CONCRETE THOUGHTS

Now What?

With last week's historic vote by over 70 percent of British citizens, the United Kingdom decided to leave the European Union. This vote took many market watchers by surprise as virtually all polls indicated that the "remain" votes, while close, were likely to prevail.

Robert Knakal

The biggest takeaway from this decision is that it has created tremendous uncertainty and markets like nothing less than uncertainty. And the uncertainty is not likely to become resolved quickly. There are many questions that need to be answered in the wake of this monumental event.

A day after the vote, British Prime Minister David Cameron announced that he would step down to allow someone else to chart the course the U.K. would take. However, Cameron will stay in office for another three months while his successor is determined. When that decision is made, the negotiation of the exit itself will have to be entered into.

How the EU's representatives will deal with the U.K. will be very interesting. For instance, what will the exit deal look like? While some high-ranking officials within the EU have said that there is no reason for them to be adversarial with the U.K., others believe a harsh position relative to the U.K. could dissuade other nations from considering exiting the Union. Moreover, it will probably be two years before the exit is actually completed.

In fact, other nations are already contemplating referendums to leave the EU, including France, Italy, Denmark and the Netherlands. Perhaps other countries will feel more compelled to try this bold move after seeing the U.K. take the lead. Some market watchers believe this is the beginning of the end of the EU, which has become increasingly difficult to maneuver within. For instance, recently 10 new members have been added, all of which are economically weak. Events like this put significant pressure on the delicate balance within the system.

The uncertainty created by this has caused equity markets around the world to sell off. The pound plunged to a 30-year low relative to the dollar. This has profound implications for our real estate markets and will certainly lead to a re-pricing of British assets. The luxury residential market in London is expected to drop tangibly. The strong dollar is also likely to impact the flow of foreign capital into our for-sale luxury residential market in New York.

The flip side of this coin is that capital flows into the commercial real estate investment market should increase. London and New York are perennially the two top destinations for this capital. With one of the markets suddenly now more uncertain, a disproportionate share of this dedicated capital will flow to the other. This will help our investment sales market, provided global recessionary pressures don't spread (more on this later).

The uncertainty and economic turmoil Brexit has caused will also help our commercial real estate market in another significant way. The Fed will almost certainly not raise interest rates again this year and may not do so again until mid-2017. While the long-term implications might not be positive, in the short-term, this will continue to exert upward pressure on property values.

But let's get back to a possible recessionary impact. Major financial institutions are already talking about reducing staff in London and relocating those employees to continental European cities. Further, the strong dollar makes our goods cost more overseas. When something costs more, you get less of it, which leaves employers cautious and unwilling to grow. This dynamic could exacerbate recessionary pressures in an already sluggish economy.

The strong dollar also hurts our hospitality industry. It becomes more expensive for foreigners to come to New York and, more importantly, makes traveling abroad less expensive for Americans. The latter is more important because over 80 percent of tourists coming to New York are domestic travelers.

Clearly, only time will tell what the impact of Brexit will be on numerous different markets. In the short run, at least, the impact on our commercial real estate market should be more positive than negative. The more important macro question is the impact Brexit could have on economies already teetering on hard times and how other EU members' perspective on staying in the Union might be impacted.

STEIN'S LAW

Brexit: Keep Calm and Carry On

Once in a while something big, different and often unexpected happens. It happened on Sept. 15, 2008, when Lehman Brothers filed for bankruptcy. Also on Sept. 11, 2001. And a few years ago when Greece almost collapsed and we heard dire rumblings that the European Union would fall apart. Our computers were going to fail on Jan. 1, 2000. There were also the Russian bond default, Long Term Capital Management, the 1986 tax act, the S&L crisis and more.

Joshua Stein

Another such event occurred on Thursday, when the U.K. electorate unexpectedly decided to exit the European Union ("Brexit"). That set off fear, uncertainty and stock dumping that destroyed, at least for now, trillions of dollars of value.

Investors and commentators fear Brexit will cause a recession in the U.K. with ripple effects elsewhere. Brexit could be long, protracted and messy—a celebrity divorce with complicated assets and no prenuptial agreement. Trade barriers will arise, hurting everyone and the creation of wealth.

Other EU members may follow the U.K., destroying a hugely important free trade bloc. Conversely, Scotland and Northern Ireland, which voted against Brexit, might switch from the U.K. to the EU, creating more chaos. The U.K., a major trading and finance partner of the U.S., will become less important in the global economy, hurting the U.S.

Maybe the Brexit vote was a populist tantrum against "the way things are" and "financial and political elites" and "big remote government." If so, what does that portend for our presidential election in November? More chaos.

If Brexit excised the British Isles from the world and let them float into isolation in the middle of the ocean, or ended world trade and capital flows and the rule of law in the U.K., it would cause a disaster for the U.S. and the world. But that didn't happen.

Trade and capital flows will continue. Today's players, especially in the U.K., generally know the value of free trade and free capital flows. Whatever arrangements the newly liberated U.K. negotiates with the EU and the rest of the world, one should reasonably expect a continuation of free trade and free capital flows. The process will take time, though, hence the uncertainty.

Instead of focusing on creating wealth and general improvement, the U.K. government will distract itself for the next two years disentangling Great Britain from the EU. That has already led Prime Minister David Cameron, who opposed Brexit, to resign. But the U.K. retains tremendous strength and resourcefulness, with plenty of smart people who favored Brexit and now can get it done.

Headwinds in the U.K. could also slow things down in the U.S. But U.K. uncertainty may make U.S. real estate and other investments more appealing for both investors and occupiers, especially in finance. That should help the U.S., especially New York City. But the sudden devaluation of the British pound, if it persists, could create a buying opportunity in London. Those two forces will sort themselves out. Neither feels like the impending end of the world.

Brexit seems likely to further defer any increases in interest rates and cap rates, thus pushing that day of reckoning further into the future. That will just continue our addiction to cheap money. Eventually rates will have to rise and it will hurt.

The EU has enacted, and will no doubt continue to enact, ever-expanding laws on finance, trade, competition, product standards and other matters of concern going beyond—and also often invading and usurping—the internal agendas of their member countries. Those invasions probably helped drive Brexit. The U.K. was subject to all those laws, often adopting them as internal laws of the U.K. When the U.K. leaves the EU, will all this legislation need to start over from scratch? Not necessarily.

It should often be practical to take existing EU laws and adapt them to U.K. tastes and agendas, benefiting from the U.K.'s new freedom and independence from Brussels. Moreover, any continuation of free trade between the EU and the U.K. will probably require the U.K. to keep complying with many of those EU edicts. It's reasonable to expect more consistency than change.

Everyone seems to agree it makes sense to try to resolve the Brexit uncertainties as soon as possible. The EU itself has said as much, perhaps in the hope that sealing the wound quickly will prevent further infection and damage (and departures). Because investors hate uncertainty, they feel likewise.

Once the uncertainty clears, which will take time, one can reasonably expect the financial world and international trade won't look all that different than they did before Brexit—just like what eventually happened after each of the earlier disruptions mentioned in the opening paragraph of this column.