Investment Insights

Brexit, Brexident or Bremain?

Scenarios and shockwaves from the UK's EU referendum

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Executive summary

Rather than a binary event, we believe the UK's European Union (EU) referendum is best thought of as a continuum of uncertain outcomes, potentially with significant financial and economic impacts well beyond the UK in the EU, extending to the eurozone (EZ) and potentially the wider world. Even so, we define three broad scenarios: the first with sub-scenarios, which we call "Brexit" – a decisive "Leave" vote, subdivided into a "Bravo Brexit" and a "Bad Brexit"; the second, "Brexident" – an ambivalent, split vote for "Leave" – almost by accident; and finally, "Bremain" – a vote to "Remain," in which the margin would have a smaller impact.

Key takeaways

- We have long believed that the UK would vote to "Remain" in its June 23 national referendum on continued European Union (EU) membership. However, as we also expected, uncertainty about the outcome has increased as the polls have swung around with shifts in the campaigns.
- Recently, the "Leave" camp has shifted the debate from the size of the economic pie to the emotive issue of immigration, with the attendant, implicit baggage about social cohesion and fairness about the distribution of the pie, rather than its size, per se.
- We believe a "Bravo Brexit" scenario could lead to positive negotiations about exit and maintaining open borders in UK-EU trade negotiations as well as in UK trade negotiations with the rest of the world. The recent growth slowdown would likely continue, but downside risks would be contained by constructive engagement among the UK, EU and global trading partners.
- A "Bad Brexit" scenario could prompt pressure for copycat exit referenda in other EU and EZ member-states. Growth could slow, led by an investment slowdown and capital outflows, causing asset price volatility and weakness.
- A "Brexident," or, a low-margin, almost accidental vote to leave, marked by voter passivity or ambivalence, could also cause growth to slow, but we would expect any financial shock to be more contained than in a full-blown Brexit scenario.
- In a "Bremain" scenario, the benefits would be the lack of a financial shock and significantly reduced economic uncertainty, but equally there would likely be no new pressure for deeper EZ integration.

While we continue to expect the UK to opt to "Bremain," we also believe that the uncertainty around this view is high enough, and the downside possibilities of a Bad Brexit, or even of a Brexident, are large enough to avoid taking substantial financial exposure.

Rather than a binary event, we believe the UK's European Union (EU) referendum is best thought of as a continuum of uncertain outcomes, potentially with significant financial and economic impacts well beyond the UK in the EU, extending to the eurozone (EZ) and potentially the wider world. Even so, we define three broad scenarios: The first with sub-scenarios, which we call "Brexit" – a decisive "Leave" vote, subdivided into a "Bravo Brexit" and a "Bad Brexit"; the second, "Brexident" – an ambivalent, split vote for "Leave" – almost by accident; and finally, "Bremain" – a vote to "Remain," in which the margin would have a smaller impact.

I. Brexit: We define Brexit as a decisive referendum result in favor of Leave, which requires major political and policy responses in the UK, EU and EZ. We subdivide the potential financial and economic consequences in two: First, a "Bravo Brexit" – a broadly positive outcome, in which a successful and constructive policy response by both the UK and EU results in a new modus vivendi that, beyond preventing downside risks, opens up upside possibilities for the EU, EZ and encourages global stability. Alternatively, there could well be a "Bad Brexit" – a generally negative outcome in line with many of the official expectations, largely due to an inadequate policy response as Europe is forced to turn inward because of similar fissile pressures within the EU and EZ; and in which the economic and financial pressures in the UK play out in line with many official scenario analyses.

Ia. "Bravo Brexit": A positive but decisive vote for "Leave:" An upside scenario in the event of a decisive Brexit would involve the UK and EU engaging in positive negotiations about exit and about maintaining open borders in UK-EU trade negotiations, as well as UK trade relations with the rest of the world under WTO trading rules. Such a scenario could also entail the post-Brexit UK stepping up to the plate, to resurrect and sustain the Transatlantic Trade and Investment Partnership among the US, EU and the UK itself as an independent trading force and voice from the rest of the EU.

