Letter 44

Brexit, 11 months later. What are the economic and stock market consequences?

"History will be kind to me, for I intend to write it"

Churchill

Boris Johnson has written a book about Churchill but, unfortunately for him, he is not Churchill and already, more than 60% of Britons consider Brexit poorly handled and not in line with the promises made by Boris Johnson.

Regarding the United Kingdom's decision to leave the European Union, our opinion has never changed: for the United Kingdom, it is a costly mistake; for the EU, it is a political disappointment because the United Kingdom shares the same democratic values as the countries of Western Europe and, on the other hand, the economic opportunity for a deepening of the Union that was systematically blocked by the British recently.

And, in this respect, the scale of the European recovery plan, €750 billion, unthinkable with the United Kingdom as a member of the Union, is an illustration of the potential of Europe freed from the British veto on common policies.

Brexit occurred at the beginning of the year and, not surprisingly, as we have advised in each of our monthly brochures to avoid the British market, the English stock exchange is performing the poorest on the European market: 12% appreciation for the FTSE 100 index of the London Stock Exchange, +21.3% for the EuroStoxx50, +25.2% for the CAC40 in France.

Similarly, as evidence of investors' caution, the 10-year UK government bond rate is at 1.06%. Within the Eurozone, demonstrating of the efficiency and confidence instilled by the European Central Bank, only Greece that is indebted at 2.3x GDP is paying more at 1.16%, but Germany is at -0.17%, France at 0.16%, Portugal at 0.40%, and Spain at 0.50%. Outside the EU, Switzerland makes the United Kingdom dream with -0.16% but the country is infinitely less indebted, has a budget surplus almost every year and enjoys a much higher industrial competitiveness.

In Letter 23, published on 30 December 2020, the objective was fourfold: to advise on the misperceptions of Boris Johnson's policy, to warn about the foreseeable political tensions with the European Union, to alert on the decline of the financial center and, to alarm about future economic difficulties.

With 11 months of hindsight, we can verify, for each of these points, political, diplomatic, financial and economic, the extent of the damage of Brexit and understand why we maintain our recommendation of caution on this market.

1. *The abandonment of Thatcherite liberalism* :

Johnson broke away from the traditional ideology of the Conservative Party. He is an interventionist while Thatcher was a Liberal.

He announced a tax increase in order to finance investments in the poor, working-class North, a region historically loyal to the Labor Party and for the first time rallied with the Conservative Party.

He professes an acute nationalism even if he has to resort to immigration to fill vacancies in agriculture, healthcare and transport because despite rising wages, the British do not want these jobs.

In short, and as we had anticipated, we are at the opposite end of the spectrum with regards to the "Singapore on the Thames" project, once imagined by some, notably Marc Roche in his eponymous book.

2. *Political tensions with the EU* :

For a long time, the Conservative Party was pro-European, but this has no longer been the case for the past few years, and Boris Johnson is in rupture again.

Far from us are the Franco-British closeness during the 1956 Suez crisis, the expectations born of the accession to the Union in 1973, the St Malo Summit on 4 December 1998, the agreement of Tony Blair and Jacques Chirac and the joint declaration on European defence. Far away is the Lancaster House Treaty, signed between Nicolas Sarkozy and David Cameron in 2010, providing for cooperation between the Franco-British armed forces in terms of equipment and deployment.

- ***Persistent tensions with Northern Ireland over trade*** :

The end of the civil war between the two Ireland only dates back to 1998 with the "All Saints' Day Agreements". There was no longer any question of borders between the two countries because both were in the EU.

During Brexit, the intention was to avoid the re-establishment of borders to prevent the risk of a recurrence of civil war. The border was put at sea and thus products destined for Northern Ireland must comply with European legislation if they want to enter the Republic of Ireland. The agreement was signed by Johnson but he does not respect it.

So, in the short term, if the British leave the protocol, the Europeans will take sanctions.

