



March 2024

The High Cost of Brexit

Why the UK will Eventually Rejoin the EU

"Brexit was a fantastic example of a nation shooting itself full in the face."

Hugh Grant

Preface

I have written this month's Absolute Return Letter with a heavy heart. I don't take any pleasure from other people's misery. Nor is there even a nanogram of "I told you so" in this month's letter. I cry with my many British friends who increasingly find life a struggle, but those tears do not prevent me from seeing the writing on the wall. The British nation will eventually rejoin the EU, but there will be much more pain to be suffered before that happens. Here is why.

How could it happen?

It is a bit unfair to suggest there was only one reason 51.9% of those who voted chose to vote for Brexit. Different people voted for Brexit for different reasons, but if I were to pick one reason that dominated, I would pick the reason explained by Exhibit 1.

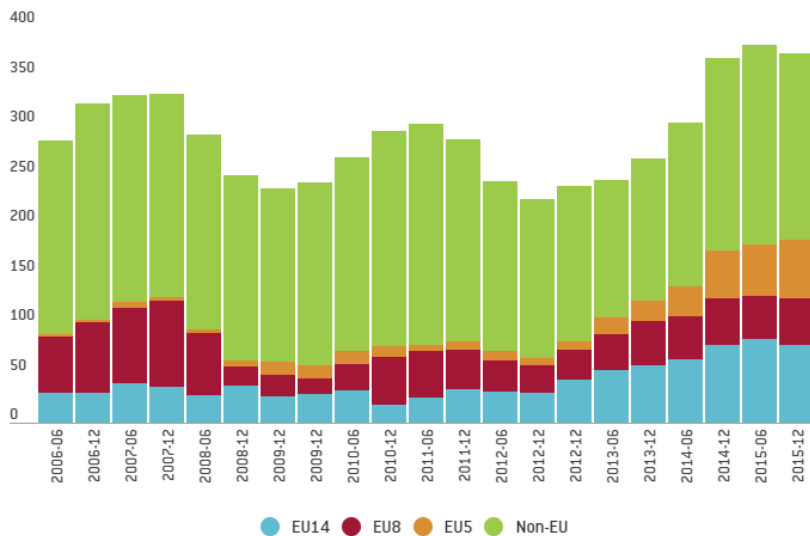


Exhibit 1: Net immigration into the UK (thousands)

Source: bruegel.org

Many Brits loathed the large intake of foreigners in the years leading up to the referendum in 2016 and saw Brexit as an opportunity to stop that. Little did they realise that Brexit wouldn't change anything. Although EU net migration began to fall immediately after the referendum and eventually turned negative, non-EU net-migration has, in recent years, risen dramatically. In other words, more foreigners than ever arrive in the UK.

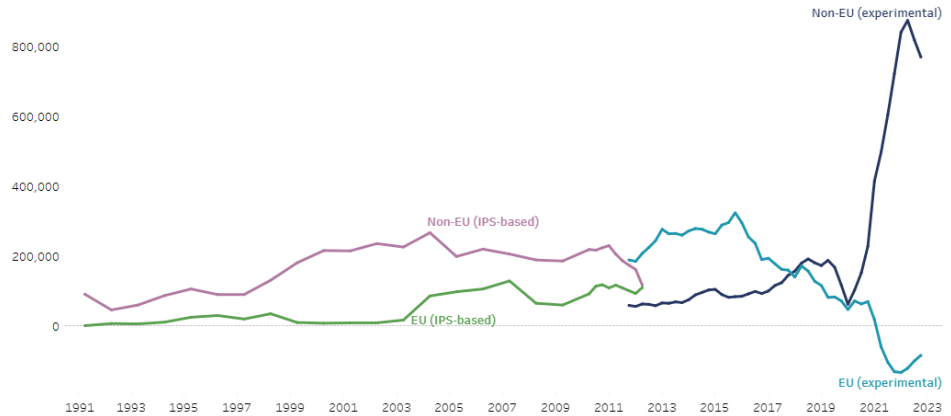


Exhibit 2: Net migration of EU and non-EU citizens in the UK

Note: Year ending December 1991 to year ending June 2023

Source: migrationobservatory.ox.ac.uk

The biggest economic own goal I have ever seen

If seven of your ten largest trading partners are members of the same free trade organisation that you are a member of, does it make any (economic) sense to leave it? Well, what do you think? Before the Brexit referendum, the UK traded more with the Netherlands – a nation of less than 18 million people – than it did with China and its 1.4 billion people (Exhibit 3). To voluntarily leave such an arrangement will probably go down in history as the biggest economic own goal ever.