> **UK, EZ, EU and global economy: The recent growth slowdown would continue, but downside risks would be contained by constructive engagement among the UK, EU and global trading partners.** The emerging financial shock reflected in sterling volatility and weakness, as well as falling risky asset prices in the UK, EZ, EU and indeed the wider world would also be contained. There would be no particular reason to expect a rapid economic reflation or complete financial rebound, because it could take some time and there would be uncertainty around post-Brexit negotiations for more inclusive, wider opening for UK-EU-global economic relations. Even so the prevention of financial risk aversion and gradual recovery in risky asset prices in response to renewed global engagement would allow for regional and indeed global economic stabilization. The avoidance of another feared financial shock, on top of US Federal Reserve rate hikes; concerns about China's currency policy, debt burden and economic slowdown; as well as EZ and Japanese deflationary pressures, would help as far afield as global emerging markets.

Ib. "Bad Brexit": A negative-case scenario: A decisive vote for "Leave" could cause a difficult and expensive UK-EU divorce. It could also prompt pressure for copycat exit referenda in other EU and EZ member-states. National governments and the EU itself might have to respond to the threat of EZ fragmentation with policies aimed at faster EZ federalization. The overriding imperative to prevent potential financial crisis due to EZ exits could discourage the idea of a two-track Europe; one with a broader, less integrated EU and a deeper EZ. As a result, the EU and EZ could become more contiguous, with Euroskeptic/anti-federal members leaving the EU.

> **UK: Growth could slow, led by an investment slowdown and capital outflows, causing asset price volatility and weakness.** Sterling could fall perhaps another 10-20%. The Bank of England (BoE) would probably elect to stay on hold because imported inflation would be transitory. The demand shock would probably result in lower inflation fears in the longer term and a flatter yield curve. The downside risks to growth and fiscal revenue might raise the risk of sovereign rating downgrades, which, in turn, could prompt central bank reserve manager diversification away from sterling and gilts.

> **EU/EZ: Lower EU-UK trade could cause a new deflationary demand shock in Europe.** Plans for stronger measures to prevent EZ fragmentation would be required, in our view, to reverse this risk and restore financial stability. Central Europe, notably Poland and other new EU entrants, could be most affected through lower migration and remittances, as well as higher barriers to continued integration. Catch-up with the far richer Western Europe could be at stake.

II. "Brexident": A low-margin, almost accidental vote to leave, marked by voter passivity or ambivalence. Downside risks might be mitigated by efforts to renegotiate by both the UK, to secure a better deal in reflection of voter ambivalence, and the EU, to prevent copycat exit referenda and the associated fissile tendencies in the region.

> **UK: Growth would also likely slow in this scenario, but we would expect any financial shock to be more contained than in a full-blown Brexit scenario.** SSterling would likely be buffeted in this scenario too, but the potential ambiguity and hope for a renewed effort to keep the EU together might limit the hit to riskier UK asset classes, including sterling credit. The BoE might be even more likely to stand pat in this scenario, looking through the impact of the market turbulence.

> **EU: The collateral damage of fissile political pressures and the deflationary demand shock would likely also be less than in a Brexit.** The policy response might not need to be as strong if the threat of copycat referenda could potentially be averted.

III. "Bremain": The benefits would be the lack of a financial shock as well as significantly reduced economic uncertainty, but equally there would likely be no new pressure for deeper EZ integration. The focus would probably return to the status quo, which is not all that positive – marked by an already weakening UK economy and EZ disinflation pressures, in the face of reasonable growth.

> **UK: A major relief rally.** Sterling would probably bounce back and gilt yields would probably rise somewhat as pricing at the short end of the yield curve would likely bring forward the timing of economic recovery and policy rate hikes.

> **EU: The EU and EZ could benefit from a relief rally too, including periphery and Central and Eastern European spreads and currencies – after all, some risk of Brexit has to be priced in across the board.** However, we believe the upside would be limited because of the absence of a political shock to rejuvenate and accelerate EZ reform and integration.

State of the debate

We have long believed that the UK would vote to "Remain" in its June 23 national referendum on continued EU membership. However, as we also expected, uncertainty about the outcome has increased as the polls have swung around with shifts in the campaigns. The "Remain" camp had seemed to be in a decisive lead when the political focus was on the economic costs, amid publication of many official and independent economic assessments, such as by the IMF, OECD, HM Treasury and others, whose advice is often taken into account in public policy choices in many countries including the UK, EZ, EU and even worldwide. But now, the "Leave" camp has shifted the debate from the size of the economic pie to the emotive issue of immigration, with the attendant, implicit baggage about social cohesion and fairness about the distribution of the pie, rather than its size, per se. As such, we believe that this referendum could influence the global economic and policy debate – as well as global markets – more directly and widely than has been the market focus so far, especially if the referendum goes for Leave.

