



STAYING IN THE EUROPEAN UNION

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OVERVIEW: Press reports seem constantly to warn us of the possibility of a breakup of the European Monetary Union (*the EMU*), or even the possibility of the withdrawal by the UK from the European Union itself (*the EU*). (*While the UK benefits from its economic participation in the EU, it has never adopted the Euro as its currency.*) These questions constantly arise not only because of the partial successes, but also the significant failures of the eurozone to achieve many of the political and economic goals that were originally sought by its founding members. Instead, today we see a Europe with still near record unemployment, barely positive economic growth and depressionary conditions in Greece (*and in parts of Spain, Italy and Portugal*). Major EU nations have failed, repeatedly, to live up to budgetary and treaty obligations (*France*). On the political front, Europe is plagued with fundamental disagreements on global policy matters (*Ukraine and Iranian sanctions*) and faces a resurgent military threat from Russia. More recently, right wing political groups have risen up, driven by swelling ranks of Middle Eastern and African refugees. The refugees are not being integrated into European society and could potentially lead to the broader radicalization of Europe's own population¹. In spite of these factors and considerations, we do not feel that the EMU or EU is at serious risk of breaking apart, or that the upcoming May elections in Britain are likely to set the stage for a British exit ("*Brexit*") from the European Union. While all these issues pose a threat to the long-term viability of the EMU, we believe the Union can weather the current pressures bearing down on it. Below we take a look at a couple of these issues on a country by country basis as well as from a geopolitical perspective.

MAIN POINTS

- Despite Europe's difficult economic environment and rising anti-austerity sentiment, we think it is unlikely the EU will fall apart
- Support for the Independence Party in the UK is growing but current economic strength makes a "British Exit" unlikely
- Reforms of existing European treaties and rules are more likely than an outright breakup of the Union
- The EU is greater than the sum of its parts; unity brings influence geopolitically and an ability to compete economically

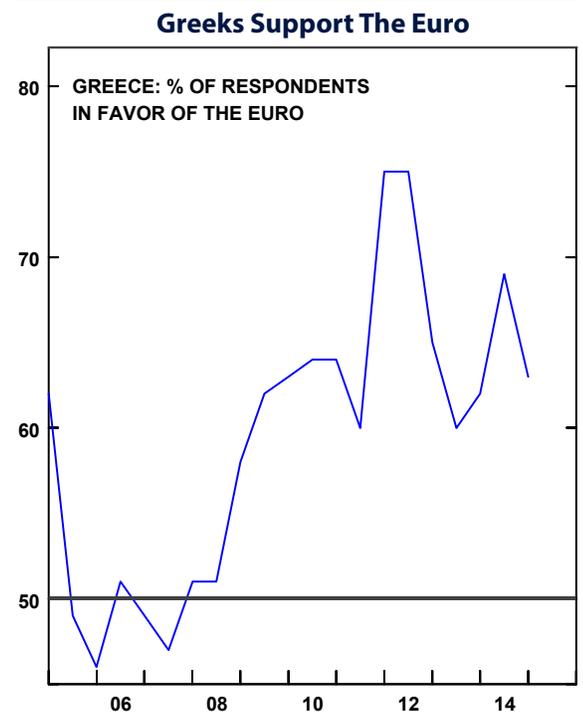
THE UNITED KINGDOM: The UK is scheduled to hold a general election on May 7, 2015 and there is the possibility that the UK Independence Party (*UKIP*) will win a substantial portion of the votes. The UKIP is expected to campaign forcefully on an anti-immigration and anti-EU ticket. These two issues are tied together, since it is membership in the EU that provides for basically unrestricted travel within EU member nations. The UKIP is not expected to win any sort of outright election victory (*it was only polling 14% in February polls*), but could certainly be part of a governing coalition set up with David Cameron's Conservative party. If a Conservative coalition wins, Mr. Cameron has promised to hold an "in-or-out referendum" on the issue of EU membership. Currently, polls show the country more or less evenly divided on the issue². A coalition led by the Labour party would not hold a referendum, which would remove this issue as a source of uncertainty for post-election UK economics. UK politics is an extremely complicated subject and votes alone don't guarantee seats in Parliament, so even broad based polling numbers can be quite misleading. The Scottish National Party (*SNP*), which recently lost a bid to achieve Scottish independence, will also play a role in any coalition government. However, the SNP is highly unlikely to cast its lot in with Cameron's Conservatives, so its influence should help push the UK towards remaining in the EU.

