



April 2017

The truth about Brexit

“Well, that was pretty awesome – and I mean that in the worst possible way.”

– Paul Krugman

Theresa May has now invoked Article 50 and, by doing so, she has triggered the Brexit process at a more formal level. As she said after the letter was handed over to President Tusk:

“It is a historic moment – there is no turning back.”

Almost every day I get another email on Brexit and, interestingly, many of those emails come from readers in countries far away. It clearly isn't a topic that only preoccupies those of us who live in the UK. We are now almost 10 months into the unknown, and one could - with some right - take the view that, as nobody knows how it will all pan out, what's the point in writing more about it?

Having said that, one could also argue that we know things now that we didn't know last summer. I certainly do; hence this follow-up note on Brexit. One disclaimer before I begin. I am a Remainer, so the following may be a tad coloured (but only a tad). I believe the future outside the EU will be a great deal more problematic than most people realise.

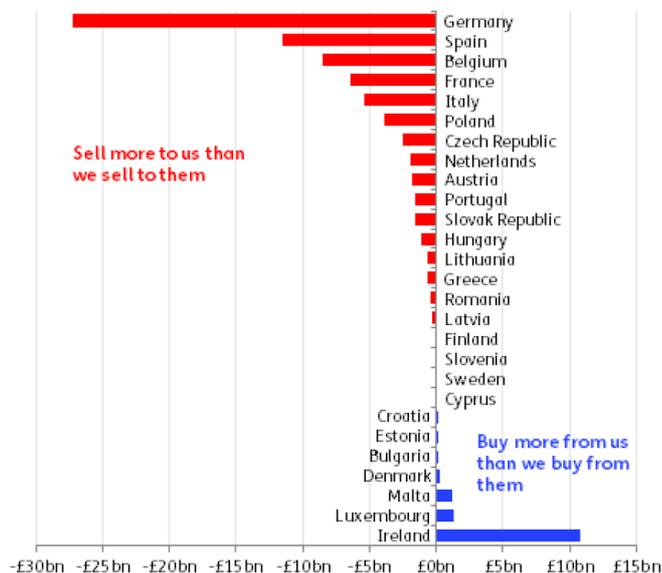


Exhibit 1: UK trade balance with other EU countries, 2014

Source: <https://fullfact.org/europe/uk-eu-trade/>, March 2017

Even if this month’s Absolute Return Letter has a negative bias, I owe to my readers to point out that Brexit is not only bad news. A weak Sterling, for example, will likely give UK industry a major boost, but that is already well advertised by the Brexit brigade and, in this letter, the aim is to focus on what is (largely) kept out of the media.

Exhibit 1 above explains the prevailing attitude amongst the Brexiters I speak to – a view I am confronted with virtually every day of the week. “Why worry? We are a net importer of goods from most EU countries. They [the other Europeans] have a great deal more to worry about than we do, if the free trade agreement is abolished.”

If only life were that simple, but it isn’t. Martin Wolf has produced a series of great articles on Brexit for the Financial Times, where he argues that, although the UK runs a significant trade deficit vis-à-vis the rest of the EU (‘rEU’), UK exports to rEU still account for almost 50% of total UK exports (exhibit 2). No free trade agreement would put those exports at risk.

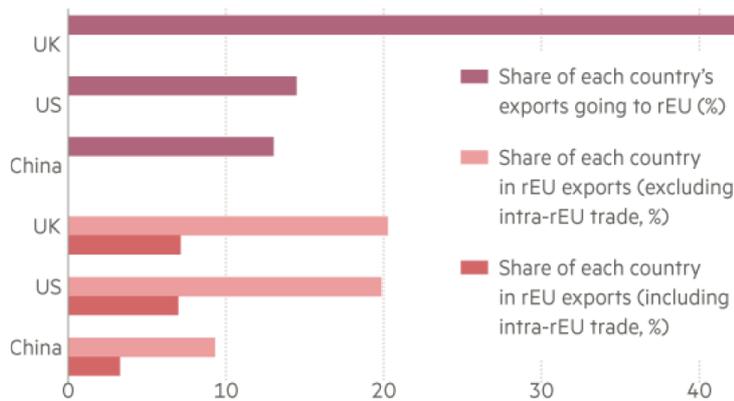


Exhibit 2: Importance of the UK and the rest of EU to one another (2015 merchandise trade shares)

Source: Financial Times, Thomson Reuters Datastream, March 2017

rEU, on the other hand, is in a far less precarious situation. If one includes intra-EU trading, the UK accounts for only 7-8% of rEU exports (the dark red bars in the lower half of the chart). In other words, trade between the UK and rEU is far more important to the UK economy than it is to the rest of the EU.