Scenario uncertainty — making sense of it all

The main difference between our "Brexit" and "Brexident" scenarios is the margin of votes for "Leave." A high-margin Brexit would be more decisive than a low-margin Brexident, in our view, which could be seen as almost accidental amid voter ambivalence. A decisive, Bad Brexit scenario could be quite challenging for the UK, EU and EZ. A Bad Brexit may require a much stronger policy response in the case of a financial market shock and to stem the risk of copycat referenda in the EU and even the EZ.

With a small margin for "Leave," the electoral ambivalence could make a return to the bargaining table conceivable. It is true that senior EU politicians reject this idea, but this position reflects their need to sharpen the importance of the current referendum for UK voters, and to mitigate the risk that other Euroskeptic parties or governments might demand more concessions, using the credible threat to hold their own EU exit referenda. But with a small margin for Leave, there is a significant chance they would reconsider, since they would likely prefer to make some further concessions, both to other governments and the UK, in order to retain them all as members.

What would constitute a large enough margin to distinguish a Brexident from a Brexit scenario? Clearly, there is no hard and fast criterion, but we believe the markets would reveal a great deal. A margin for "Leave" sufficient to embolden Euroskeptic nationalist parties in other EU or EZ member-states would likely reignite a divergence in risk premia across the EU and EZ in a Bad Brexit outcome.

These could include weaker currencies in Euroskeptic non-EZ members, and higher bond yield spreads in both the EZ periphery and Euroskeptic Non-EZ EU members. Within CE, Poland would stand out, but Romania and Hungary would be affected too. Among high-income EU members, Sweden would stand out for its avoidance of EZ membership despite not having a legal opt-out (unlike the UK). Even France and Italy could be affected, given Euroskepticism in the rising far right of the former, and in the Northern League and other parties in the latter.

A crucial distinction between our Bad and Bravo Brexit scenarios would be the political and policy signals from all concerned parties. Key players to watch would be authorities in the UK, EU (such as the European Council, European Commission) and EZ (such as the ECB, and possibly the European Stability Mechanism as regards EZ Periphery and program countries), key member state governments (particularly Germany, France, Italy and Spain), other official agencies such as the OECD and IMF, and even the US authorities vis-a-vis US Federal Reserve policy as well as trade policy and engagement with Europe from the current administration. The signal of global authorities in support of re-engagement would be very supportive of confidence in markets as well as investment and consumption, by reducing policy risks and uncertainty.

Comments by US authorities and presidential candidates could have an impact as well, given the long historical context and the political calendar in the US and UK. The context is dominated by the close historic, economic, political and security ties among the US, UK, EU and NATO – as well as ongoing efforts to further integrate the US and European economies via the Transatlantic Trade and Investment Partnership. Against this backdrop, the US executive branch has suspended the practice of avoiding direct involvement in the internal political choices of allied, sovereign democratic states. President Obama quite in effect endorsed Bremain and suggested that logically, logistically, legally and, implicitly, politically, Brexit would place the UK at the back of the queue for free trade negotiations with the US. Several former US Secretaries of State, Defense and the Treasury have spoken out and written formally and publicly about their strong preference for Bremain.

The official US reaction in the event of Brexit would need to begin under the Obama Administration and current Congress, ahead of the November general election, opening the door to ambivalence once the campaign begins in earnest after the summer Republican and Democratic National Conventions. The US-UK-EU relationship would become part of the foreign policy debate, and take in the integrity of the Transatlantic Alliance, in the context of Brexit and the challenges of maintaining European coordination not just on trade and investment policy, but also security. Without the UK, the largest military spender in the EU, the security challenges on the EU border in Ukraine, Turkey/Syria and the NATO boundary, given complications with Russia, suggests that a Brexit could become part of the foreign policy debate in the US presidential campaign.

Our Bravo Brexit, by re-energizing the UK-EU relationship, could conceivably even have a positive demonstration effect on political pressures to turn inward elsewhere, even including the US political process. Such an approach would help limit the downside risks to investment and activity overall, as well as to sterling and other UK or EU asset prices that are part and parcel of official economic analysis and commentary about Brexit. Indeed, if and when such a constructive response to a decisive Brexit referendum vote materialized, there could be a significantly positive response across asset markets.