If a Conservative-UKIP coalition forms the next government, an “EU in-or-out” vote is likely to be put to the general population no later than 2017 (*although it is my understanding that Cameron could bring this vote forward to 2016*). At this time, in spite of the now evenly divided polls, we do not feel that there is a significant risk that this vote will be successful. First off, economic conditions have generally been improving in the UK and good economic conditions have tended to lead to increases in pro-EU membership sentiment among UK voters. Anti-EU sentiment peaked in 2011-2012, the worst period for the EU economic crisis, and at that time a majority of Britons favored an exit, with only 28% holding a favorable view towards continued EU membership. Economic forecasts for 2015 show expected GDP growth for the UK to be around +2.6%, more than double the predicted growth rate for the EU area as a whole, which should be a major positive for anti-Brexit forces.

In addition, we feel that, once analyzed, the full implications of a UK withdrawal from the EU will likely push voters towards staying with the status quo. London continues to act as the major European financial center and it serves as a focal point for monies arriving from all over Europe, Africa, the Middle East and Asia. The UK enjoys this “safe haven” role for capital at least in part because of its “...centuries of [legal] governance and common law institutions...” that could be damaged by a Brexit victory. An exit from the EU could serve to isolate London, diminishing its importance on the global financial stage. Ease of EU transportation would diminish and the ability to access all EU goods and services would be reduced. In the EU, the United Kingdom is a part of the second largest economic block on the globe, comprised of over 500 million citizens with 2013 GDP of around \$16 trillion. Standing alone, the UK has a mere 64 million in population, making it an after-thought among the global giants of the US, EU, China and India. Simply stated, size matters in terms of modern economic clout. Finally, UK stocks are nominally at their all-time highs and there is little in the way of incentive for the UK to upset this apple cart. Therefore, while this issue is likely to be hotly debated in the upcoming election, we feel that odds certainly favor continued participation in the EU by the United Kingdom.

GREECE: Although other threats to the stability of the European Union exist, we feel that these are also highly unlikely to result in a breakup of the union and will be dealt with from within the existing European legal, treaty and political structures. First among these threats is Greece, where the Syriza party recently swept into power. However, Syriza’s support appears to be coming more from their anti-austerity, anti-German dominance and pro-growth economic policies than from any desire to leave the EU. As the chart to the right illustrates, Greek popular support for remaining within the EMU has not dropped below 60% in the last five years⁴ and with the country’s ruling coalition now actively trying to win concessions from Europe’s governing institutions, the threat of secession is likely to diminish. While the ultimate outcome is certainly not free from doubt, our best assessment is that even a default by Greece on its outstanding sovereign debt is unlikely to force Greece out of the EU since the vast majority of the losses on such debt will be absorbed by the ECB, other EU central banks and the so-called supra-national institutions that own Greek debt.”

GEOPOLITICAL: In addition to the above, there is a **very** long list of currently active separatist or secessionist movements and breakaway political parties in Europe that is too long to discuss here. The movements include the National Front in France, the Alternative für Deutschland in Germany, the Sardinian Nation Party in Italy, and Catalan Independence and Basque separatists that straddle France and Spain. In fact, Spain has no fewer than 12 separate independence movements⁵. Suffice it to say that Europe remains European in nature and will likely maintain its diverse