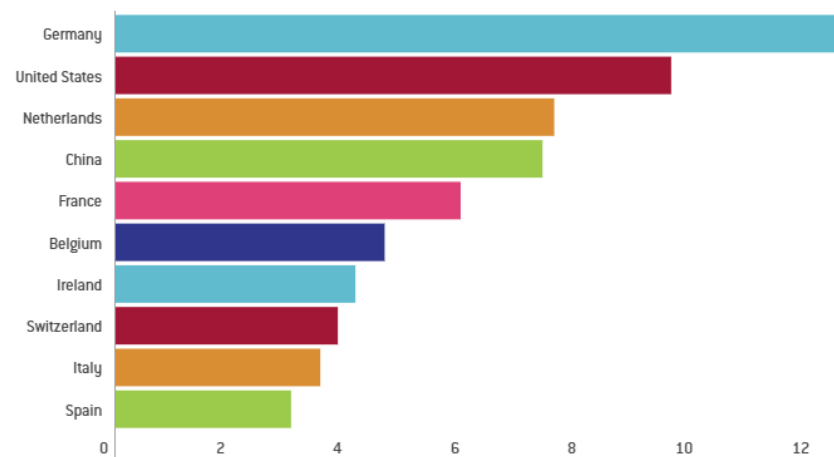


Exhibit 3: Top-10 trading partners of the UK in 2014 (% of total UK trade)

Source: bruegel.org

Prior to the Brexit referendum in June 2016, only 14% of total trade in the UK took place with countries that were not members of the EU and/or not covered by any EU/EEA trade agreements (Exhibit 4). Obviously, some of the trade with the EU has been maintained, but a meaningful proportion of it has been lost (source: [House of Commons Library](http://House_of_Commons_Library)).

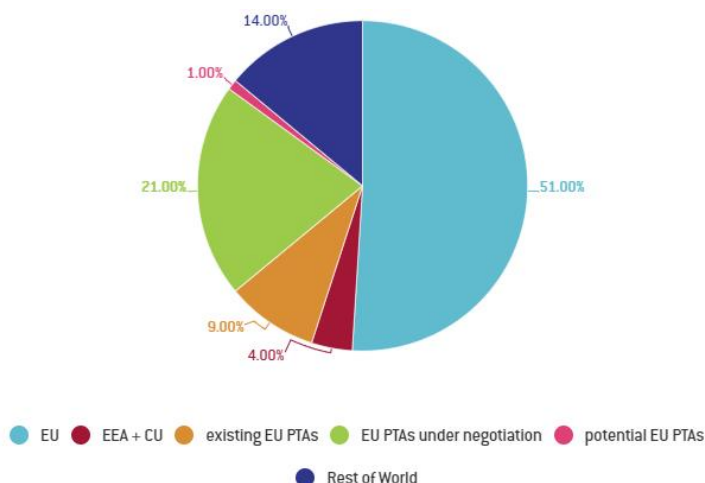


Exhibit 4: Share of total UK foreign trade by trade agreement in 2014 (% of total)

Source: bruegel.org

This has resulted in a massive loss of economic momentum. As you can see in Exhibit 5 below, many academic studies have been conducted in order to assess the economic damage. The studies do not agree on the extent of the damage – it ranges from -2% to -10% – but they all agree that the net impact has been far from positive. I should also point out that the 12 studies below weren’t conducted at the same time, which explains much of the variety in estimates.