The internal UK political challenge of this scenario would be to reconcile two intellectual strands of the Brexit campaign – those who promote further liberalization in the UK, which they see as limited by the EU; and those who advocate restricting migration which they attribute to the EU – and with regards to both migrants seeking refuge and asylum from conflict, and economic migrants seeking a better life in a UK whose economy has outperformed those of EU and other global alternatives. We believe such a reconciliation could come about in order to maintain the UK as an important global trading nation as well as the world's most important global financial center. After all, the philosophical basis of the Brexit camp does not include an anti-trade or anti-foreign investment manifesto, but quite the reverse – greater openness to global trade and investment. The signal of closure is all about immigration – protection of labor, but openness to competition in goods, services and financial markets – all of which makes it very far from the kind of protectionist sentiment that does pose a risk in many countries in a time of slow growth and financial shocks in the aftermath of the global financial crisis and Great Recession.

What about the margin in a Bremain scenario? We do not doubt that Brexiters and nationalists in other parts of Europe might well keep the debate alive in the event of a small margin for "Remain." However, we would expect that both the UK and Europe would use even a small margin to lay to rest any suggestions of exit; making the case that such a large change in UK-EU relations could not be justified without a clear popular mandate. The possibility of future efforts to renegotiate the terms of membership or hold repeat referenda could not be ruled out, however, with a low-margin Bremain in the UK itself or the wider EU. With a high-margin Bremain, such risks would be correspondingly lower.

United or Untied Kingdom? The United Kingdom is a unitary monarchy, yet comprises four countries – England, Scotland, Wales and Northern Ireland – to which some powers of government have been devolved over time. There is much concern that the question of Scottish independence might return to the fore if the UK votes to "Leave," mainly because Scottish voters have tended to be more pro-Europe than voters in England. It would also be worth monitoring the risk that concerns over Northern Ireland would be renewed by Brexit, with a part of the population wanting to remain with the UK and another part wanting to rejoin Ireland itself.

These challenges would be significant if they materialized, creating major ambiguities for the UK outlook. Scotland has no economic border with the UK at all – the entire UK is a complete political, fiscal, monetary, banking, financial/capital markets and economic union. If Brexit triggered fragmentation of the UK itself, the fiscal and other economic consequences could be far-reaching, but would likely take time to play out. Our Bad Brexit sub-scenario could elevate the risk of an untied United Kingdom, whereas the Bravo Brexit could all but eliminate such a risk.

Economic and market implications of Brexit — Uncertainty rather than risk

We believe it is impossible to be precise about the economic consequences of Brexit, although a number of official studies have come to relatively specific conclusions about the potential economic and financial costs. High uncertainty is a result of the intangibles, which are many: Bilateral UK-EU exit negotiations would likely take at least two years once the decision to exit is triggered after the referendum, under EU and UK law, but the timing of that decision could vary and the negotiating stances of the UK and EU could range from friendly to contentious. Negotiations with other trading partners would also likely need to take place, otherwise, the UK could face higher import tariffs or other barriers to exporting to the rest of the world – even if it went for the unilateral trade liberalization that some "Leave" campaigners have suggested. Such negotiations could be complex and could take many years, based on previous experience. It is conceivable that the UK might be able to negotiate better tariffs with other trading partners from outside the EU, within which it must share a common tariff and trade negotiation stance as a member of the customs union. However, much expert opinion on this topic, including those of former trade negotiators and current and former directors of the World Trade Organization (WTO) and its predecessor, is that, under WTO rules, it would be complicated both politically and legally to offer more preferential tariffs to the UK than to other trading partners. Thus, for a symmetric reduction of tariffs between the UK and other trading partners below general tariffs, any countries so inclined would have to reduce their tariffs with all .

Stepping back from the specifics of trade negotiation, the underlying question for UK, regional and indeed, global economic and financial performance is whether the ultimate destination would be for little change, more opening, or higher barriers in the trade and investment environment in the UK, Europe and by extension the world economy. Trade liberalization is well known to increase specialization, efficiency and activity, and thereby both income and wealth. Protection is equally well known to do the reverse, and generally restricts the growth of income and wealth. But the extent of the impact of an increase in UK-EU trade barriers, potentially covering both tariffs and, in effect, non-tariff barriers, such as standards and other regulatory constraints would be of uncertain magnitude, all the more so because it probably would occur over a protracted period.

