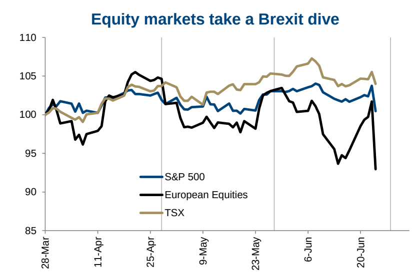
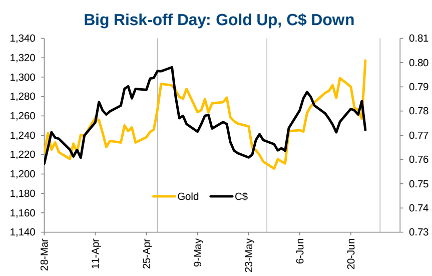
UK to EU – It's not me, it's you

24 June, 2016

Yesterday the referendum in the UK narrowly went the way of Brexit, setting in motion what will be a multi-year ordeal that will likely end with the UK no longer a member of the European Union. As this was a big surprise, we have a dramatic risk-off trading environment at the moment. That means equities are down sharply, industrial commodities are lower, gold is higher, bonds are higher and safe haven currencies such as the Yen and U.S. dollar are higher. European financials are down a ton and so is the pound. Scotland is already talking about redoing their recent referendum about remaining a part of the UK as they voted largely to remain in the EU. A number of financial companies have indicated they will be moving significant personnel and operations from London to Frankfurt or Dublin.





So what does it mean now or in the future? What could it mean for our investment strategy? Is there a trade? How does it impact our positioning now and in the future? To be honest, it is way too early and there are likely many different scenarios that could play out. Below we will share our thoughts, fears, opportunities and, as we always do, open up our investment process and thinking.

What now?

There is going to be a long lag between this vote and the actual Brexit. Operationally, leaving the EU is a relatively easy process for the UK and would take about two years based on how the structure works. This could be extended, especially if political turmoil develops in the UK. To invoke the exit clause of the treaty, the UK will have to elect a new PM, so we are about to have a bit of a cooling off period. It is also possible there is a renegotiation of some sort, hard to say. Suppose they could plug up the chunnel too, but that seems extreme.

Most believe the UK will slip into recession, which is likely especially if capital / people flow out of the country abruptly. A cheaper pound should help exports, but uncertainty will likely lead to less travel. Plus, the UK is more service-oriented than hard manufacturing. I believe their biggest exports are cars and soccer hooligans. The drop in the currency will likely stoke some inflation pressures. Will this impact global growth? Not really.

Connected Wealth Market Ethos posts are market thought pieces from the Richardson GMP Asset Management team. As part of our philosophy for managing money, we believe in providing quality objective advice and services with greater transparency. These reports are designed to provide a deeper look into our current thinking.

Market Ethos - Ethos is defined as the character or disposition of a group. In this case it's the disposition of the market itself.

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RICHARDSON GMP

Today's good news

The near-term fear in the early hours (and I mean very near-term as in hours or days) is this instability triggers some financial problem. Bank and Financial services in the Europe 500 index are down 13% today. Some banks, such as Barclays, are down 20%. Add huge moves in some currencies like the pound's 7.5% drop against the U.S. dollar, which may have ripple effects that we simply don't know the extent of. Margin calls next week may add to the volatility.

Very likely the BOE and other central banks would be pretty quick to jump in and provide liquidity if something started to develop. That is a good thing. The other good news is **no flash crash developed**. During past periods of market turmoil even as recent as earlier this year or last August we saw small flash crashes in some ETFs and some equities. That doesn't seem to have developed today (so far, anyhow).

Damn, this June got hot

We have been writing about a hot June for a month now given all the potentially market moving events. Brexit certainly turned out to be the big one impacting the market today. Brexit itself was never the big fear, it is the knock-on effects. We continue to see political instability spreading across many countries as the populaces become disenchanted or angry with the current path. There are elections in France, Italy and of course the U.S. that could see material changes in leadership. The UK leaving the EU may change the balance of power within the bloc, and it certainly opens the door for others to consider exiting should times get tough. I think the market can live with Brexit and the weakness it is driving today will likely fade. The big risk is we have another euro crisis—or more accurately, Part Three of the on-again off-again euro crisis. That may be down the road as the central bankers will likely be smoothing things out in the near term, but Brexit has raised the likelihood.