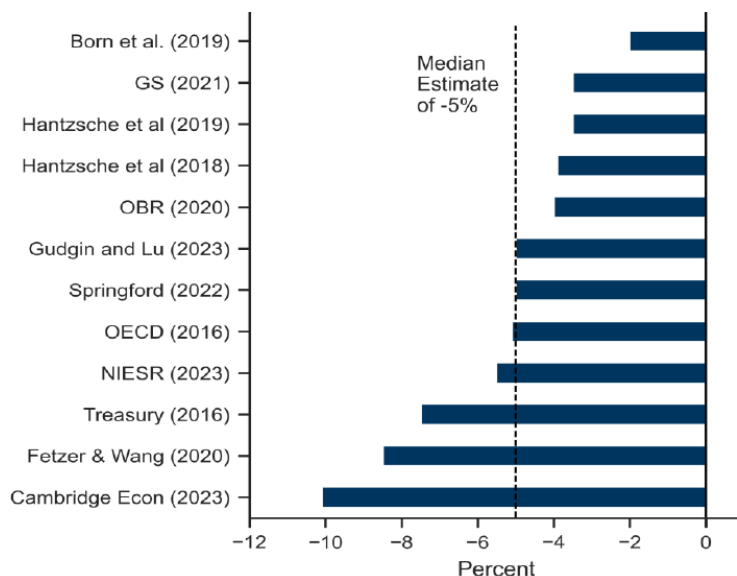


Exhibit 5: Estimated effect of Brexit on UK GDP

Sources: Various academic studies collected by Goldman Sachs Global Investment Research

In relative terms, as you can see in Exhibit 6, Brexit has also led to more difficult conditions. UK living standards are now well behind those of the EU and the US. And, as you can also see, the UK began to fall behind almost immediately after the referendum in 2016, making it hard to blame it on anything but Brexit.

Admittedly, the pandemic took a bigger toll on the UK economy than it did elsewhere, and the same is the case as far as the recent energy crisis is concerned. That said, the fact that the UK economy began to underperform immediately after the referendum makes it crystal clear that Brexit remains the root cause.

Why the UK will rejoin the EU eventually

Before I go any further, let me make it as clear as I possibly can. I am not a big fan of the EU. Its many shortcomings are a constant source of irritation. A key concern of

mine is the right of veto, which is being blatantly abused from time to time – most recently by Viktor Orbán, the Hungarian Prime Minister. The EU leadership must find a way to weed out this and other sorts of malpractice before adding more countries. Despite my frustration, the economic advantages of being part of a free trade zone overshadow all those little nags, and the Brits will reach the same conclusion one day, I believe.

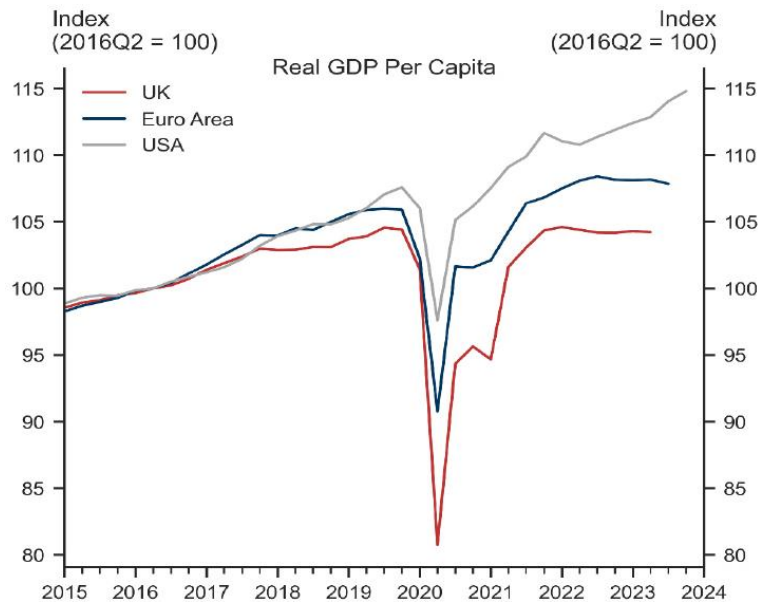


Exhibit 6: Real GDP per capita, various countries/regions

Source: Goldman Sachs Global Investment Research

More recently, the British government has been busy blowing the trumpet after having landed ‘all those wonderful’ free trade agreements since leaving the EU. Let me share the truth with you. The UK has landed three free trade agreements since leaving the EU – one with Canada, another one with Australia and a third with New Zealand. The UK had a free trade agreement in place with all three countries when in the EU and, in every single case, the new agreement is a copy and paste of the existing EU agreement. In other words, the UK has achieved *nothing* they didn’t have before.