Even so, we would expect an immediate shock, led by a sharp fall in sterling, due to both current and capital account implications of a Brexit. Expectations of higher trade barriers could discourage foreign direct investment and could be equivalent to a fall in the competeviness of UK exports. To offset the likely increase in many tariffs between the EU and UK, there may need to be an offsetting real depreciation of sterling. If the depreciation were sharp enough, it could help mitigate the impact of lower investment demand on inflation. The fall in sterling would cause a realignment of "relative prices" with tradable goods and services prices rising against non-tradables, as in any sharp real devaluation.

Large manufacturing firms in the UK could benefit by being more competitive in UK, European and global markets. However, manufacturing is a very small share of the UK economy at about 10%, which is dominated by services, about 80% of GDP. This economic structure in turn is the underlying reason why many official and academic assessments point to a recession, a lower level of potential output and, in some cases, a lower potential growth rate. An EU exit would imply higher trade barriers – higher tariff rates and potentially non-tariff barriers such as standards, regulation or other constraints, for UK-EU trade in both services and manufacturing. The UK is a major importer of manufactures from the EU and exporter of services, especially, but not only, financial services, to the EU. A weaker sterling would help manufacturing competitiveness, but it would require a lot of time, investment and re-orientation of the labor market – both in terms of wages and skills availability, to re-balance the economy away from services towards manufacturing.

A key area of focus would be the effect on financial services, with London the largest regional and global financial center in the world, and already "offshore" in some respects from the EZ. It is far from clear how London's role as a financial center would be affected, though it's role could conceivably be diminished in a Brexit, and probably considerably more so in our Bad Brexit variant, than our Bravo Brexit scenario. One much-discussed possibility is that the EU and many EZ member-states would want to bring many banking and other financial services "onshore," given the importance of the euro, the ECB, banking and capital markets union and the like – all to the potential detriment of London.

However, it is unclear where the new EZ financial center would be, with several possibilities including Paris, Frankfurt, Dublin and Milan. Indeed, Europe broadly has many regional financial centers inside and outside the EU and EZ, including Switzerland and Luxembourg, as well as national financial centers. So it is possible that different financial centers would serve various different specializations in the financial markets. The UK authorities, consistent with the idea of being a more globalized and less-EU focused economy, may well seek to make London even more of a global financial center to compensate for the potential loss of EZ or EU-oriented financial services. Such decisions may well be subject to negotiation and bargaining both between the UK and EU/EZ, and potentially within the post-Brexit UK political system, probably taking years rather than months to become clear.

We would expect the BoE to ease rather than tighten, despite the imported inflation and relative price shift from the fall of sterling. The BoE Governor has indicated that he does not yet know whether he would cut or raise rates, but we would expect the Monetary Policy Committee to give greater weight to the threat to investment and net trade from exit than to a temporary rise in prices. The BoE's actions during and after the Global Financial Crisis can be seen as a precedent: it eased sharply and kept rates at or near the zero lower bound despite a long period of above target inflation due to a sharp fall in sterling.

Lessons from UK and EU experience — The risks of opening and challenges of closure

Brexit could take the UK, EU, EZ and arguably the world into analytically uncharted territory, because models do not usually provide reliable economic and financial forecasts after a structural break, such as exit from a customs union. In such circumstances, it is often useful to turn to historical precedents or analogues. But there are simply no directly applicable modern precedents for the political, economic or financial repercussions of EU exit, in our view.

Some have taken the ERM-I crisis of September 1992 as a precedent, when sterling was floated and devalued sharply on exit from its Deutsche mark peg. While there is some appeal in this example, it is useful only as a very rough guide for several reasons. First, the peg itself: sterling and many other EU member currencies were pegged to the Deutsche mark – whereas sterling is in a pure floating regime today. Second, the UK is now near the zero lower interest rate bound, whereas back then, interest rates were sky high in order to defend currency pegs, so could come down significantly after currency flotation. Third, the customs union was intact both before and after the event.

European history does offer contours for painting broad-brush pictures, but no basis for formal, "what-if" scenario analysis or forecasts. Europe has seen many break-ups of political, economic and even monetary unions during and before the 20th century: the Soviet collapse or closer to hand, the exit of Ireland from political union with the UK (in the event of fragmentation of the UK itself); or the break-up of the Warsaw Pact and COMECON (in the event of exits from the EU).

These can serve as useful political comparisons, but economic and financial contrasts, in our view. Ireland was a far smaller economy and financial system than the UK, and, in any event, the end of its century-long political union was succeeded by a half-century of continued monetary union, and continued free trade and de-facto open borders to investment and migration.

