

March 4, 2019

The Irish Question: Part II

Last week, we examined the geopolitics of Britain and offered an abbreviated history of Irish/British relations. This week, we will begin by analyzing the Good Friday Agreement, followed by an analysis of Brexit regarding the Irish question. As always, we will conclude with market ramifications.

The Good Friday Agreement

By the late 1990s, conditions that had led to British colonization of Ireland and the need to maintain some degree of control there had changed. Britain was no longer a major imperial power and had become a member of the European Union and NATO. In fact, like the rest of the EU, it was outsourcing its defense to the U.S. U.K. access to sea lanes had little to do with the power of the Royal Navy; instead, it was dependent on global and regional trade agreements and the U.S. Navy. Thus, securing its western coast was no longer an imperative.

The three-decade guerilla conflict in Northern Ireland had become a drain on resources. No longer was Northern Ireland a major industrial center. Instead, it was a place that required constant support. At the same time, the long war had steadily undermined the idea among Irish Republicans that unification could occur by force.

Out of these two realizations came the Good Friday Agreement. There are five key elements to the agreement:

1. The Status of Northern Ireland was acknowledged. The agreement begins with the claim that the majority of people in Northern Ireland wished to remain part of the U.K. It also acknowledged that a substantial minority in Northern Ireland and the majority of those in Ireland supported unification.
2. The Irish Constitution was amended to accept that Northern Ireland was part of the U.K. U.K. laws were amended to support unification.
3. Both sides agreed that, at some unspecified point in the future, a referendum on the border would be held. If the majority in Northern Ireland agree on unification then both sides would honor the results of that vote.
4. Citizens of Northern Ireland could carry passports from both the U.K. and Ireland.
5. Paramilitary groups on both sides would be disarmed and decommissioned.

To a great extent, the Good Friday Agreement is a classic exercise in strategic ambiguity. After nearly five centuries of tensions, it had become clear that neither side's ultimate aim would be immediately achievable. As noted above, the British had concluded that Northern Ireland wasn't a geopolitical imperative any longer and the costs of maintaining a state there were becoming burdensome. Those in the Republican movement who supported violent unification were also defeated as it was seen as counterproductive to continue to support conflict when unification would eventually occur. At the same time, there were still pockets of Unionists in Northern Ireland who opposed immediate unification, so delaying that event into an indeterminate

future allowed nearly all parties to agree to the terms of the accord. Only the most hardcore Unionists and Republicans rejected the agreement and they essentially became marginalized.

Since the agreement was signed in 1998, numerous demographic, political, economic and social changes have developed that further support unification.

Demographic changes: The 2011 census of Northern Ireland revealed that Protestants are only 48% of the population and Catholics are 45%. It is widely assumed that by 2021, when the next census is held, Catholics will be the majority. The primary reason is age; in the 2011 census, 51% of Northern Ireland school children were Catholic and only 37% were Protestant. Simply put, the Protestant population in Northern Ireland is shrinking relative to the Catholic population through the aging process.¹ Over time, as Catholics become a majority, the likelihood of a referendum on unification will increase and will support the end of Northern Ireland as a political entity.

Political changes: In the 2017 elections, the Unionist parties won less than 50% of the vote for the first time in Northern Ireland's history. It would appear that voters are becoming less supportive of the Unionist cause.

Economic changes: In 1922, when the two Irish states were formed, Northern Ireland was an industrial center for the U.K., predominantly a shipbuilding and textile producer. The Irish Free State was primarily agricultural and poor. These positions have changed over the near century. Ireland, with its membership in the EU and the Eurozone, became a "Celtic Tiger." Although GDP per

capita figures are distorted by Ireland's corporate tax policy, it is generally acknowledged that Ireland has a more dynamic economy. In 2017, the U.K. generated revenues of £11.7 bn in taxes but spent £20.5 bn.² Years of conflict undermined Northern Ireland's economy, while Ireland's membership not just in the EU but in the Eurozone as well made Ireland an attractive venue for foreign investment. Thus, it might be a more attractive economic prospect for Northern Ireland to join Ireland rather than remain in the U.K.

Social changes: For years, Ireland was a very socially conservative nation. Under the sway of the Catholic Church, divorce, marriage and reproductive legislation was restrictive. However, social constraints have steadily eased. Contraception was legalized in 1980, as was divorce in 1995. Same sex marriage was legalized in 2015 and abortion was legalized last year. Ireland has become steadily secularized over time; accelerating the process has been the revelation of Catholic clergy abuse in Ireland.³ Before the secularization of Irish society, there was general reluctance among those in Northern Ireland to unify with such a state, especially among Protestants. However, a nation less dominated by the Catholic Church makes unification less threatening.