Do you really think the UK economy will benefit from deals identical to what they had before whilst giving up a very attractive deal with Germany and other European trading partners? I don’t think it takes an Einstein to answer that question.

In terms of the continued wave of immigrants, had the situation improved post Brexit, many Brits would probably have been prepared to accept *some* reduction in living standards, but it hasn’t. As you saw in Exhibit 2, the immigrants just come from other parts of the world now. The longer this wave of immigration lasts whilst living standards continue to decline – and they will – the more intense the popular pressure for another referendum.

Why will living standards continue to suffer? When you say farewell to free trade with 450 million people in your own backyard and enter a new regime where you *at best* can obtain the same terms you already had with the rest of the world, things can only go one way. Do I need to remind you that international trade is the source of most pockets of wealth around the world? Take a few of the wealthiest cities in Europe – Amsterdam, Antwerp, Barcelona, Copenhagen, Florence and Nice. Where do you think all their wealth comes from?

One last point to wrap it all up. Allow me to go back to Exhibit 1 for a moment. I argued that large amounts of immigration drove many Brits to vote for Brexit. I ought to tell you that the UK is nowhere near the top of the list of OECD countries with most

foreigners. As you can see in Exhibit 7, Luxembourg is in a league of its own which is explainable. Amongst the 5-6 largest European countries, the UK finds itself very much in the middle of the range.

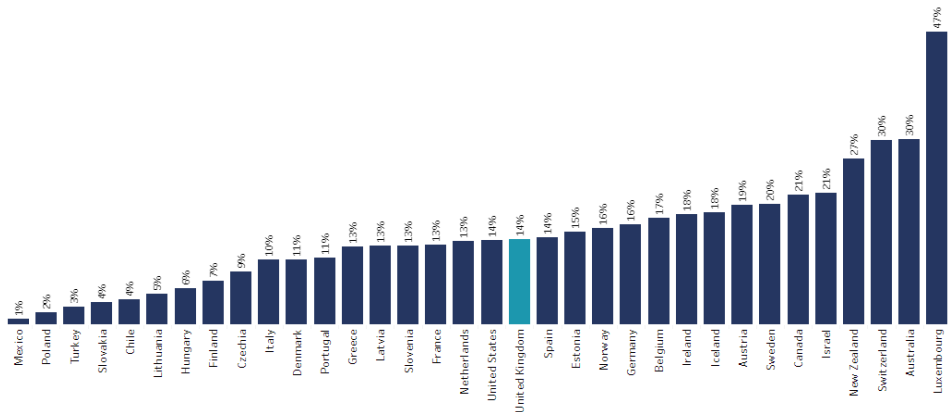


Exhibit 7: Foreign-born population as share of total population (2019)

Source: migrationobservatory.ox.ac.uk

After having lived in the UK for 35 years, I know one or two things about that country. And I don't think immigration is the root cause behind the problem. It is just being used as an excuse – either consciously or subconsciously. No, the root cause is the North-South divide, as inequalities in the distribution of wealth has led to frictions.

Whilst understable, this is a slippery slope. London will become less and less attractive as a centre for international trade (remember what I said earlier about the importance of international trade for wealth creation). Consequently, the whole country will suffer. At some point, the masses will *demand* another referendum, and that will lead to a re-entry. The only problem (for the UK) is that it will take a new generation of political leaders to understand (and accept) this, i.e. nothing will happen the next 10-15 years.

Niels C. Jensen

1 March 2024

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