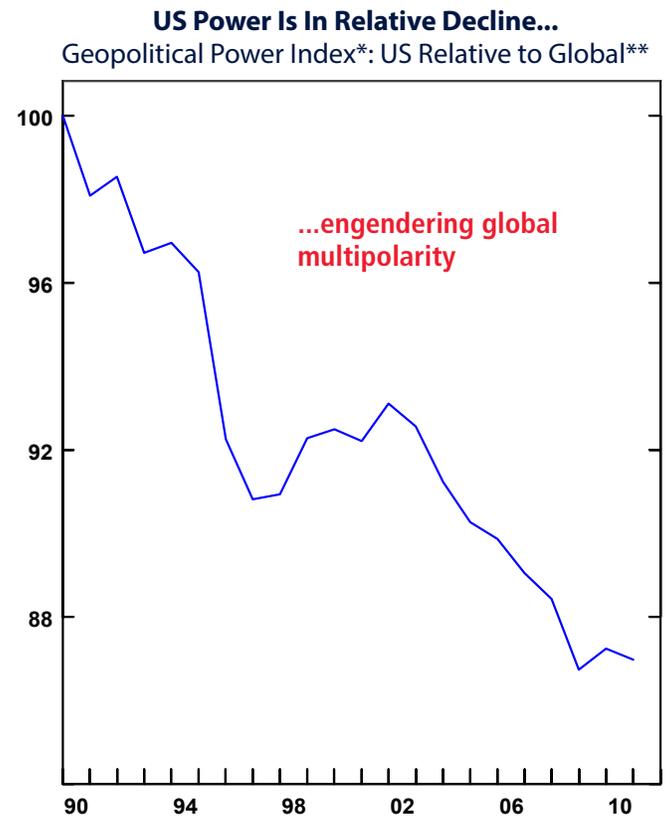


Source: BCA Research, March 2015

ethnic, religious and language differences indefinitely. In addition, recent extremist violence in Europe, epitomized by the attacks on Charlie Hebdo, have given added support to far right claims that Europe's free immigration policies may be dangerous. Political violence combined with weak economic fundamentals (*as we saw after WWI*) can be a particularly combustible mix with far right parties such as Syriza in Greece and Podemos in Spain becoming politically significant virtually overnight.

None of this means, however, that it is in the best interests of all of these parties to cause a breakup of the EU. In fact, there are a number of major, strategically important reasons to believe that Europe's nations should, and will, continue to band together. First is the fact that in the 100 years since the First World War, Europe's leading nations (*Britain, Germany, France, Spain and Portugal*) have seen their once global ability to carve up the world into separate spheres of influence reduced to that of not even regional, but merely local (*peripheral*) importance⁶. None have any remaining meaningful military power. Second, these countries have safely operated under the umbrella of US military and economic power for two generations. However, the power of the US is in sharp decline on a relative basis (*see chart to the right*⁷) as the world evolves into a multipolar world, instead of one dominated by the US and the former Soviet Union. It becomes more important than ever for these countries to continue to band together as US relative power continues to decline. (*Just look at the recent negotiations concerning sanctions and cease fires in the Ukraine in which the US did not participate at all.*) Third, from an economic perspective, Europe's countries are simply too small to compete in an effective way with the giants of the US and China today and with India and a reconstituted Russia of the future. It takes the EU community to build jet aircraft (*Airbus*) to compete with Boeing. Ultimately, Europe's nations are simply too small and have too much to lose from splitting up.

CONCLUSION: Exit from the European Union by Britain, Greece or any other disaffected province or region could be interpreted by the markets as a signal that the EU "construct" was beginning to fall apart on a piece-by-piece basis. However, as noted above, we think that this is highly unlikely to happen. While anti-immigration and far right-wing parties have gained in popularity over the past several years, their goals are much more oriented towards reforms of existing EU policies than they are on exiting the European Union. As economic conditions continue to improve in Europe, we expect that populist, anti-EU rhetoric of the various extremist political parties will moderate so that they can remain in power. The European Union has been tested during the financial crisis and will be tested again by future events. However, their overwhelming interests lie in unity, not division. We favor adding exposure to European risk investments on any pullback in markets caused by concerns of a British or other country's exit from the European Union.



Source: BCA Research, *Geopolitical Strategy*, February 2015

* The Geopolitical Power Index measures a country's power based on a weighted aggregation of its economic, military, political, technological, and geographical endowments.

** Shown rebased to 1990 = 100

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- ¹ BCA Research, *Geopolitical Strategy, February 2015, In Focus – Europe: The Euro and (Geo)politics*, page 24.
- ² BCA Research, *European Investment Strategy, Geopolitical Strategy, Special Report, U.K. Election Review, February 26, 2015*, page 6
- ³ BCA, *Op cit.*
- ⁴ BCA Research, *Geopolitical Strategy, March 2015, Europe: Final Words on Greece*, page 16
- ⁵ See: http://en.wikipedia.org/wiki/List_of_active_separatist_movements_in_Europe for details.
- ⁶ BCA, *Op Cit., March 2015*
- ⁷ BCA, *Op Cit., February 2015*, page 24

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