The AUTUS Review

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The Economy

History was written on June 23rd when the British populace voted to exit the European Union. During his 2013 election campaign, UK Prime Minister David Cameron promised that, should his Conservative Party win a parliamentary majority at the 2015 general election, the UK Government would negotiate more favorable arrangements for continuing British membership in the EU, followed by a referendum on whether the UK should remain in or leave. Widely viewed as a concession to energize the Eurosceptic wing of the Conservative Party, the referendum was seen as political campaign strategy with little chance of ever passing. Even as the referendum vote drew near and polling numbers began to tighten, most economic and political prognosticators, along with the media, continued to believe that a Brexit from the EU was highly unlikely.

While the votes were still being tallied, the financial fall-out began to reverberate through global capital markets as investors moved to reduce risk and limit exposure to the British sterling. "Safe-haven" government bonds rallied as a flight to quality pushed yields to extraordinary lows. The long-term impact from this historic decision is difficult to predict and will depend in large part on how major central banks decide to reassure markets, along with what steps the UK and the rest of Europe take to address the departure. Short-term, the political uncertainty surrounding the timing of an exit and the damage to both the UK's financial institutions and economy could likely be substantial.

While the UK only accounts for roughly 2% of global GDP, the increased uncertainty and hit to consumer confidence will most certainly add additional pressure to the already struggling European economy. The growing influence of nationalism and rising populism in Europe could encourage other countries to consider leaving the EU as well, which will weigh on global capital markets as we move forward. In the end, most economists believe that the Brexit vote was more of a political event than economic or financial, and is therefore unlikely to push the European Union into recession in the near-term. But as we recently learned, they've been surprised (wrong) before!

Domestically, the US economy continues to plow along. GDP growth in the first half of the year is expected to rise nearly 2.0% on an annualized basis. Employment gains have slowed but the economy is still near full employment and consumer confidence remains relatively high. Brexit has rattled global markets and will likely delay any near-term rate hikes by the Fed, keeping a lid on yields for the time being. Global volatility has triggered a flight to quality which has strengthened the US dollar. If sustained, this will place pressure on US exporters, US multinational corporations and commodity prices. We are also in the middle of our own election season with populist undertones, which will only add to market uncertainty as the vote approaches. At this point, the impact from Brexit on the US economy will probably be minimal, but the situation is fluid and could change quickly as things unfold.

Capital Markets

Global capital markets were roiled by the Brexit vote as investors moved to reposition portfolios. US equity markets experienced declines of more than 5% over a two-day period and European equity markets fared even worse. As the risk-off trade accelerated, money flowed into "safe-haven" government bonds driving yields to new lows.

Much of the value lost from the initial shock was recovered quickly over the following week as investors processed the news. Short-term repercussions should be primarily limited to the UK and to a lesser extent the EU, with specific distresses facing regional banks and financial institutions.

Longer-term, global capital markets will be burdened with uncertainty regarding the execution of the exit, diplomatic relations between the UK and the EU and the threat of populist contagion spreading through the rest of Europe.

Portfolio Implications

Equity

The stronger dollar will have a transitory negative impact on US multinational companies as foreign revenues will be hurt by currency conversion. Developed European stocks may also remain under pressure as details of the separation are worked through. However, we do not feel that this will have a lasting or overly meaningful impact on global GDP growth or domestic corporate earnings moving forward.

Fixed Income

The flight to quality trade has pushed yields significantly lower since the beginning of the year. The uncertainty surrounding Brexit will likely delay any Fed tightening in the near-term, so yields should remain low for the foreseeable future. We believe that short/intermediate term investment grade corporate bonds continue to deliver the best value in this asset class.

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Mark Fiedler, CFA
mark@autusam.com

Don Cuppy

Steve Fields, CFP®

Kipp Goll, CFA