Eventually, if Northern Ireland performs better than the rest of the UK, then doubts about the relevance of Brexit will be heightened and a reunification of the two Irelands could occur, further weakening the UK.

- ***Fishing*** :

In the Brexit agreement, a degree of continuity seem to be preserved. But a few months later, 11 European countries, including Germany and the Netherlands, are complaining of having difficulties in obtaining licenses.

The issue is particularly acute with France. Only 100/175 licenses were granted to the French to fish in coastal areas within 12 nautical miles. London assures that 98% of the licenses have been granted, France claims 90%.

The economic dispute is insignificant, as fishing represents only 0.1% of British GDP, but the political tension is exacerbated.

- ***Borders and immigration*** :

The French police are strict, but Johnson wants to show that the border is not watertight. Let us leave aside the political aspect, irrelevant for this Letter, and focus on the economic consequences.

Johnson's restrictive immigration policy is inflationary on wages and penalizes the competitiveness of companies. According to recent figures, wages have risen by 4% in the private sector and this is probably just the beginning.

- ***The sanctions envisaged*** :

They are diverse but could extend to a reduction in electricity supplies by France.

3. Economic difficulties :

According to the OECD, GDP in real terms at the end of 2022 will be only 1% higher than in 2019 because 2020 recorded the worst performance (-9%) by the country in a century, the worst of all major developed countries, and because the recovery seen by the Bank of England this year, 5%, is weaker than expected due to shortages and bottlenecks.

By way of comparison, France has returned to its pre-crisis GDP level, the Eurozone is at 99.5%, the United States is at 102% and China at 108%.

The spread of Covid again is not expected to improve the situation. Mr. Sunak, the finance minister, in his budget presentation, is planning to spend £100 billion to support various areas of the economy but it is not clear how his expectations of 6.5% growth this year and 6% next year can be achieved. The Bank of England is only expecting 5% in 2022.

In 2023, companies will have to face an increase in corporate tax. By then, inflationary pressures will have forced the Bank of England to raise rates. This will penalize variable rate borrowers and has already resulted in a 15 to 35 cents rise in real estate rates in a month.

- ***Decline in purchasing power :***

This is the consequence of an increase in social security contributions of 1.5 points to finance healthcare and an expected inflation of 4% and even 5% according to the forecasts of the Bank of England.

Inflation at 5% means that the Bank of England will be encouraged to raise interest rates more quickly and this will have an impact on real estate prices.

Tight food supplies are a source of rising prices. Retail sales in September fell 0.2% after a 0.6% decline in August.

Next year, low-income workers will benefit from an increase in the minimum wage to £9.50/hour, or €11.25/hour, but income tax will increase from 2022.

- ***Job shortages*** :

The unemployment rate is low at 4.5% and, after the departure of one million foreigners, 1.1 million jobs are to be filled mainly in construction, hotels, restaurants, and logistics.

Labor shortages e.g., 100,000 vacant truck driver positions and 1/4 of petrol stations without supplies, are the consequences of Brexit.

Boris Johnson claims to be solving the problem by simply offering 3-month visas for 15,000 drivers but obviously he is not having much success.

- ***Deterioration of foreign trade*** :

In export, many companies are not equipped to carry out all the formalities, thus losing access to the European market: the most prosperous market in the world, nearly 450 million, and the most important for the United Kingdom because it attracts nearly 50% of exports. A number of companies are choosing to set up directly in Europe to take advantage of demand, the opposite of the expectations of Brexiteers who thought they would repatriate activities. Imports from the EU fell by 20% in the first eight months and exports by volume are still more than 15% below the peak of 2019 while global trade is growing by 3%.

The United Kingdom is losing market share: in 2019, it accounted for 7% of US imports, it now represents only 4.3% according to Eurostat. Exports to China are 25% lower than in Q1 2019, those to the United States are 16% lower, those to Japan by almost 9%, and those to Germany are 19% lower. Exports to Spain and France are almost 30% lower and overall, exports to the EU fell by 18% in the first six months, according to Eurostat.