Another way to look at things is to look at how many jobs are at risk, should we end up with no free trade agreement between the UK and the EU going forward. OECD provides an estimate as to how many workers are employed in jobs that depend on foreign demand (i.e. exports).

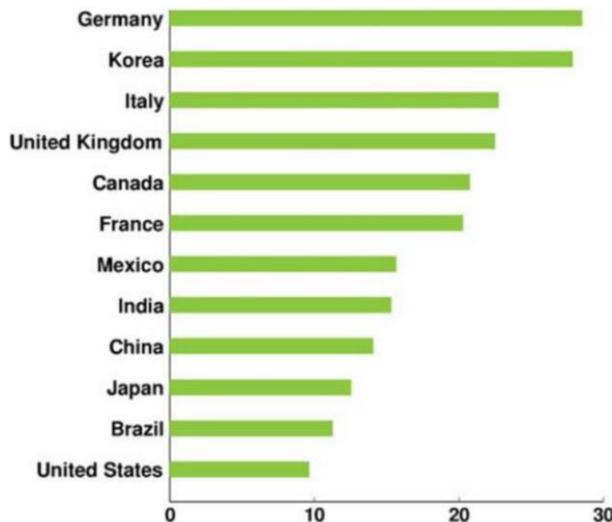


Exhibit 3: Percentage share of total employment embodied in foreign demand

Source: The Daily Shot, OECD, March 2017

If you adjust for the fact that exports to the UK are not that important to rEU (as they aren't - we just learned that), the only conclusion I can draw from exhibit 3 above is that the UK will put many more jobs at risk than any other EU country will.

What you export also matters

By far the biggest German export article to the UK is - not surprisingly - vehicles (see [here](#)), and I would be very surprised if the Brits suddenly fall out of love with their beloved German cars, just because there is no longer a free trade agreement in place between the two countries.

The UK is a very different story. The UK exported £220 billion worth of goods and services to rEU in 2015, whilst importing £290 billion worth in the same year, generating a trade deficit in goods and services of about £70 billion (see [here](#) for details). Services alone generated a trade surplus of about £21 billion, though, highlighting the importance of the financial industry for the UK economy - an industry the EU could do significant damage to, if the UK doesn't play ball in the upcoming negotiations.

Pharmaceuticals also deserve a mention in this context. Being one of the largest UK export industries, it is a critically important industry for the wellbeing of the UK economy. The EU could quite possibly make life very difficult for the UK pharma industry by slowing down the regulatory approval process.

Consequently, I wouldn't be enormously surprised, if a future without a free trade agreement would hurt UK exports to the EU a great deal more than EU (German) exports to the UK. Only time can tell.

Why immigration isn't bad at all

Let's re-visit one of the core themes of the June 2016 referendum for a minute or two. I doubt many would disagree that immigration was indeed a major theme - probably the most important of them all. As you can see from exhibit 4 below, EU migration to the UK has, after having lagged non-EU migration for several years, picked up more recently.

