

Something to Think About



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Hmm. What to write about today?

Last night, I stayed up pretty late watching the BBC report the results of the 'Brexit' referendum. I had one eye on the TV screen and another on my iPhone watching global stock futures; it wasn't pretty. After the vote became a fait accompli, I went to bed knowing today was going to be, well, less than fun, with more than enough red ink to fill the wells of every bureaucrat in the EU.

But, other than the predictable short-term market freak out, what does Britain voting to leave the European Union actually mean? After giving this much thought, before and after the referendum, I can only answer that with: it depends on just how petulant everyone is.

Will the French and Germans try to punish the UK in some form or fashion for opting to get out of the club? Will Washington really put London at the proverbial 'back of the queue,' as the President has suggested, when it comes to hashing out a trade deal with the US? In the President's own words, from what I can tell: "The UK is going to be in the back of the queue."

Really? Our 7th largest trading partner and strongest military ally is going to the back of the line, in anything? I find that hard to believe. Further, the UK is Germany's 3rd largest export market, not far behind the US. It is France's 5th largest export market; the 3rd for the Dutch; the 4th for the Italians, the Spanish, and the Belgians; the 2nd for Ireland, and the 3rd for Denmark.

Simply put, the UK is a major trading partner and an important market for most of the export driven economies in Europe, if not all. Further, the Britons run a pretty massive goods trade deficit with the EU. So, do you think European manufacturing companies would want to upset that apple cart? Do you think they would exert whatever influence they could over their elected representatives to NOT engage in a trade war with London?

Since I am not a European, I don't know exactly what the psyche would be, but I find it hard to believe this Brexit will engender any sort of negotiations which would be counter to the best interests of the individual economies in the EU, the UK, and even the US. Why would the EU deal differently with the UK after Brexit than it does currently with the Norwegians, the Swiss, or even the Canadians? Besides, why would the US really even care? I mean we haven't turned NAFTA into a regional government like the EU have we? I wonder why not.

But what if this sets off a disintegration of the EU in general? What if the Italians opt to get out? What if the Portuguese do? Or the Spanish? The Maltese? The Austrians? I mean, what happens if it all just sort of falls apart? Would that, then, be an economic death knell? Is this the real issue with Brexit? That while the UK will end up being just fine over the long haul, Europe, at least a combined one, will just sort of collapse?

First things first: if Europe really is that fragile, the British made an extremely wise decision. Second, I am old enough to remember the world without the euro and without the European Union as it is currently configured. I don't believe I am necessarily waxing nostalgic when I say the Maastricht Treaty and the adoption of the euro by most EU countries has been sort of a, well, non-event in terms of growth. I have looked at any number of historical charts for the primary economies in

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the EU, and it is hard to immediately discern any sharp spike in output due to either (Maastricht or euro). It might be in there somewhere, but I fear you would probably have to peel back a lot of the layers of that onion to find it. Apologists might say the economic results would have been better but for aging demographics and the like, and they might be right. However, if that is the case, the results would have been better regardless.

Third, the EU is just too good a deal for too many countries in it. Would Bulgaria really be able to hammer out as favorable terms with the US, China, or Japan but for the EU? Would Romania? Estonia? Slovakia? Hungary? The Czech Republic? Lithuania? Latvia? Croatia? Slovenia? Portugal? Malta? Cyprus? Greece? All these countries have GDPs of roughly \$250 billion or less. Individually, they don't carry much clout in the global economy. Combined, shoot, these countries have a GDP of \$1.4 trillion+, which makes them relevant as a group.

Britain? 65 million people PLUS \$2.9 trillion GDP = 5th largest economy = relevancy and NOT 'back of the queue' as our President suggests.

When push came to shove, which it apparently did, I suppose the average Briton, at least the 52% of eligible British subjects age who went to the polls and voted to leave, couldn't find a good enough reason to stay in the EU, and that is about it. Had the economic argument been stronger, and had it been obvious the EU was a good thing for wallets and pocketbooks, this whole thing/mess wouldn't have gotten this far.

Long-term, this should be a non-event of the highest magnitude. However, as we are seeing today, it can, and probably will, cause some short-term pain. However, the biggest problem isn't what you might think. You see, global central bankers will make sure there is enough cash in the system to ward off or mitigate a significant liquidity crunch. So, I am not worried about that...no.

The biggest problem, and this couldn't have happened at a worse time, the market uncertainty, if there really is any, over Brexit has thrown a wrench in the currency markets. When wrenches get thrown into the currency markets, the US dollar tends to rally. When the US dollar rallies, it depresses the reported earnings of domestic multinational corporations. This is because accountants will translate foreign revenue back into fewer dollars, the reporting currency. Obviously, this will depress net income, which will depress earnings per share. Stock investors generally prefer more earnings per share than less, even if due to accounting gimmickry. Most companies report earnings on calendar quarter ends.