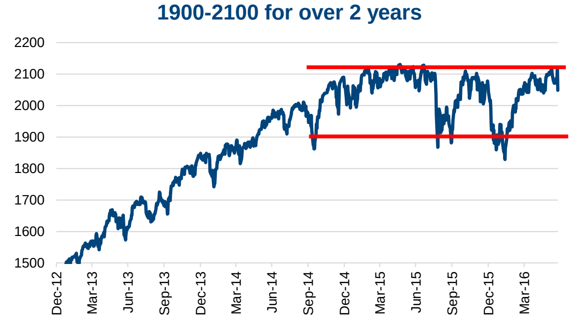
The revival of the euro crisis carries much bigger global market implications. That would contribute to reducing global growth, which is already pretty anemic. It could also be the trigger for a flare up in China. China is a bigger trading partner with the EU than the U.S., so any slowdown in Europe would impact China. To be honest, even after the Brexit vote shocked markets, we still have more concern about China than the impact of the Brexit. **China exports to the EU was $388 billion dollars in 2015. The EU has been a key source of growth for China, as the EU's imports from China have more than doubled since 2005.**

Following the exit vote, the chances of further yuan weakness and rate cuts have increased. This brings our attention to a possible acceleration in the already torrid pace of capital flows out of the country which could deal another blow to Chinese asset prices. Capital flight is a large concern. It's hard to see a concrete serious impact to global financial markets from the Brexit event in isolation, but financial market contagion is a real risk and no country has been more contagious than China.

Late cycle = More volatility

There is one thing that almost everybody was right about heading into the Brexit vote last night: volatility would be heightened coming out of it, particularly for the pound and financial stocks. Of course if the vote went the other way we would be looking at a lot of green on our screens. At the start of June fears began to rise that a Brexit was a real scenario, causing a 4.8% decline in the currency in just two weeks. Then the betting poles began to move strongly in favor of the U.K. remaining in the Eurozone which lifted the pound nearly 7% in five trading sessions, only to give it all back in today's move which caused a true range of nearly 12% in the currency. These are unprecedented moves for one of the world's most liquid currencies.

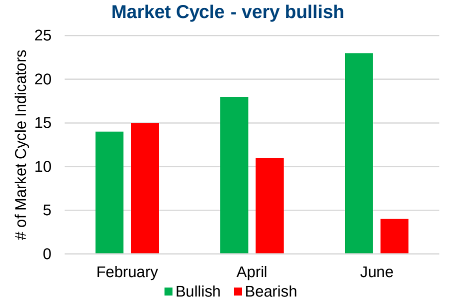
S&P 500 remains range bound between 1900-2100 for over 2 years



These bouts of volatility are consistent with late market cycle behavior. Being in year eight of the bull market and have already seen two major bouts of volatility over the past twelve months in North American equity prices; one last August and one in January/February of this year. We expect this trend to persist. This environment does lend itself to employing a more tactical strategy, especially if we continue to see high volatility in a range bound market. It should be noted that the S&P 500 at 2,050 is right where it was two years ago. That is a long time to remain in a range.

Good longer term news

While this volatility is unpleasant, the vast majority of our market cycle indicators continue to point to a continuation of the current bullish phase of the cycle. In fact, we have not seen this many positive indicators in a couple years and that does have us optimistic that once this Brexit issue fades, we may break out of this trading range. We see good strength in both U.S. and global economic indicators, fundamentals, technical and rates.



There is also earnings. The market entered this 2-year range-bound range roughly at the same time earnings growth for the S&P 500 turned negative. We have seen declining S&P 500 earnings since Q4 2014 but Q2 2016 appears to be lining up with some earnings growth. Reduced capex especially around oil and the earnings drag of a high U.S. dollar are having a diminishing impact on earnings as comparables become easier. This is setting the stage for good earnings season starting in a few weeks. That may help markets as well.

We don't know if the volatility will continue or for how long. But we do know that this market does have many good things going for it including economic growth (albeit slow), earnings growth and continued low interest rates.