"BREXIT" — AN UNKNOWN WITH DIMINISHING IMPORTANCE

FIRST — SOME BREXIT GEOGRAPHY

I will eventually make an effort to put the United Kingdom's recent decision to leave the European Union in economic perspective, but before I do I'd like to take a moment to distinguish between some overlapping regions that are apt to confuse those of us who are not world travelers. While the media sometimes refers to The United Kingdom, Great Britain, Britain, and England as if they're interchangeable, they're not, so to save a bunch of words, the shaded area below is the U.K. Of course, that's shorthand for The United Kingdom, which is also short for The United Kingdom of Great Britain and Northern Ireland. The unshaded area to the left is the Republic of Ireland which, despite similarity of name, is a sovereign state that's distinct from Northern Ireland.

The U.K. (hereinafter "the U.K." with a purposely small "the") is comprised of four "administrative regions," as highlighted here:

Northern Ireland

Wales

England

Scotland

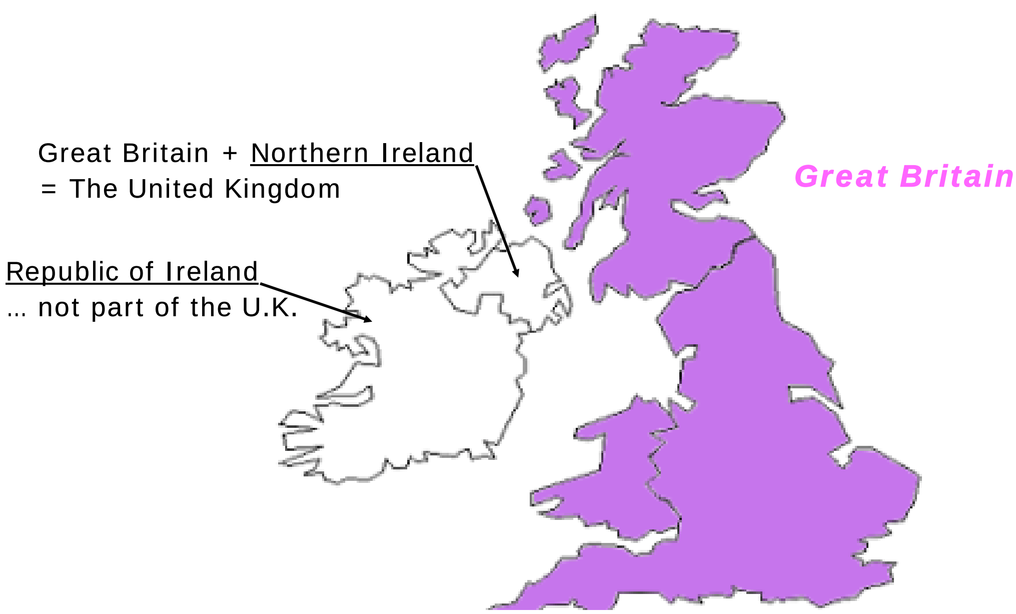
ENGLAND — DOMINANT WITHIN THE U.K.

With around 85% of the U.K.'s total population, England is the dominant administrative region within the union. Confusingly, it is also a country, as are Scotland and Wales.

Owing to England's dominance, people sometimes regard England and the U.K. as though they're one in the same, but of course they're not. This confusion is furthered by the fact that London is, at once, the capital of England as well as the capital of the U.K. as a whole. But even though England is the most influential component of the U.K., it is important to realize that England's political standing is similar to that of the U.K.'s smaller members.

GREAT BRITAIN — AN ISLAND, NOT A POLITICAL ENTITY

Great Britain is an island land mass that's comprised of England, Scotland, and Wales, as pictured below.



Geographically, the only difference between Great Britain and the U.K. is that Northern Ireland is not part of the island of Great Britain. Like England, Great Britain has no particular political standing aside from the fact that its constituent parts, England, Scotland, and Wales, comprise over 97% of the population of the U.K. as a whole.

Confusingly, the English, Scottish, and Welsh are also apt to identify as British, simply because their respective countries are part of the island of Great Britain.

IRELAND — ANOTHER ISLAND

Ireland is an island that's comprised of Northern Ireland and the Republic of Ireland. About a hundred years ago, the southern portion of the island severed its political ties with the United Kingdom to form what is now the Republic of Ireland. The Republic of Ireland is an independent country with its own president and prime minister. The Republic of Ireland is *not* part of the U.K. and is, therefore, not in the news.