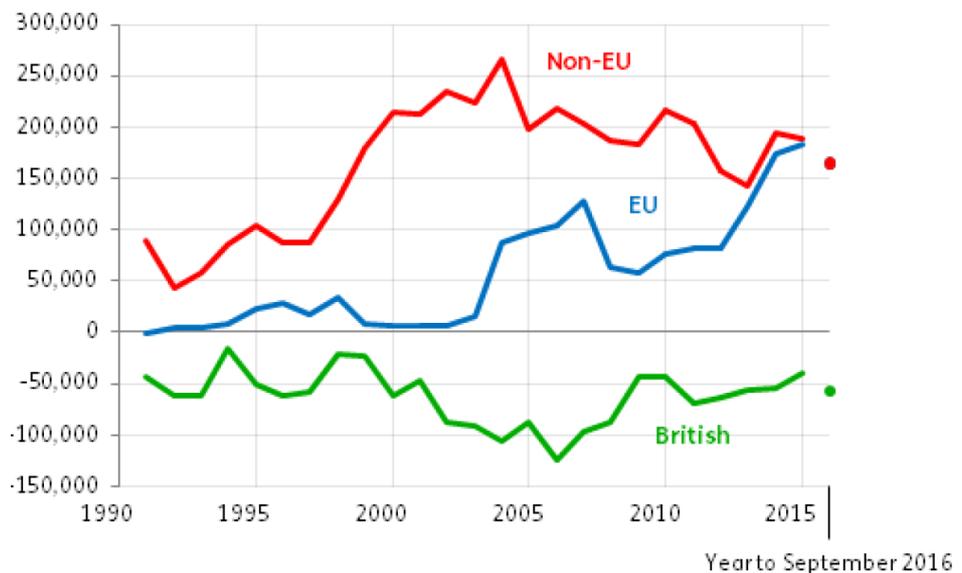


Exhibit 4: UK international net migration by nationality

Source: Fullfact.org, March 2017

Immigration has had at least three major effects on the UK economy in recent years, one of which is negative, whilst the other two are overwhelmingly positive. On the negative side, immigration into the UK has increased the supply of low skilled workers, putting pressure on wages at the bottom end of the food chain - more about this later.

On the positive side, it has provided many Brits with the opportunity to move to high skilled jobs. In the words of Deutsche Bank, there is strong evidence that immigration has enabled the UK workforce to 'up-skill' (exhibit 5).

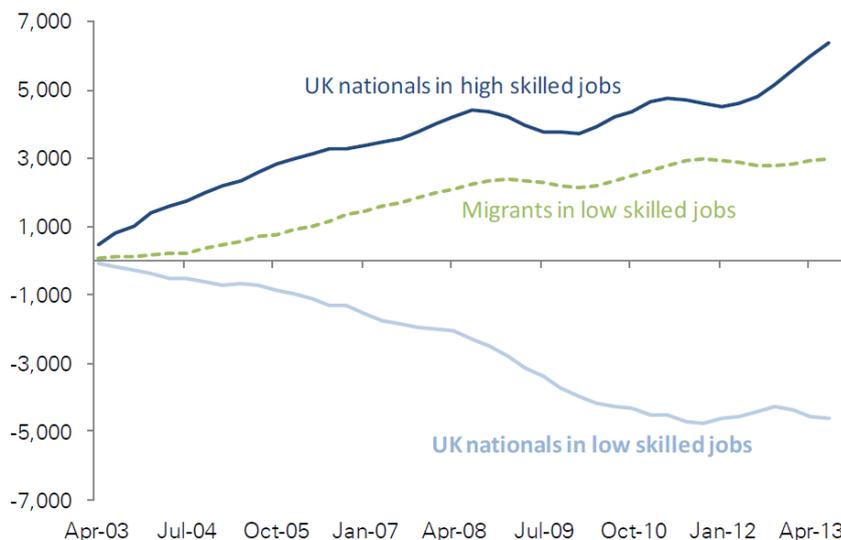


Exhibit 5: Cumulative UK job growth (thousands)

Source: Deutsche Bank, ONS, March 2017

And the story only gets better. For you to understand the significance of my next point, allow me (for the umpteenth time) to remind you of a simple economic identity. At the most fundamental level, economic growth is a function of two factors only – workforce growth and productivity growth. Algebraically, the link can be expressed as follows:

$$\Delta\text{GDP} = \Delta\text{Workforce} + \Delta\text{Productivity}$$

Now, look at how important immigration will become in the years to come, assuming the aim is to grow the economy (exhibit 6). The ‘culprit’ is obviously a low fertility rate amongst UK-born citizens.

