party in Austria, and Alternative for Germany. A "leave" vote in the UK referendum could strengthen the hands of fringe political parties throughout Europe, enhancing their ability to impact political outcomes—with or without attaining legislative control—thereby undermining the economic cooperation and structural reforms needed to improve Europe's long-term economic prospects.

## The Vote

While today's referendum is an important landmark in the long-term process of determining the UK's future role in Europe, the outcome is not as binary or deterministic as it may seem. Since the vote is "advisory" (i.e. non-binding), it doesn't automatically trigger legislative action and has no legal standing regarding the UK's membership in the EU. While it would be difficult for the UK parliament to ignore the will of the people if the outcome is decisive, a narrow victory either way would likely mark the beginning of a contentious and high stakes political process that could include a recount, a second referendum, and senior-level changes in the UK government.

Should the UK parliament eventually vote to leave, Article 50 of the EU's governing treaty stipulates that a withdrawal agreement would need to be completed and approved by the European Council within two years. The UK would undoubtedly seek to maintain strong ties with the EU, most likely through an alternative trade pact similar to the European Economic Area ("EEA") or the European Free Trade Agreement, which provide Norway and Switzerland access to the EU's common market. However, the process around this could be prolonged and messy. The EU would have a strong disincentive to provide the UK favorable terms given the inherent need to curtail other member states from pursuing a similar path. Meanwhile, the UK would be negotiating from a position of weakness given its reliance upon the EU for capital flows and exports, and would likely be forced to accept many of the conditions of EU membership (adherence to regulations, product standards, etc.) without the benefits of influence or representation within the EU.

## Investing Implications

As the referendum draws near, global policymakers have registered their concerns regarding the impact of a so-called "Brexit". Within the span of two business days in mid-June, the leadership of the Federal Reserve, the Bank of Japan, the Bank of Canada, and the Swiss National Bank each indicated that a Brexit scenario would be damaging to global cyclical growth trends. The OECD, the World Bank, and the IMF have also issued reports indicating that the economic effects of leaving the EU would likely be "negative and substantial" for the UK.

Against this backdrop, the prices of UK and European risk assets and global safe havens have fluctuated sharply as the odds of a Brexit have appeared to ebb and flow. While the referendum will undoubtedly influence markets in the short term, efforts to predict the outcome of the vote are futile. For starters, the polling data indicate that the vote is simply too close to call. More important, the opinion polling and survey techniques employed in more frequent and standardized elections have proven to be notoriously unreliable for unique, one-off votes. For instance, the final polls missed the mark by several percentage points in the 2014 Scottish plebiscite on independence from the UK and in Quebec's 1995 vote on secession from Canada, significantly underestimating the desire for the status quo in both cases. In addition, academic studies of past referendums, including those held in the UK, suggest that a large portion of voters (20% to 30% by some measures) make up or change their minds in the final days leading up to the vote.

In light of the inability to handicap the outcome of the referendum and our general aversion to short-term thinking, we are sitting tight at the moment. We did, however, initiate a broad, yet modest de-risking of client portfolios back in mid-May following a double digit rally in global equities this spring. For most clients, this involved a slight reduction in equities and an increase in the duration of fixed income holdings. While these changes would likely prove beneficial in the short-term if market conditions deteriorate, they're reflective of our evolving outlook for growth and asset prices over a cyclical horizon and a broader mosaic of "known unknowns", as opposed to tactical maneuvering based solely on the UK referendum. It's possible that the referendum and subsequent events may yield opportunities or risks that warrant additional action. In the meantime, we remain vigilant and watchful, and will provide additional updates as necessary.

Gene Lohmeyer

**Gene Lohmeyer, CFA**
Chief Investment Officer

Sean P. Cook

**Sean Cook**
President

Dislcaimer

David Cook and Associates (DBA "Cedar Rowe Partners") is an investment advisor headquartered in Atlanta, GA and registered with the Securities and Exchange Commission. Registration does not constitute an endorsement, and does not imply any level of qualification, training, or skill.

This message is provided for informational purposes only and is intended for the sole use and benefit of the recipient. The contents of this message, to include text, images, logos, icons, and other materials, are considered valuable intellectual property and proprietary to Cedar Rowe Partners. No portion of this communication may be transmitted, broadcast, transferred, reproduced, or utilized in any manner without explicit written consent from Cedar Rowe Partners. Any and all unauthorized use or reproduction shall be deemed a willful infringement upon the intellectual property rights of Cedar Rowe Partners.

While Cedar Rowe Partners uses reasonable best efforts to provide accurate information, Cedar Rowe Partners makes no representations or warrantees regarding the accuracy or completeness of any information contained. Nothing contained or referenced in this document constitutes tax, legal, or investment advice. Recipients in need of tax or legal assistance should seek such assistance from a qualified professional services organization. This communication reflects the opinion of its author as of the time of publication, and will not necessarily be updated as views or information change.

This communication does not constitute an offer or solicitation to provide any investment advisory service or to sell or purchase any security. Cedar Rowe's publications reference historical performance data. Such data do not guarantee or imply future performance. To varying degrees, the investments and investment strategies referenced in Cedar Rowe publications entail risk of financial loss.