Brexit. Inaccurate Polls. Long Term Consequences.

The latest Yougov poll on the EU referendum has the 42% voting to Remain, 43% voting to Leave and 11% undecided. The result in any case will be unpredictable because the voting intentions are not driven by commercial interests but by political, social and emotional ones, and the material consequences of leaving the EU are to a great extent, unknown. Bookmakers odds paint a different picture with odds of exit at mid-30s percent. One explanation is that the polls reflect what people want to do, whereas the odds reflect what people realistically intend to do. Opinion polls have become more inconsistent as negative voting has become prevalent. If this thesis is true then the UK will vote to remain in the EU.

Depending on how acute the fear of Brexit becomes before June 23 and the extent of damage in the markets and sterling, the rebound could be significant. The bond markets have been fairly resilient even controlling for the compensating impact of duration. Last week, Euro investment grade outperformed euro sovereigns although investment grade did also outperform high yield. The commencement of the ECB's corporate securities purchase program had some impact on the euro IG market. The euro leveraged loan market lagged with a flat performance. As we approach June 23, don't expect credit markets to remain resolute. They will likely also experience volatility.

Notwithstanding the bookmakers' odds favoring Remain, the situation is very volatile and a geopolitical or security event could easily overturn the odds in an instant. Even without an event, the words and actions of the players in the theatre could spark market volatility as well.

The consequences of Brexit are difficult to quantify. The UK is the EU's single largest destination for exports representing 17% of the total while the EU accounts for 45% of UK exports. The UK runs a goods trade deficit (-66 billion GBP) against the EU but a trade surplus (+10 billion GBP) in services. For both sides, the rationale for a trade agreement is therefore strong, however, a liberal agreement on services may be more difficult to obtain. The impact on sovereignty will depend on the UK's intentions regarding maintaining trade access and could involve retaining compliance with the majority of EU legislation while losing the ability to influence its formulation. Trade access would also mean continuing to contribute to the EU budget. Broadly, the UK can leave the EU for reasons of budget contributions, sovereignty, immigration and benefits arbitrage, but it would have to forego trade access. To obtain trade access it would have to reinstate contributions to the budget, compliance with EU legislation, open its borders and provide access to benefits. This would be analogous to a switch from a contractual telephony plan to a pay-as-you-go plan. Complete replication will neither be desired nor achievable. The EU will want to discourage other members of the EU from leaving and would have to impose costs upon the UK to set an example.

Any analysis will be inadequate because only the instantaneous effects are the least bit predictable. The impact on sovereignty, trade, immigration and politics will vary as each agent's behavior evolves in reaction to the actions of other agents. In the best case, one could hope that the UK economy is sufficiently flexible that the new degrees of freedom are used wisely and growth is enhanced. In a more sober scenario, the event of Brexit is a Y2K event, a non-event, where an omnibus relationship is replaced with a series of specific ones which largely replicate the pre Brexit status quo. In the worst case, the UK either cannot or will not negotiate to reinstate trade access and goes down the path of trade war to the detriment of both the UK and the EU. Given the already fragile economic condition of Europe, this is a scenario they can ill afford and the region plunges into a protracted recession. In a scenario which is hard to classify as good or bad, the UK example emboldens other members to leave the EU which ultimately threatens the Eurozone and the single currency is abandoned.

The reaction functions of players in this game are non-linear. But the range of our vision allows us only to extrapolate.

It is unlikely that the UK will vote to leave the European Union.

If it does, the consequences will be short term instability and long term gain on both sides simply based on the adaptability and resourcefulness of humans.