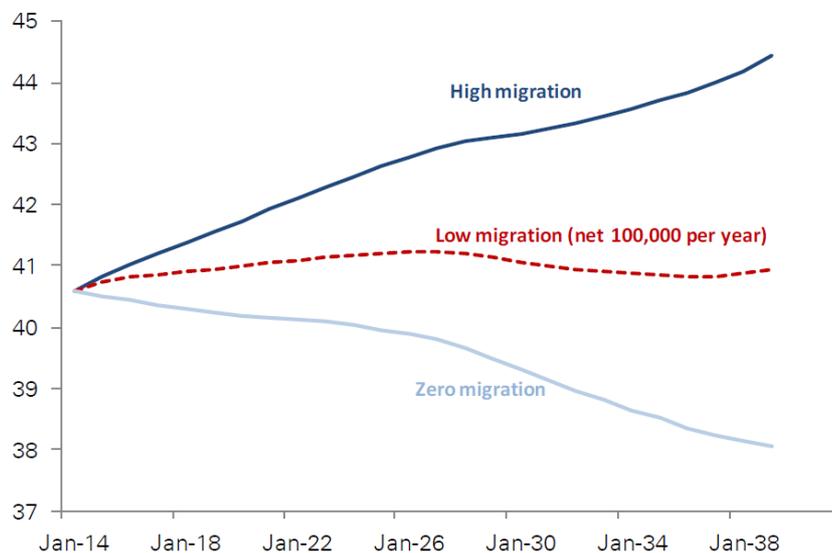


Exhibit 6: UK working age population (millions)

Source: Deutsche Bank, ONS, March 2017

If we do what sheep do best and blindly follow the leader of the mob, and only allow in a very modest number of immigrants, there is only one way we could possibly generate a decent amount of GDP growth in the years to come, and that would be through sharply rising productivity growth. Trust me, that isn’t easy.

The UK economy is one of the most indebted countries in the world, and lots of new debt is taken on every year just to service existing debt – debt that could, and should, be used for productivity enhancing purposes.

Consequently, UK productivity growth has lost momentum for many years. Even at the best of times, productivity has only grown 2-2½% a year, and since the financial crisis productivity

hasn't improved at all (exhibit 7). It would be outright foolish to suddenly expect productivity to save our bacon.

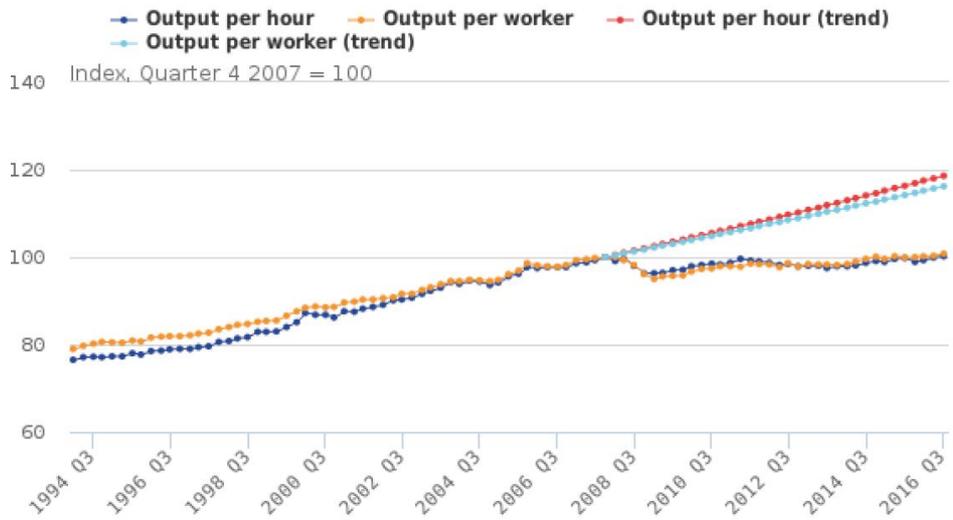


Exhibit 7: UK productivity (seasonally adjusted)

Source: Office for National Statistics, March 2017

Simply put, we need to expand the workforce to grow the economy at a reasonable rate. Otherwise, we won't generate enough economic growth to service the mountain of debt in front of us and, if the economically illiterates amongst us don't understand that, they could quite possibly take us down a road that can only end in disaster.

Brexit's impact on inflation

Near term, one shouldn't be surprised at all if UK inflation continues to rise (exhibit 8). A weak pound has made any other outcome virtually impossible. Longer term, the picture is not so straightforward. It very much depends on aggregate supply and demand.