In contrast, the northern portion of the island chose to remain allied with the U.K. As such, Northern Ireland is an administrative jurisdiction of the U.K. as are England, Scotland and Wales, but unlike them, Northern Ireland is not a distinct country. Although Northern Ireland is clearly not part of Great Britain, residents of Northern Ireland are still apt to identify as British due to their inclusion in the U.K. which is dominated by England and the island of Great Britain as a whole.

UNITED KINGDOM — A COUNTRY OF COUNTRIES + NORTHERN IRELAND

The United Kingdom is comprised of four regional jurisdictions: England, Scotland, Wales, and Northern Ireland. Northern Ireland is not considered a "sovereign state." And, even though England, Scotland, and Wales are distinct countries with long histories, they're not sovereign states either, which is confusing for Americans who tend to think of states as being subordinate pieces of a country. What's more, these four countries/jurisdictions form the United Kingdom which is a country in its own right that, unlike its constituent pieces, *does* qualify as a sovereign state.

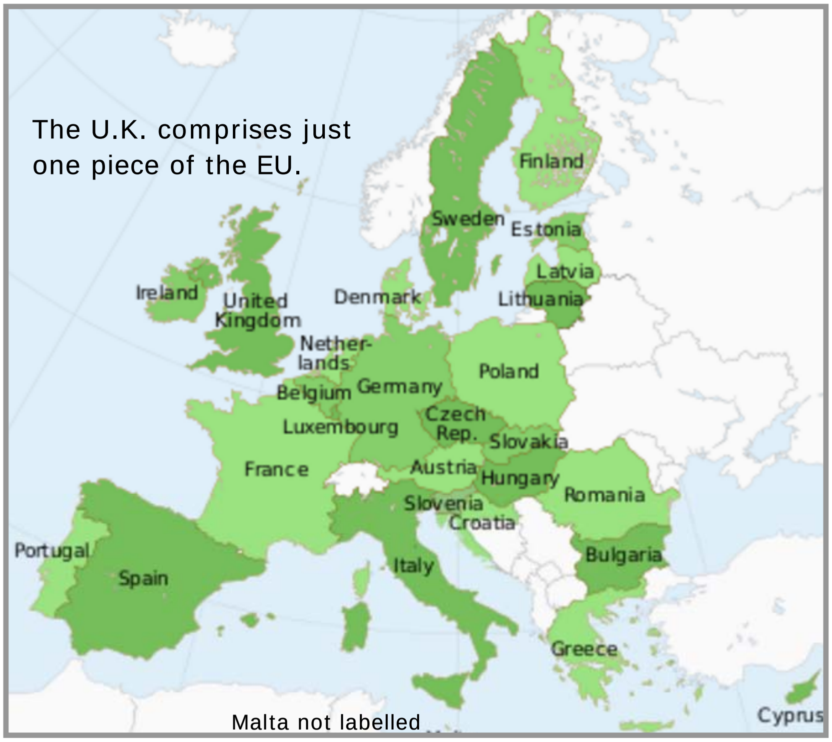
BREXIT MISNOMER

Since Northern Ireland is part of the U.K. and because over 97% of the people living within the U.K. reside on the island of Great Britain, many Northern Irelanders go with the flow and identify as British even though they're really Irish. So, it's expedient, if not phonetically catchy, for the media to label the U.K.'s pending exit from the European Union as "Brexit."

Before I attempt to gauge how much the U.K.'s planned exit from the European Union might matter, I'd like to explain what the European Union is and to then differentiate it from another confusing term, the "Eurozone."

THE EUROPEAN UNION (EU)

The European Union is comprised of 28 member states, as shown here:



In exchange for adherence to certain rules and laws as set forth by the union, EU policies aim to ensure the free movement of people, goods, services, and capital within and between its member states. A number of legislative and judicial institutions serve the entire European Union as summarized here ~ followed by the equivalent U.S. body:

- European Council: Sets political priorities and direction ~ Political Parties & Media
- European Parliament: Represents the electorate & makes laws ~ House of Reps.
- Council of the EU: Represents member states' executive branches ~ Senate
- European Commission: Functions as the EU's executive body ~ President
- Court of Justice of the EU: Oversees and interprets EU law ~ Supreme Court
- European Central Bank: Administers monetary policy ~ Federal Reserve
- European Court of Auditors: Oversees the budget ~ Office of Management and Budget

THE EUROZONE — NOT THE SAME THING AS THE EUROPEAN UNION

The European Central Bank (ECB) implements monetary controls and policies much like our own Federal Reserve does, but there is a key difference. Whereas our Fed's policies affect all 50 states within our union, the ECB's policies affect only 19 of the European Union's 28 member states. More specifically, its policies affect only those 19 states that have adopted the Euro as its official currency. That 19-member subset of the European Union is known as the Eurozone.