While trade agreements have been signed with a dozen countries including Japan, South Korea and Canada, these are small markets for the United Kingdom. For example, trade with Japan accounts for £30 billion against €700 billion with the EU. The agreement with Australia, according to the Office for Budget Responsibility (OBR), will not result in an increase in British GDP of more than 0.01%! In the latest example, the trade agreement with New Zealand represents only 0.2% of British trade and will have little impact in the coming years.

Johnson, full of illusions, thought he would sign a trade deal with the United States, but Biden is irritated by the British management of the border with Ireland.

In short, the United Kingdom is not benefiting like other major countries from the recovery in global demand.

- ***Tensions with China*** :

If the Chinese, according to Times, holds majority stakes in 200 British companies for nearly €160 billion, the United Kingdom is distancing itself and playing the American card. Recent examples include Aukus, the ousting of Huawei for 5G and the desire to force the Chinese to give up their 20% in a nuclear power plant project in the East of England.

4. The financial downturn :

In the mid-80s, the City had experienced a tremendous boom with the deregulation of the financial markets. Today, apart from the success of welcoming the "unicorns" that have capitalized more than $1 billion, slightly more than 30 of them and more than Germany and France combined, the London market cannot pride itself on any specificity.

Since the vote on Brexit, the city has been destabilized and weakened. In 2003, London-listed companies accounted for 40% of Europe's market capitalization, currently it is just over 20%. In 2006, companies listed in the city still accounted for 10% of the global equity market, but today it is just over 3%.

The absence of a financial passport, as the European Commission has pointed out, will force new relocations or job creation in finance, to the detriment of the United Kingdom and to the benefit of the Eurozone. In a few months, the United Kingdom will lose the benefit of the European passport, while 40% of British financial services are destined for Europe. And London's clearing houses will no longer be able to deal in Euros.

Conclusion :

- ***The economic cost*** :

The British Office of Budget Responsibility (OBR) still estimates the cost of Brexit at 4 points of GDP, or $80 billion/year and this is the consequence of lost exports, relocations of companies, and therefore job losses in industry and finance. A great misfortune at a time when the debt to be repaid has never been so high since the end of the war. In this context of difficulties, one can expect a depreciation of the £ against the major currencies.

Boris Johnson's Malthusianism on immigration, the exit from Erasmus, are not solutions for a service economy like the United Kingdom.

- ***The healthcare cost*** :

Many people have written about the mismanagement of Covid but we will refer to two very good recent books. ***Niall Ferguson,*** a brilliant professor at Oxford, wrote in ***Apocalypses*** that the number of Covid-related deaths in the 1st half of 2020 alone was higher than the number of victims of the German air raids on London in 1940-41, the 29,000 killed in London and the 44,000 in Britain as noted in ***Erik Larson's Splendor and Infamy,*** a very good book on the air war over London.

- ***The political cost*** :

Relations between the EU and the United Kingdom have never been so bad because, at a time of economic difficulties for the country, Johnson thinks he can improve his popularity by maintaining a conflict with the EU, especially with France, but fundamentally, the vigour of the discussions does not hide the modesty of the disputes.

These dissensions are reminiscent of some of the moments of tumultuous relations between France and England and those who visited St Malo will have noticed the statue of Surcouf, the illustrious privateer, pointing at England. The British, should they continue to derogate from the treaty signed by them less than a year ago, exposes themselves to a strengthening of customs control on trucks, a ban on English fishermen selling their fish in France, an increase in electricity prices...

Yet France and Great Britain are like Siamese sisters, there are no two countries whose DNA are closer and have led ***Clemenceau*** to say, ***"England is a French colony that has gone wrong".*** Basically, we will remember the same membership of the UN Security Council, the same possession of the nuclear bomb, the same population of 66 million, the same GDP, the same past as a colonial power, the same status as a middle power today.

Geneva, 8th November 2021

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