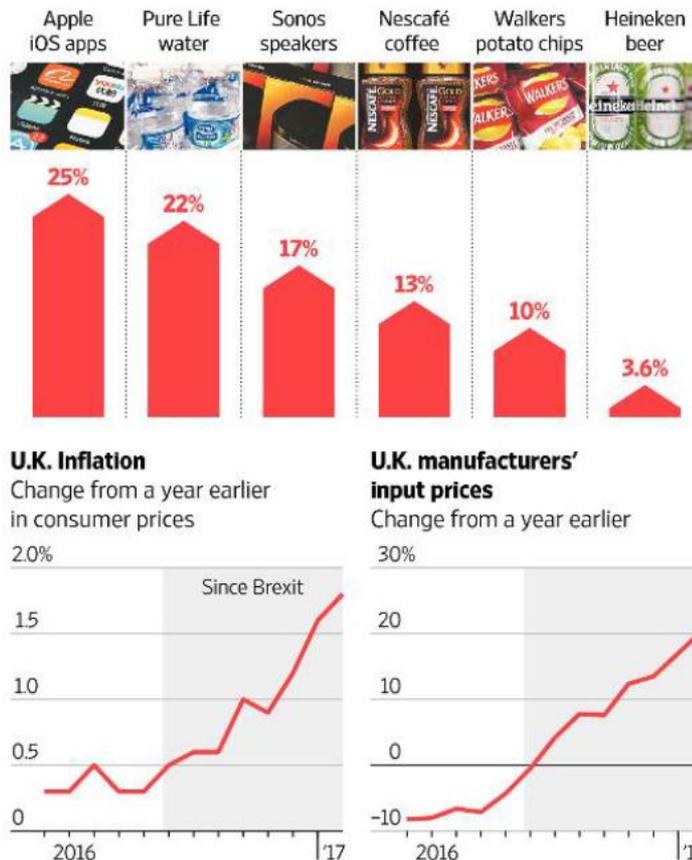


Exhibit 8: UK price increases following Brexit referendum

Source: Wall Street Journal, March 2017

Let's look at the employment market for a minute. A very substantial percentage of new jobs created in the UK in recent years have gone to immigrants. Only 25% of all new jobs since 2000 have gone to UK-born citizens, with 35% going to rEU-born citizens, and no less than 40% going to people born outside the EU (exhibit 9).

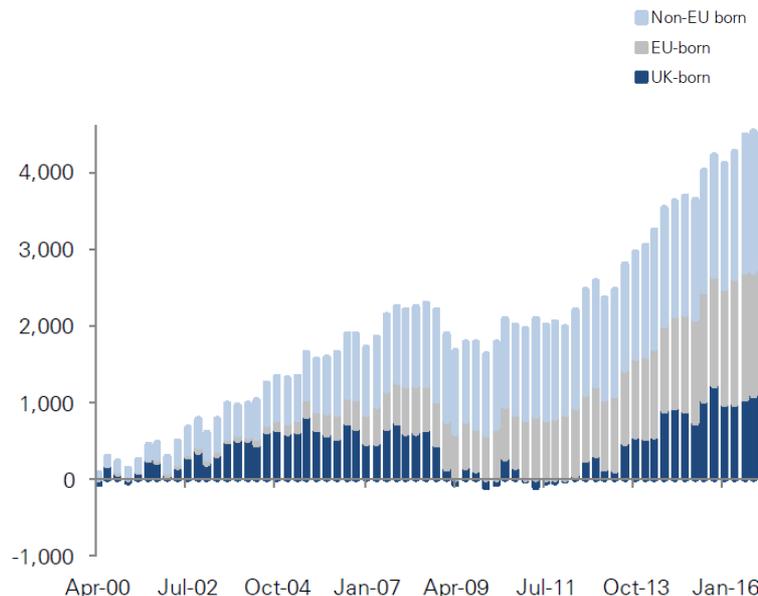


Exhibit 9: Cumulative jobs growth (000) by country of birth

Source: Deutsche Bank, ONS, March 2017

Fewer immigrants will almost certainly lead to higher wage inflation, as there is likely to be a shortage of labour supplies in some industries. I would go as far as to say that certain industries in the UK are now run almost entirely by migrant workers, and how you will persuade the Brits to take those jobs again, I am not entirely sure. It is not particularly attractive to 'down-skill'.

