CAPITAL MARKET NOTES

24 June 2016

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Brexit Commentary

Thursday's historic "Leave" vote in the UK will have both immediate and long-term consequences for the global economy and financial markets. The initial flight-to-quality reaction across asset classes has been exacerbated by the market's misplaced confidence in a "Remain" victory leading up to the vote. Stock markets around the world rallied this week while the British pound strengthened. This action has swiftly reversed with the global equity markets off, bond yields plummeting, and the pound dramatically weaker. Not surprisingly, gold has rallied. The vote has clearly caught markets on the wrong foot.

This immediate reaction has been swift but is likely to reverberate across time zones in the coming days. Perhaps the three most immediate questions will be: What will a new government in the UK look like? Will the EU offer to renegotiate more favorable membership terms in light of the "Leave" victory? How soon will the UK invoke Article 50 to begin the withdrawal process? These questions will bring a high degree of uncertainty and may continue to pressure asset values globally, but more directly across Europe and the UK.

The longer-term implications of the "Leave" vote are more difficult to handicap. For the immediate future, the UK will continue to exist under EU law throughout the withdrawal process. However, businesses will quickly begin assessing the new landscape of how they will operate outside of EU oversight post-withdrawal. This uncertainty will be just another headwind constraining activity across Europe in a period where organic growth has already been difficult to find. The developed economies of the U.S., Japan, and Europe have been unable to come up with a catalyst to shock growth meaningfully higher. The "Leave" vote will make finding this catalyst even more difficult.

Perhaps more damaging will be the longer-term effects on the European Union. Given that euro-skepticism has been on the rise, the precedent set by the Brexit vote may compel other EU members to contemplate withdrawal. Unless EU leaders can better unify their members in both philosophy and policy, the union could face a more existential threat in the years to come. In this regard, the EU is likely to be an onerous counterparty in the UK withdrawal negotiations, if only as a deterrent to other nations. This again will bring more unknowns, more uncertainty, and more volatility across assets.

In the coming days, investors will be buffeted by conflicting data, new risks, and wild price swings. The macroeconomy, already laboring under sub-par growth, may stumble again. But asset price volatility is often an overreaction to the underlying economic fundamentals which evolve more slowly. Activity across the UK and Europe will not come to a standstill. Companies will continue to produce and employ – despite the clouded outlook. Central banks will likely supply additional liquidity to act as a firewall against further contagion. And policy makers will quickly seek to address areas of acute vulnerability. The next few days will certainly test investors' tolerance for risk.

It is also a time to review portfolios and reassess the opportunities a Brexit vote may uncover. For starters, extreme price moves bring with them the chance to rebalance and reset portfolio allocations. Stock valuations, which have been elevated recently, will look more reasonable. Plunging bond yields will result in previously unthinkable (and perhaps temporary) gains in fixed income allocations. While rebalancing can't prevent losses, it helps to mitigate a potentially larger problem – the risk that the portfolio wanders too far from its long-term risk/return objectives. The market calamity following Brexit may also provide a good opportunity for investors to assess their true risk tolerance. "Can I live with this level of volatility? Do I have the stomach for this?" This type of financial self-assessment can only be done during periods of actual losses. It cannot be simulated in a lab or understood from the textbooks. For those investors unfazed by these market gyrations, what ideas have emerged? Which assets now look cheap and can be purchased "on sale"? Which assets have become more overpriced and can be shunned or trimmed? It is almost a cliché to say that "volatility presents opportunity", but market dislocation can bring new ideas into sharper focus.

The long-term political, economic, and financial repercussions of the "Leave" vote are incalculable at this point. But markets adapt. Policymakers adjust. Businesses will change course while they continue to seek profits. Prices will reset. Opportunities will emerge. Market volatility brought on by the UK's historic Brexit vote is no excuse to disengage from portfolio planning. Investors who are willing to look forward, with one eye on the opportunities and one eye on their goals, will be more likely to realize both.

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Exp. 9/30/2016
CC283G-0616