In terms of relative economic size, exits from Eastern European political, economic and monetary unions are more comparable vis-a-vis the threat of EU or EZ disintegration, but represent far more radical political and economic regime changes: The financial and economic shocks would be far smaller, because there is no question of a loss of market access due to national insolvency (as with the USSR, Poland or Bulgaria in the early 1990s). The political risks would be considerably smaller almost by definition, since the UK and any other EU exit referenda would be about releasing internal tensions through popular expression, rather than bottling it up until it can no longer be contained.

However, the threat of EZ exits could be as risky in monetary and financial terms as the Soviet break-up and the subsequent collapse of its partial successor, the Russian ruble zone. That post-Soviet monetary union was not supported by a political, fiscal and financial union. The EZ still suffers from similar deficiencies, but this is precisely why the EZ might federalize in the event of a Brexit significant enough to destabilize the monetary union. Indeed, it was the existential threat posed by "Grexit" risk that prompted major EZ steps such as ECB President Draghi's "Whatever it takes" commitment to mutualize EZ public debt through a program of "Outright Monetary Transactions" that stabilized the EZ in 2012-13, as well as mechanisms for partial support for fiscal and structural reform (e.g., the European Stability Mechanism, restructuring of Greek debt and similar programs in the other EZ periphery program countries).

Finally, a critical market concern, in our view, would be the long-term and global impact of a formal political rejection of cross-border flows that lubricate the European and global economies in the event of a decisive Brexit. A key founding principle of the EU is the so-called "Four Freedoms" – of goods, services, labor and capital across national borders within the EU. The UK had been the primary advocate of openness in Europe for decades and indeed throughout the world for generations, as the birthplace of open markets, free trade and global investment – all ideals which were realized along with Great Britain's global and regional political role as a force for integration and stability.

Thus, today, the idea of Brexit represents a political irony: The UK was the first country to immediately open its borders to migration as part of the EU expansion in 2004 that formalized the shift of former Warsaw Pact members into Western Europe, including Poland as the largest new member-state. This autonomous UK decision reflected two goals, economic and geopolitical – to accelerate the integration of the new members from the East and to recognize that large-scale immigration was already a fact of life and could not be overturned. Legalizing economic migrants would bring them out of the shadows into the formal economy, into the tax and social safety nets.

In contrast, France and Germany, among others, opted for a seven-year transition period in response to domestic political concerns about immigration. They abandoned this transition well before the seven year deadline because, like the UK, they experienced large-scale migration. Indeed, they started with delaying tactics, but ended up implicitly acknowledging that the UK approach was at once more practical and more principled by being fully aligned with EU rules.

Today's UK immigration issue is more complicated because it incorporates a decade-long expansion of East-West migration within the EU, as well South-North migration in the aftermath of the EZ crisis and protracted recession the southern EZ. On top of these, there is the role of London as the world's foremost financial entrepot, attracting financial and economic elites. As a result, it is also a cosmopolitan and cultural enclave that is generally believed to be more globalized in most fields than almost any other city in the world. Yet, all these categories are seen by many British voters to be capitalizing on and contributing to London's attractions without contributing adequately to the UK's costs for infrastructure, education, social cohesion and financial support. Indeed, these are the reasons for London's demand for greater authority over its own destiny and budgetary resources. The Syrian refugee crisis has added fuel to these fires in media visibility and insecurity/terror – even though the numbers have abated since the EU deal with Turkey, providing financial support to restrict the flow of refugees.

The desire for greater control of immigration in the UK debate is proving the most effective for the Brexiters. The same argument would also have the most appeal in other parts of the EU and EZ for Euroskeptic parties and voters. In turn, the closure of the UK, one of the most liberal, open economies and financial markets in the world, to immigration, and the risk of this idea catching on in Europe, could well spread to other countries facing similar popular concerns with immigration, as well as economic security and personal safety.

None of this is to say that Brexit would necessarily lead to radical increases in trade or investment barriers globally. However a decisive Brexit could well mark the end of EU and EZ expansion, which has been a force for opening previously autarkic economies to global trade and investment and restoring the rapid convergence of an "emerging markets" Europe toward "developed market" living standards, income levels, capital endowments – and asset valuations and risk premia.