On the other hand, fewer immigrants also means reduced consumer demand for goods and services, which will have exactly the opposite effect on inflation. How that will all pan out is difficult to say, but I suspect that rising wage inflation will have a bigger impact on overall inflation than falling consumer demand will. In other words, I suspect that fewer immigrants will lead to (modestly) higher inflation in the UK longer term.

Another way to look at this question would be to estimate the unemployment rate under the assumption that no immigration at all had taken place in recent years. Deutsche Bank did exactly that and found that the UK unemployment rate would now be a silly -6% (exhibit 10).

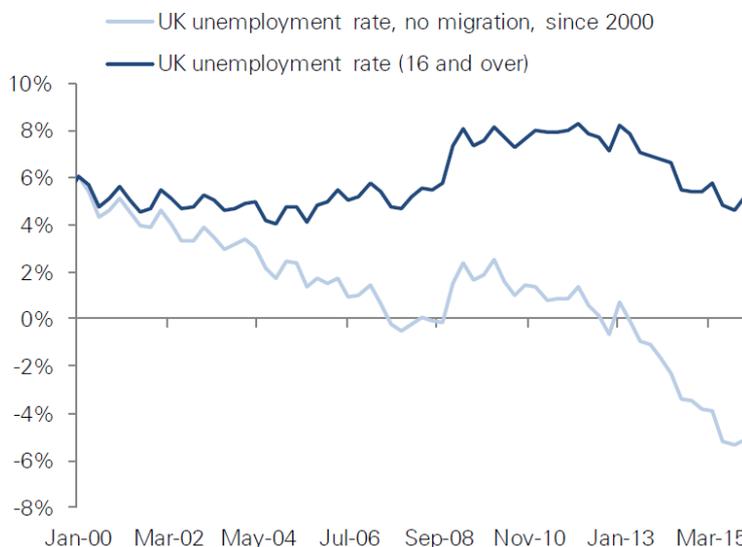


Exhibit 10: UK unemployment rate with and without immigration

Source: Deutsche Bank, ONS, March 2017.

Of course, the unemployment rate can never be -6%, but it provides some insight into what UK inflation would have been like today, had the Brexiters got it their way at the start of the Millennium.

Could Brexit lead to rising real wages?

Following on from this, and given that UK real wages are in decline at present, it would only be fair to ask if Brexit could possibly reverse that trend?

UK real wages have been under pressure for years, and falling living standards go a long way in terms of explaining recent years' modest GDP growth and the desire for fundamental changes, as became apparent in last year's EU referendum.

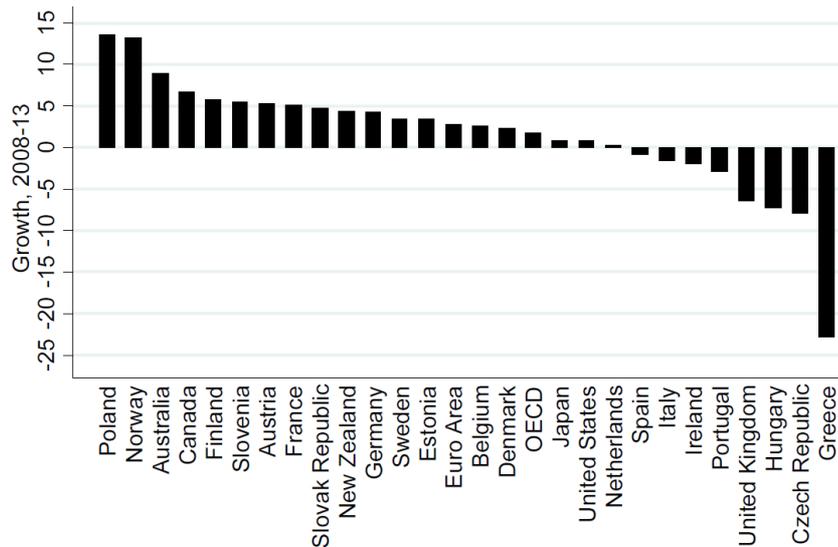


Exhibit 11: Real wage growth in various countries, 2008-13

Source: Stephen Machin, Bank of England, September 2015.