The Good Friday Agreement essentially says that someday unification will occur. Because it didn't set an established date for unification, both sides could put off the referendum indefinitely and wait to hold the vote until the outcome is obvious. For the most part, the Good Friday Agreement ended "The Troubles" and led to peace, essentially dissolving the border. It went

² Ibid.

³ <https://www.reuters.com/article/us-pope-ireland-abuse-factbox/factbox-reports-into-abuse-in-the-irish-catholic-church-idUSKCN1L51J0>

¹ <https://geopoliticalfutures.com/provisional-brexit-deal-northern-ireland/> (paywall)

from a heavily fortified frontier designed to prevent weapons from being brought into Northern Ireland to an afterthought. The dissolution of the border has been an important element in undermining those in Ireland who support violence as a tool of unification; after all, time appears on the side of a unified Ireland which makes violent unification difficult to justify.

Brexit

Brexit has, however, upset these arrangements. It doesn't appear that the supporters of Brexit carefully considered the ramifications of leaving the EU regarding the Irish border issue. When U.K. Prime Minister May negotiated her Brexit plan, it included a "backstop" that would allow the open border to continue on the Ireland/Northern Ireland frontier. However, that backstop would require the U.K. to remain in the EU Customs Union, which would prevent the U.K. from negotiating its own free trade deals with other nations, a key point of Brexit. Brexit supporters have floated a number of border arrangements based on non-existent technology, but for obvious reasons those have failed to address the EU's concerns. A goal of Brexit is to allow the U.K. to make its own regulations on goods and services; the Tories would likely want to reduce regulations. Such changes with open trade borders would be an anathema for the EU as it would undermine the EU's regulatory process. Another idea was to put the trade border at the Irish Sea, effectively leaving Northern Ireland in the EU. Since PM May's coalition government includes members of the Democratic Unionist Party (DUP), the only major political group in Northern Ireland to oppose the Good Friday Agreement, this outcome was not tenable.

In the Brexit referendum, Northern Ireland voted 55.8% to Remain.⁴ Polling suggests that if Brexit leads to the return of a hard border then Northern Ireland would likely accelerate the border referendum and vote to join Ireland and leave the U.K.⁵ However, as the demographics above showed, there is probably a substantial number of Unionists who would aggressively oppose unification. In an ideal world, the unification referendum would be held in 10-20 years when opposition will have likely aged out. Brexit could potentially force the issue sooner than anticipated with the potential for unrest from dedicated Unionists. And, if the Unionists turn to violence then the Republicans who support violence would likely reemerge.

For now, the most likely outcome remains a temporary backstop that keeps the border open while the U.K. and EU negotiate a trade agreement. However, PM May still wants her agreement to pass Parliament and appears willing to use the deadline on March 29 for leverage, which means she is using the threat of a hard Brexit to bring MPs to her position. The risk with this strategy, as modeled by the classic game of chicken, is that the odds of a hard Brexit are increased.

Ancillary Issues

Britain faces other problems related to Brexit and the Irish border issue. First, the U.S. Congress has warned the U.K. that a hard Brexit that returns a strict border to the Ireland/Northern Ireland frontier could impede a free trade deal with the U.S.⁶ One of the primary reasons for Brexit was to give

⁴ Op. cit., Geopolitical Futures.

⁵ <https://geopoliticalfutures.com/brexit-border-poll-backstop/> (paywall)

⁶ <https://www.ft.com/content/79cdf2a8-2b02-11e9-a5ab-ff8ef2b976c7?emailId=5c5d05bdd83b3f00042c1d53&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22>

the U.K. the ability to form its own trade arrangements. Supporters are assuming these arrangements would be superior to the ones currently negotiated by the EU. This position is questionable on its face—the EU economy GDP is slightly smaller than the U.S., while the U.K. economy is the fifth largest in the world. This isn't to say the U.K. economy isn't important but the relative size alone suggests it won't have the same leverage as the EU. It is important to note that free trade deals are tricky to negotiate, and with about 11% of Americans claiming Irish heritage, second only to Germany, the potential for a crisis on the Irish border affecting U.K. post-Brexit trade arrangements should not be underestimated.

Second, in the Brexit vote, Scotland overwhelmingly voted to Remain, 62% to 38%. All council areas voted to Remain. Scotland, like Ireland, has an undercurrent of independence from Britain. A Home Rule movement began in the 1850s. Devolution, the concept of a separate legislative body, had a referendum in 1979, when it failed, and again in 1997, when it passed. An independence referendum was held in 2014, which failed 55% to 45%.