Although the U.K. has opted to exit the European Union at some point, it has *never* been a member of the Eurozone. Accordingly, it maintains its own currency (the British Pound … aka "Sterling") and its own central bank (The Bank of England). In theory, this makes its eventual exit somewhat less complicated.

A MAJOR FLAW WITHIN THE EUROPEAN UNION & THE EUROZONE …

Policymakers and analysts sometimes grouse that being a member of the Eurozone results in member states losing control over an especially important economic lever — the ability to devalue their own currency in an effort to maintain economic competitiveness. It's true that the U.S. gets by pretty well using a common currency, so it's tempting to dismiss Eurozone members' common-currency complaints as being unfounded, but there is a difference.

… NO UNIFIED TAX SYSTEM LIKE WE HAVE IN THE U.S.

States within the U.S. also lack the ability to control their own currency, but the U.S. does possess an important structural advantage over the EU and the Eurozone that helps it not matter — a unified tax system that continuously relieves the economic tensions that inevitably accumulate between its wealthier and poorer members. Since poor areas tend to consume more than they produce, they tend to become increasingly indebted to wealthier areas. Unless ongoing trade imbalances are mitigated in some fashion, debt tends to accumulate to a point that exceeds poor areas' ability to repay it.

As politically contentious as various forms of economic equalization are, revenue sharing is the only reason the Green Bay Packers can compete with the New York Giants, and it's the primary reason poor states within the U.S. haven't crumbled under a mountain of accumulated debt that would otherwise be owed to wealthier states decades ago. People on the political Left and Right will forever argue about the proper balance between suffering and economic aid, but unless a system to prevent debt burdens from becoming unmanageable is in place, economic tensions between members are sure to accumulate to the point of eventual breakage. Because the European Union lacks a unified treasury, it is difficult for it to prevent those stresses from accumulating.

In the U.S., Congress has generally allowed poor areas to remain poor, but not to the point of collapse. The mechanism by which poor areas receive aid is via a unified, federal tax system that funnels federal funds and services into those areas. This scheme of partial equalization occurs more or less continuously within the U.S. and is the primary reason many states within the U.S. remain economically viable. Were it not for this system of partial economic equalization, large chunks of the U.S. would have had to cope with cries for "austerity measures" long ago, the same way Greece has.

Unfortunately, neither the European Union nor the Eurozone has such a system in place, so economic tensions that develop between its members are not easily relieved. Instead, members are tempted to address their deficits by raising taxes. Unfortunately, if taxes increase faster than an area's economic growth, the result is a little like trying to get to the north pole by running backwards on a southbound train.

THE BIG QUESTION — HOW MUCH WOULD A BREXIT MATTER?

It certainly mattered to investors once they realized the U.K. actually had voted to leave — at least initially as investors fought each other to be the first to sell. But major stock indexes bounced back a couple of days later and are now higher than they were before. Investors have a long history of overreacting and getting the timing of things wrong, so each move could be as meaningless as the other. In truth, the ramifications of the Brexit vote are not likely to crystalize for some time.

At first, I thought a re-vote might be likely, but the U.K.'s new Prime Minister, Theresa May, seems inclined to honor the "leave" vote even though she favored remaining within the EU. It is also worth noting that under the British constitution, Parliament is sovereign. Therefore, it is not required to pass the legislation necessary to implement the break from the European Union simply because voters have requested it. However, it does seem likely that Theresa May and Parliament will honor the will of its people.

THE EXIT — A CLEAR NEAR-TERM NEGATIVE FOR THE U.K.