As you can see from exhibit 11 above, the UK is not the only country suffering from declining real wages but, in a European context, workers in this country are not doing particularly well. There is no single reason why that is, but the large influx of migrant workers prepared to take low skilled jobs has most definitely had an impact on the average pay in large parts of industry.

With Brexit around the corner, that might change but, first and foremost, it would require that the Brits are prepared to take those jobs again, and I have my doubts. If I were a betting man, I would bet on the following outcome:

1. Brexit kicks into action and the borders are 'closed'.
2. Many (but not all) migrant workers are asked to leave the country.
3. As the Brits won't take those low skilled jobs (at least not to begin with), many public or quasi-public services break down.
4. Consequently, the government is forced to tighten its welfare programme further, and being a 'career benefit seeker' (of which there are many in the UK) is no longer a viable strategy.
5. Eventually a compromise is reached; more migrant workers (but not as many as now) are allowed into the country, and British workers begin to 'down-skill' again, as a life on the dole is no longer deemed attractive.
6. Unemployment falls further as many benefit seekers begin to work again, whilst real wages and inflation rise as the competition for low skilled jobs falls.

Could Scotland go their own way?

Nicola Sturgeon has recently called for a second Scottish independence referendum, this time using Brexit as the excuse. She cannot keep calling for a referendum every time she doesn't get the outcome she so badly wants, but she has a point. Brexit does indeed change things quite fundamentally.

The point Sturgeon has chosen to disregard, or at least has chosen not to bring up in the public domain, is that Scotland can hardly afford the independence that she so desperately seeks. Scotland runs a fiscal deficit of about 9.5% of GDP at present and only survives because of grants from London. Yet, she has promised a significant increase in welfare spending in an independent Scotland. Her case was a great deal stronger when oil prices hovered around \$120-130 per barrel. With oil prices around \$50, she has no case at all.

Unless Scotland is prepared to pay EM-like interest rates on their foreign debt, some very serious cut-backs in welfare spending await. Looking ahead, it won't be particularly amusing to be a tax payer in an independent Scotland. For that reason, I suspect she will also lose the next referendum, but you never know. Stranger things have happened. Growing nationalism created a president called Trump, and it created a UK outside the EU. Could it also create an independent Scotland?

One final word on Scotland. As a colleague of mine said the other day: "As a tax payer in the south of the country, I wish Theresa May would call Nicola Sturgeon's bluff. Give her the referendum she so desperately wants but, this time, make it a referendum for the whole of the country. 65% will be in favour of letting Scotland go, and the South will save billions of pounds every year." Given the rapid ageing of the UK population, we could certainly use that money elsewhere.

Final comments

The sad reality is that politicians never tell you the truth. Well – let me re-phrase that. They only tell you the (full) truth, if it serves their agenda. And it serves no political agenda to tell the truth about Brexit.

It is quite simple. If we want to maintain the service standards of recent years, we will most definitely need a fair chunk of migrant workers (and the same could be said about many other developed countries). The demographic story confirms that. Who else is going to look after our elderly, and who is going to empty our dust bins every week?

Having said that, we need to find ways to raise the living standards of low skilled UK workers. Otherwise the gap between rich and poor will only get bigger, which will lead to even more political instability going forward.

Brexit was, and still is, a serious wake-up call. I have been accused of turning into a socialist in old age, just because I want to raise living standards amongst low skilled workers, but my only aim is political stability.

Hence we would make a grave mistake by closing the borders. We can most certainly control the influx a bit better than we have been capable of in recent years, but don't go too far! If the hardcore Brexiters get it their way, GDP growth will stall, and the mountain of debt we are saddled with will turn from a manageable problem to a truly disastrous one.

Niels C. Jensen

3 April 2017

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Absolute Return Letter contributors:

Niels C. Jensen	nj@arpinvestments.com	T +44 20 8939 2901
Mark Moloney	mm@arpinvestments.com	T +44 20 8939 2902
Nick Rees	nr@arpinvestments.com	T +44 20 8939 2903
Tom Duggan	td@arpinvestments.com	T +44 20 8939 2909
Alison Major Lépine	aml@arpinvestments.com	T +44 20 8939 2910