Scotland wants to stay in the EU and has a history of independence. If Northern Ireland votes to leave the U.K. and unify Ireland, then the Scots might be inclined to follow a similar path. Unlike Irish unification, which would put what is now Northern Ireland in the EU, the EU would need to decide if it would accept an independent Scotland as a member. Although the EU has been cool to breakaway regions within member states joining the union, we suspect the EU might welcome an exiting region from a nation that left the EU under Article 50. Simply put, Brexit might end up spelling the end of the U.K. as we know it, leaving the kingdom as merely England and Wales.

Third, Brexit might bring a return of geopolitical risk to England's western coast. The initial reason for controlling Ireland was to protect England's western coast and prevent a foreign power from using Ireland as a base to contain the British Isles. As we noted above, those concerns have generally eased under American hegemony. However, if Ireland unifies and the U.S. steadily withdraws from its superpower role, the potential exists for a return to the threat that Ireland could pose to England. At present, there is no European power that would likely consider invading Ireland in order to build a platform to do the same to Britain. However, history suggests that one cannot fully eliminate this outcome as a potential threat. Given Ireland's history with British colonization, we suspect the Irish might be more inclined to take their chances with a different power, or at least no longer be an automatic ally to Britain's geopolitical goals.

Ramifications

The Irish border issue has become the most difficult element of Brexit. As we have shown, left up to time and demographics, Northern Ireland would likely, at some point, unify with Ireland. In fact, until Brexit, the U.K. probably would have welcomed that outcome. In the short run, supporting unification would likely bring down May's government as unification is opposed by the DUP. In the long run, unification might trigger further devolution of the U.K. and resume Ireland as a geopolitical threat. These issues could be addressed, given enough time. A well-negotiated trade arrangement with the EU could keep Scotland in the fold. A plan to avoid a hard border could foster a free trade agreement with the U.S. But, due to the lack of planning by Westminster, time isn't a luxury currently afforded to them. In fact, PM May's negotiation tactics have been

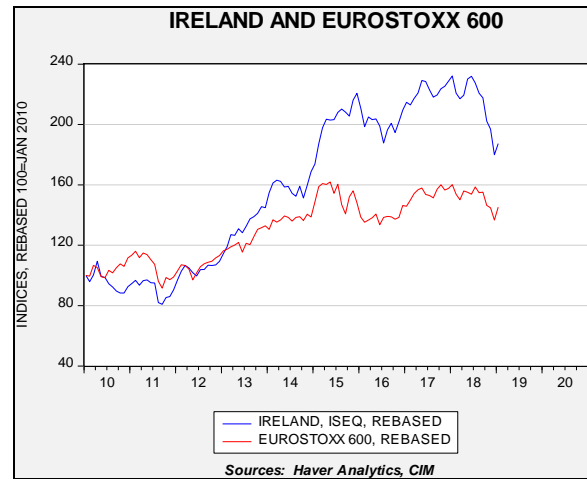
based on brinkmanship tied to a hard Brexit at the end of March.

Currently, financial markets are leaning toward a delay of Brexit and an avoidance of a hard Brexit and the subsequent Irish border crisis. We generally accept the market’s outlook. Much of May’s position is based on keeping the Tory Party from splitting as much as it is to avoid a hard Brexit. But, investors should realize that the potential for mistake is elevated.

There are two outcomes that we focus our attention on for Brexit. The first involves the GBP exchange rate. Purchasing power parity models project fair value for the British pound around \$1.65, suggesting the currency is undervalued. Just before the Brexit vote in June 2016, the exchange rate was \$1.49. It made a low of around \$1.20 after Brexit but has been recovering on hopes that a hard Brexit can be avoided. We believe that avoidance of a hard Brexit or a new referendum would likely trigger a rally back to fair value, whereas a hard Brexit would take the exchange rate to \$1.10. Using those levels as reference, the markets have discounted roughly a 65% chance of a hard Brexit. Intuitively, this level strikes us as about right but still shows that a significant decline could follow if the U.K. leaves the EU without a deal.

The second area of concern would be Irish financial assets. Since 2010, the Irish stock

market has generally outperformed the broader European market.



Note that the Irish market has come under significant pressure recently. This is likely due to growing worries about a hard Brexit. Again, if a hard Brexit is avoided then we could see a recovery in Irish equities relative to Europe; however, a hard Brexit would likely lead to even deeper declines in the Irish equity market.

For now, we still expect that a hard Brexit will be avoided, but it would not surprise us at all if this outcome isn’t decided until the deadline approaches. The closer we come to March 29 without a deal, the higher the probability that the GBP and Irish equities could come under pressure.

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