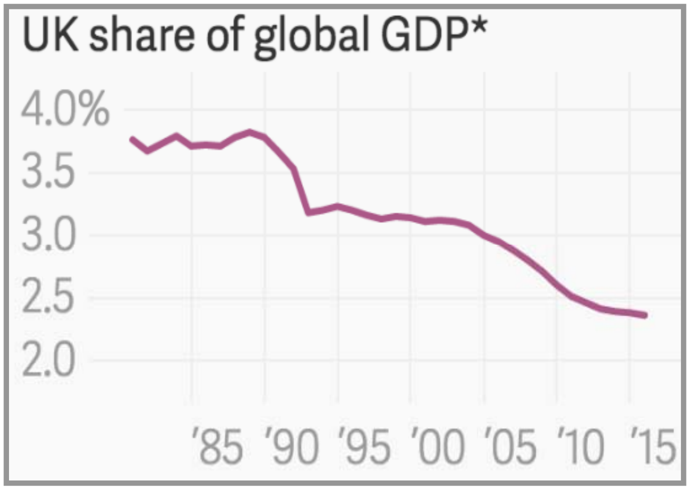
Initially, there was some thought that the EU might give the U.K. ample time to formally announce its exit from the EU (by invoking "Article 50" of the Lisbon Treaty), but in an effort to make an EU exit less appealing to other member states that may be considering a similar move, Germany, France, and Italy have pressured the U.K. to act sooner rather than later. This is an unambiguous negative due to the messiness of the situation. For instance, leaving the union will require many new policies within the U.K. along with a host of new trade agreements with many long-standing trading partners.

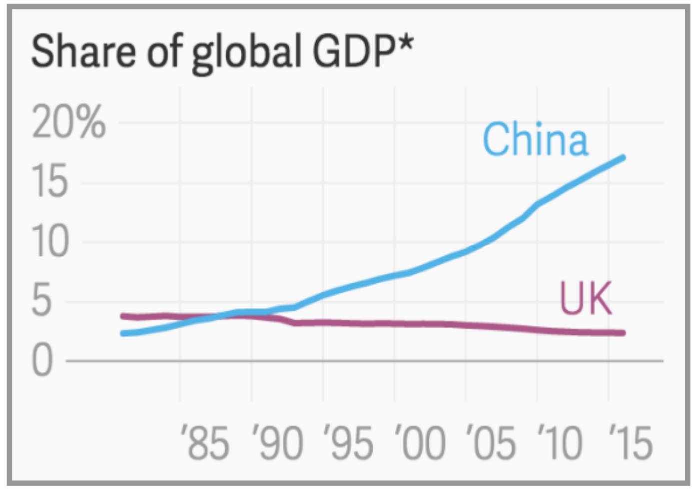
Leaving the EU would also place auto manufacturers operating within the U.K. at a clear disadvantage to the extent they face higher, post-exit tariffs. Relocating manufacturing plants would certainly be disruptive to the U.K.'s economy and labor force. And since London is a financial capital, there is legitimate concern that leaving the EU would result in London's financial firms no longer having access to the rest of the EU. The specific problems associated with this issue are beyond my level of understanding, but it seems clear to me that this is another unambiguous negative.

THE U.K.'S DECLINING ROLE IN THE GLOBAL ECONOMY

Regardless of however disruptive the Brexit issue turns out to be, I was pleased to have found some International Monetary Fund data showing the relative importance of the U.K.'s contribution to global economy over the past few decades. In short, the U.K.'s role in the global economy has been declining since at least the 1980s as shown in the graphs on next page.

Therefore, it may not be too surprising that Goldman Sachs' economists estimate the spillover effect on the U.S. economy from the Brexit vote to be "a scant 0.1%." In contrast, China's share of global GDP continues to surge, despite the fact that its rate of growth has been moderating. If the world is to suffer an economic malaise, better for it to be from an acute infection in the U.K. than even a generalized one in China.





WHAT ABOUT THE REST OF THE EU ... AND OUR PORTFOLIOS?

The near-term impact on the rest of the EU is not as clearly negative as it is for the U.K. If certain businesses do relocate from the U.K., they are likely to move to other areas that are still within the EU, which might then stimulate those other areas. Most of the portfolios we oversee have only limited exposure to European equities, and of the exposure we do have, most of it is in parts of Europe *other* than the U.K.

With respect to the limited exposure we do have to the U.K., most of it is through open-ended mutual funds that are free to reduce their exposure to that region if they feel such a move is warranted. For what it's worth, our researchers continue to be relatively sanguine regarding Europe's economic prospects, so on balance, I'm not inclined to alter our European exposure much.

A FEW POSITIVE TIDBITS

Here at home, GDP figures keep surprising to the upside, unemployment remains low, consumer confidence and investor confidence readings remain high (in Asia and Europe, too!), and oil prices have rebounded somewhat (a good thing). Low interest rates remain supportive of the housing and construction industries, and major banks have mostly passed rigorous stress tests with ease which suggests they are well situated to withstand the next ugly thing that will surely come along. Things could be a lot worse.

If you'd like to worry about something you can't control, worry about a credit bubble developing in China like I do. — Glenn Wessel