ATLAS
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Political Risk has Risen

1. London has fallen

While on the flight back from a recent business trip, I took a breather and caught one of the movies on the in-flight entertainment system. The movie happened to be 'London Has Fallen'. In the movie, London's infrastructure was gloriously decimated in splendid CGI, as many famous landmarks came crashing down. Meanwhile, in the real world, little did I expect Britain to crash out of Europe. And no I was not referring to England's defeat to Iceland in European football.

As we are well aware by now, the UK voted to leave the European Union on 23 June, and the final tally was 51.9% to 48.1% in favor of the exit. The pound plunged as much as 12.5% in a few hours following the shock results, and risk aversion was evident all across the globe while safe haven currencies such as JPY and USD rallied. Soon after the Standard & Poor's cut the country's credit rating a hefty two notches to AA from AAA while Fitch followed with a one-notch move to AA. Both gave a negative outlook to UK.

Thoughts on the exit vote

Although the polls suggested a close fight, many of us 'outsiders' had expected UK to remain, especially after the impassioned plea by the well-respected Prime Minster. After all, who would want to see his own currency plunge, his property value plummet and his country experience long term economic decline (the consensus scenario for Brexit)? I think there is a lesson here for every city—it would seem that the masses are increasingly becoming more anti-establishment and anti-elite, and this protest vote is but a manifestation of the undercurrents of dissatisfaction amongst the commoners despite the economic growth and financial market recovery in the past 8 years.

We are living in a cycle where asset appreciation (fueled in recent years by easy money), globalization and technological disruption are creating some big winners, some small winners and some losers. If the losers reach critical mass and have the means to voice their displeasure, there will a revolt of some sort.

As an example on asset appreciation, I will use Singapore to illustrate the point, and I believe parallels can be drawn with other countries. In the past, the main source of wealth was income from one's job. The typical man in the street works owns one public housing unit for residential use — property appreciation gain is an after-thought. This started to change in the noughties when Singapore experienced a property boom—suddenly the gain in wealth from property appreciation makes the income from working in a normal job miserly. In the 1st quarter of 2016, the median resale price for a 5-room public housing in the popular Bukit Merah area costs a cool SGD 750,000. This flat cost about SGD 409,000 at the beginning of 2006. Now the median annual salary in 2006 was SGD 34,300. With the gain from the property amounting to SGD 341,000, this equals 10 years of annual income. Note that we have been using median prices so far, i.e. the 50th percentile price and we have not even mentioned about private housing, where prices are much higher. As you can imagine, society suddenly sees a number of big property winners (those who bought 3-10 apartments, etc), and inevitably envy and resentment builds up amongst some of those who did not catch the property boom.

At the same time globalization serves to suppress wages while asset prices continue to go up with easy money policies. Those with assets will tend to be the winners in this type of environment rather than those who main source of wealth is mainly from a job.

Meanwhile, technology will continue to disrupt and replace many jobs globally. As recently as a few years ago it was thought that technology would only replace 'menial' jobs. These days we are deep into research on driverless cars (goodbye cab drivers…) and other forms of artificial intelligence. One of the campus here is already employing robotic receptionists who has image recognition prowess and thus can remember you and greet you by name the next time you re-visit. In fact, this reminds me of the "robot goddess" called Jia Jia that has lifelike features and selfies can be taken with her. Jia Jia is smart enough to ask for some space if someone is too close when taking the picture and remarked that her face will look fat if the camera is too close to her. While some of us marvel at the progress technology has made, others are fearful of the impact on their livelihood.

While we marvel at the technological advancement and the good it has done us, and while the economy has grown over the past decade, the benefits are not equally shared amongst the people. Many are displaced and did not have good jobs. Many felt the rich continue to prosper while the poor remains poor. This becomes a real problem when asset prices are rapidly rising while income levels stay stagnant (or diminishing). John Maudlin wrote an insightful article called 'Life on the edge' - this dovetails in nicely with what is happening right now. John classifies people into the Protected class versus Unprotected:

'There are the protected and the unprotected. The protected make public policy. The unprotected live in it. The unprotected are starting to push back, powerfully. The protected are the accomplished, the secure, the successful – those who have power or access to it. They are protected from much of the roughness of the world. More to the point, they are protected from the world they have created... They live in nice neighborhoods, safe ones. Their families function, their kids go to good schools, they've got some money. All of these things tend to isolate them, or provide buffers. Because they are protected they feel they can do pretty much anything, impose any reality. They're insulated from many of the effects of their own decisions...

This insulation is now so common we don't even notice it – and not just in government. Business executives meet in a nice office, tweak a few numbers, and somewhere down the line people lose their jobs. Those folks are thousands of miles away, and the decision makers never even see them. This is what it means to be "protected."

The protected are not just the politicians and bureaucrats who make and execute public policy;
they are all the people who, because of their jobs and income, can generally protect themselves from the vagaries and vicissitudes of life. They have the money to hire the lawyers, doctors, mechanics, pay for the insurance, etc., to deal with whatever problems arise.'

It would appear in UK's case the unprotected class has outvoted the protected class. There will probably be a need to take care of the losers from globalization and technology. And who will fund that? It will have to come from the winners. Ideas like universal basic income may not be too far-fetched down the road too and may even serve to stabilize the political climate in many regions.

2. Implications of Brexit

What's going to happen to UK?

Cameron gave a rousing speech as he stepped down from his role as Prime Minister. He said that UK's finances is stronger than what it was 6 years ago, and to never to under-estimate the will of the British people, who would prevail and would make UK a great place for themselves and their children.

In the short term however, I still expect a fair bit of pain. The UK economy is likely going to enter a recession as many firms dither on hiring and making investments. As an example, we have a bank here in Singapore suspending its overseas loans program for London properties. UK politics will be tumultuous to say the least, and negotiating Brexit will take at least two years.

European Periphery

The base case scenario would be negative impact on European assets, as the uncertainty caused by Brexit will spread to the Eurozone. The EU would want UK to exit quickly to stem the contagion, but that is not likely to happen. Peripheral economies will remain pressured, and politics will get in the way. Remember how a smaller country (in terms of GDP) by the name of Greece had wanted to exit the Eurozone and sent the Euro crashing. Spain's recent election ended in a stalemate and the country faces continued political uncertainty. Meanwhile referendums are sprouting up like mushrooms all over Europe. According to the Telegraph, we are looking at a "tsunami" of referendums: A survey published on Monday by the European Council on Foreign Relations (ECFR) found that these parties are currently calling for a total of 33 popular referendums in the coming year. (Are there even that many countries in the EU?)

Trump

The Brexit referendum is set to be a dress rehearsal for US November elections, and there would be market volatility as we head into the US elections. Are we under-estimating the anti-establishment vote in the US? If Trump is elected, would he become more 'presidential', utilizing his phalanx of advisors well and guiding the United States on a sensible path? Or would he do irreversible damage to the country?

Asset prices

While this development is negative, central banks globally may continue to be on hold for longer to ensure market stability, thus we may not see a bear market in equities. Indeed, many have called for a bear market for the past many years and have been proven wrong. Investors are also holding highest levels of cash since 2001 according to the Bank of America Merrill Lynch survey. The silver lining could be that property and direct investment would be diverted to the US (notwithstanding Trump) or Asian countries with stable political climates.

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