It is often the case that after major economic and financial crises, countries turn inward as electorates seek to protect their own from perceived external threats. Indeed, this is a major part of what followed the Great Crash, and made the Great Depression and Great Deflation that much deeper – with tremendous cost. Modern financial, economic and political crises have been different: The world economy has remained open for business and, finance, if anything, has opened up further despite serial emerging markets, and more recently, global financial crises. Indeed, various European political crises including the Soviet collapse and the EZ crisis have been followed by financial support which enabled structural reform and continued openness to trade and investment.

A decisive Brexit, because it threatens an increase in restrictions on both trade and immigration, may therefore be seen as a medium-to-longer-run threat to the open, multilateral order starting in Europe. Other economies may have a lot to lose – especially emerging market economies in Europe, more than developed market economies, in general, or other emerging markets. Some prominent economists have suggested that there could be a significant global economic cost as a result. But we would expect that UK, EU and EZ politicians would continue to remember the lessons of history that have enabled global openness to survive the Global Financial Crisis of 2008, the EZ financial crisis of 2011-13, and the Tequila (1994), Asian (1997), and Russian (1998) crises.

Post-referendum political crises are important risks in a decisive Brexit scenario for the UK and EU/EZ. However, the hope would be that the UK's existing trade and financial openness and stated desire of prominent Leave and Remain campaigners to open up further would outweigh the desire of Brexiters to restrict immigration, for the UK itself- and that continued UK openness would outweigh regional or global political pressures to turn inward. The first, and foremost, of these would be the potential need of the EZ to turn inward to re-unify, should a decisive Brexit spur on the existing fissile pressures in the EU or EZ.

Conclusion — sometimes it's better not to put your money where your mouth is

In summary, while we continue to expect the UK to opt to "Bremain," we also believe that the uncertainty around this view is high enough, and the downside possibilities of a Bad Brexit, or even of a Brexident, are large enough to avoid taking substantial financial exposure.

The asymmetry of Brexit risk is another major constraint: We just do not see much upside in the European complex, not least because the focus of Brexit risk has mainly affected the behavior of sterling. The cost of purchasing insurance in the derivatives market is high enough, and the volatility in sterling itself high enough to discourage using most markets – spot currency, bond and options markets, even if one wanted to express one's Brexit views, whatever the expected scenario.

The upside in the rest of Europe in the event of a Bremain outcome is limited because we remain concerned by the persistence of low inflation and inflation expectations, despite EZ economic recovery. And furthermore, a Bremain would not by itself enhance EU or EZ stability. It would not guarantee that either EU or EZ fissile pressures would dissipate.

Bremain would solidify the concept of a two-track Europe, one for EZ-outs like the UK, to participate in economic union without monetary union; the other for EZ member-states, which, in principle, would pursue ever deeper political union. And that would be good for the integrity of the EU customs union – which would be whole-heartedly welcome, for the reduction in the risk of higher trade barriers and investment constraints.

But Bremain would also avoid a near-term shock - whose upside silver lining could be to precipitate rapid EZ integration. The absence of crisis would probably discourage Europe from addressing its issues, as in the past, and in most other countries. This, in turn, would probably draw out the already glacial pace of fiscal, financial, economic and above all, political integration of the EZ, which retards its progress toward a full-fledged, fully-integrated, continental economic union like the other major potential growth poles of the global economy – such as the US, China, India and even Russia or Brazil (though the latter two are in deep recession and subtracting from global growth at present).

It is true that safe-harbor assets may be benefiting from the risk of Brexit (such as German bunds, US Treasurys, UK gilts, or Japanese government bonds), but there is a generalized demand for long-duration assets perceived to be free of credit risk, a phenomenon that is both global and persistent, which suggests strongly that the underlying issue is deflation and global overhangs of debt and excess capacity, rather than Brexit risk per se. It is quite likely that the link between a perceived increase in the possibility of Brexit and lower safe-harbor bond yields is two-pronged: First, there might be a financial shock, which increases the demand for liquid, high-quality government bonds as protection. Second, a Bad Brexit might also increase deflationary pressures in Europe and thereby in the world as a whole, which in turn would induce buying of bonds of governments that are expected to be able to refinance and issue debt despite disinflation or even deflation; in contrast, weaker issuers, whether public or private, would face an additional deflationary debt burden and greater credit risk in the event of a Bad Brexit. Thus, Bremain should imply lower risk premia in risky assets, but removing the threat of Brexit would only remove one potential straw from the deflationary burden on the world economy, and do little to alleviate the burden of all the others.

Important Information