July, 2016

COMMENTARY

The obvious topic for this quarter's Commentary is the "Brexit" and the impact on markets. Many of you may have heard about the Brexit vote prior to the election in Britain. You may have decided it was a complicated subject and probably had no direct impact you. Then on June 23rd you woke to find out that the Brits voted to exit the European Union (EU) - i.e., there would be a Brexit - and the Dow Jones Industrial Average was opening more than 500 points down. We wouldn't be surprised if your reaction was one of frustration – frustration that these surprises out of left field keep occurring just as the markets begin to perform well. We understand, and we hope what follows will help put things in perspective.

So let's first discuss what actually happened on June 23rd. The vote was a referendum by the British people for the government to initiate Britain's exit from the EU. In order to actually leave the EU, Britain will have to invoke something called Article 50 of the Lisbon Treaty which spells out the steps for withdrawing from the EU. Once invoked, a two year clock begins for negotiations between the EU and Britain to formalize the exit and relations between the parties. British Prime Minister, David Cameron, who was staunchly against any Brexit, announced he would resign effective in October and would leave it to his successor to invoke Article 50 and negotiate the Brexit. Therefore, it will be well over two years before Britain actually leaves the EU. There is still a possibility Britain might not leave the EU, but we are assuming the government will honor the voters' wishes. Until the actual exit, all relevant EU laws and regulations will remain in place.

So why did markets react so negatively? First, markets were expecting a "remain" vote. In anticipation of this, equity markets had been advancing in the prior days. So the market's reaction to the "Brexit" was as much to the surprise as it is to the reality. That does not mean the reality is a positive ... at least in the near term. There is heightened uncertainty as to what happens next. Besides impact on security prices, there can be near term impacts in the real world until the picture becomes clearer.

Having said that, the picture is not all negative. This is NOT a disaster. There is no reason why Britain can't establish bilateral agreements with the EU. They can also establish bilateral agreements with other nations without having to consult the EU. The US is not in the EU and has trade agreements. Our exclusion from the EU is not a problem. Britain's exclusion shouldn't be a problem either. Once a formal exit submission to the EU is made, Britain and the EU will be able to negotiate over the course of the two year waiting period. Unless EU negotiators are vindictive – or incredibly unwise – normalization is possible and even likely.

While Britain will face short term risks until terms are negotiated, the longer term risk is to the EU. Ironically, a successful Brexit will make it likelier that others might leave. That we believe is the real concern. Once again, this creates uncertainty. However, decentralization and competition among nations can be quite positive for long term growth. In case no one has noticed, centralized control of economies has not been particularly successful in recent years. We realize that's a bit contrarian, but we think it should be noted.

Getting back to market reactions, we noticed something on which there has been little commentary. In terms of what sectors of the equity markets fell the most, they were clearly the traditionally "economically sensitive" sectors. Industrial companies, manufacturers of consumer durables, and materials manufacturers were among the biggest losers. Also, companies with significant exposure to Britain had substantial drops. Meanwhile, small ticket consumer companies with a predominance of U.S. exposure were joined by companies perceived as high growth and tied to the "cloud" in experiencing much smaller stock pullbacks. In the brief period of time since the Brexit vote in which the market has rebounded, these latter stocks have reached new highs while the former group still has not reached pre-vote levels. What is the market saying? Clearly, the markets are expecting very weak growth, if not a recession. This is confirmed by the continued falling level of interest rates. Judging by the action of the British equity markets and the fall in the price of the British pound, things are expected to be much worse there.

We tend to disagree with this assessment, particularly in terms of degree. Within the U.S., there are a few changes in our outlook as a result of the Brexit vote. There is virtually no chance that the Fed will raise interest rates any time soon ... but you already knew that. The dollar should be strong which will help consumers, though this will likely make things tougher for exporters. This is what the U.S. economy experienced for much of 2015. It was difficult though not a disaster. We still see economic growth as being positive, but it should be extremely modest at best through the end of the year.

Globally, we see overall investment in new plant and equipment remaining at weak levels. Ironically, there is a very positive side effect to this low level of investment. Business cycles tend to come to an end when high rates of growth in industrial capacity and business inventories outstrip demand. Often triggered by monetary authorities, the investment in capacity rapidly slows while businesses reduce inventories. Layoffs follow, and the economy falls into recession. In this expansion the high level of fear has tempered the growth rate of investment in capacity and inventories. Continued fear is likely to continue tempering that investment, thereby reducing the probability of any sharp downturn in the near term. It is this lack of confidence that mostly explains why the current economic expansion has persisted for so long. It has been over seven years since the economy troughed in March of 2009. We give far less credence to the impact on the economy in recent years due to the Federal Reserve's efforts to grow the economy via monetary easing. We won't repeat past discussions here, but we believe the mispricing of interest rates has actually held back the economy.

With respect to Great Britain, many think there is doom ahead for that nation. Certainly there will be a difficult adjustment and a negative impact due to the impact of uncertainty. However, the currency has already fallen significantly, rendering British producers more competitive. Consequently, a significant amount of the negative effect has likely already been offset .

As to what we can expect in the markets going forward, we recognize that the road can be bumpy for a while. This condition will probably last through the U.S. elections in November. We repeat our sentiment that this has not been a disaster. Risk premiums in the markets are already high. They just got higher, and we can't rule out them getting higher still. So while we're still bullish for the long term, little would surprise us in the short term. However, since we are starting from low valuations, and we don't expect the economy to plunge into a deep recession, we advise investors not to panic.