The 2nd Quarter of 2016 ends next Thursday. The US dollar has rallied over 2% today, and is now stronger relative to a trade weighted basket of foreign currencies than it was at the end of the quarter. As a result, as I type, the foreign currency translation impact on 2Q earnings for domestic multinational corporations will be slightly negative. Oh, it won't be debilitating, but it will be something...and, right now, the markets need all the somethings they can get.

That is the real problem with Brexit....short-term disruptions in corporate earnings and market valuations. Will investors be able to see through that 'noise'? That remains to be seen, but I am hopeful the big/smart money will be able to do so.

Today, you will have any number of retail investors freaking out and selling in an attempt to 'catch the falling knife.'

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Frankly, if this had to happen, I am happy it happened on a Friday, as it will allow folks to cool their heads over the weekend. That OR it will allow any true negative ramifications to more clearly emerge. Either way, the markets will have a more sober view of the situation on Monday, or they should. It will depend on just how much garbage the media spews forth between now and then.

You see, there will be those who view Brexit as an indictment of globalization in general. Others will view it as the start of increased isolationism and nationalism. Folks can buy into this all they want, but globalization is pretty much here to stay, whether we like it or not. While isolationism can be debilitating, there is nothing inherently wrong with either globalization or nationalism. The two aren't necessarily mutually exclusive. Why can't an American be proud of being an American, and still conduct business internationally? Why can't a German or a Frenchman or a Briton do the same? As I type, I don't believe there is any real reason to believe the Brexit vote will engender strident xenophobia in the UK.

After all, according to the UN, in 2015, roughly 13.2% of the UK population was 'foreign-born.' By comparison, it was 14.5% here in the United States, 12.1% in France, 9.7% in Italy, and 1.6% in Japan. So, Britain has been at least reasonably accommodating over the years with its immigration policy.

Others might disagree, arguing Brexit is the first step in Britain closing its doors, specifically to refugee immigration from the war-torn Middle East. While that could indeed be the case, should the Britons not be able to decide how many refugees enter Britain? Or should that be the property of the Belgians, French, Italians, Germans, Slovenes, Greeks, Portuguese, Spanish, Danes, Dutch, Maltese, Cypriots, Croatians, Swedes, Bulgarians, Poles, Irish, and Finns, etc.? How would Americans like it if the OAS (Organization of American States) had the authority to do the same thing here in this hemisphere? I imagine we wouldn't like it one little bit.

Also, some subset of us will worry what will happen if the Scots and the Northern Irish vote to secede from the UK. Presumably, Northern Ireland would become part of the Republic of Ireland, and no one would be too much worse for the wear....for all intents and purposes. As for the Scots, well, they would have a much harder go of it than they would like without UK military bases and defense contractors. They are a huge chunk of the reason why public expenditure per capita in Scotland was £10,374 relative to the UK average of £8,913 in fiscal year 2014/2015 (about 1/3 of per capita GDP....seriously). So, Scotland arguably has a pretty sweet gig being in the UK, at least economically....kind of like Alabama in the US.

Finally, there is the not so small issue of the UK remaining in the EU for up to 24 months, or perhaps even longer, due to procedural requirements. Here is a summary of Article 50 of I lifted off the Independent UK website. *The right of a Member State to withdraw from the European Union was introduced for the first time with the Lisbon Treaty; the possibility of withdrawal was highly controversial before that. Article 50 TEU does not set down any substantive conditions for a Member State to be able to exercise its right to withdraw, rather it includes only procedural requirements. It provides for the negotiation of a withdrawal agreement between the EU and the withdrawing state, defining in particular the latter's future relationship with the Union. If no agreement is concluded within two years, that state's membership ends automatically, unless the European Council and the Member State concerned decide jointly to extend this period. You see, the Brexit vote was really nothing more than either a thumbs UP or a thumbs DOWN to begin negotiations with the rest of the EU. Seriously, that is all it was....a green light to begin the process to get out and NOT the actual getting out itself. It wasn't Pearl Harbor for goodness sake.*

In the end, no matter how I try to come up with a Doomsday scenario due to Brexit, I keep coming back to the same thing: it depends on just how petulant everyone is. In practical terms, this shouldn't be an issue in a relatively reasonable amount of time. Yes, there will be some short-term pain and depressed earnings reports. However, if cooler heads prevail, the UK will develop relationships with the remainder of the world not unlike Canada, and it is substantially larger than our friends to the north.

Basically, we can tie ourselves in knots, and we can do mental gymnastics until our brains hurt. However, in aggregate, Brexit shouldn't have a major impact on the global economy unless 'we' are so stupid as to let it.

The question then remains: will we?