Deron T. McCoy
CFA, CFP®, CAIA, AIF®
Chief Investment Officer

‘Bremain Calm’ or ‘The British are Leaving!’

WHAT HAPPENED

UK citizens in a non-binding national referendum voted to leave the European Union (EU) trading bloc. Reasons likely vary from voter to voter, but two main constituencies seemed to propel the leave vote: rural/industrial working-class voters who feel economically left behind and are spurred on by a nationalistic desire to control immigration and take back power from perceived “appointed EU bureaucrats,” along with older pensioners fueled by a yearning for the old days of a more powerful and sovereign UK.

WHY

The last several days have seen an overwhelming amount of news outlets opine on the subject but many miss the underlying point (at least through the lens of an investment firm). Perhaps best put by Strategas Research Partners:

> *“We read a lot of commentary trying to explain the recent surge in populism and most of the explanations are symptoms of the problem (income inequality, trade, immigration, wages, etc.) rather than the actual problem: lack of economic growth. If the economic pie is growing, issues that bother voters such as trade policy become more tolerable. But since 2007, the problem has been that the pie is growing at such a slower rate than voters are used to (In fact, starting in 2008, world GDP transitioned from a long-run growth rate of 3.4% to 2.1%). Historically, recessions lead to voters removing the party in power, then growth resumes and the political environment goes back to normal. But since the financial crisis, economic growth has not returned to normal and this situation has persisted for eight years. It’s no wonder we are seeing unimaginable political events taking place.”*

IS THERE A PRECEDENT?

In a word, no. No developed country has ever left a trading bloc without joining a larger trading bloc. Furthermore, no country has ever left the European Union (the UK has been economically tied to Europe for over 42 years). Anyone predicting what will happen next is basing his or her view on pure speculation rather than hard evidence, as there is simply no historical antecedent to draw upon.

WHAT WE DON’T KNOW

- Will the UK even file Article 50 (the clause in the Treaty of Lisbon that formally announces a member’s departure from the EU)? Post-referendum political backpedaling has already begun.UK political leaders could potentially reverse course after seeing the scorched-earth economic aftermath (remember that Congress initially voted against TARP before the markets caused everyone to rethink their position).
- When will they file? Some estimate November (after a new Prime Minister is named) would be the earliest filing date. That would officially start the clock on a process likely to take the better

part of two years to restructure trade agreements and officially leave the EU. Meanwhile—nothing changes.

- If the UK ultimately leaves the EU, will the London-based financial sector (which voted to Remain) still have access to Europe? Will the expats within London be forced to move back home? To compensate, will UK Brexit leaders allow open borders which would go directly against one of the major facets of their own Brexit campaign?
- If the UK does file, will Scotland (which voted to Remain) leave the UK and rejoin the EU? Might Northern Ireland (also voting to Remain) consider the same by reunifying with Ireland?
- And in the "anything is possible camp," if Scotland leaves, would London join Scotland and thus remain in the EU?
- Will a weaker Pound stimulate the English economy by making exports cheaper, or will it crimp the economy with a massive amount of capital flight?
- If the UK ultimately leaves, could it trigger a domino effect among other EU nations? What about Italy, Spain and the original antagonist of this tragedy—Greece?
- Will the EU substantively change its membership rules? No “club” would idly sit still if most of its members threatened to leave.
- Etc., etc., etc.

WHAT WE DO KNOW: MACRO

The recent events in the United Kingdom and resulting capital market meltdown reminds us of events that happened here stateside a few years back. No—not the great recession of 2008. That was a financial crisis and a resulting liquidity crunch. Rather, the debt-ceiling showdown that occurred during the summer of 2011. Both crises brought outside political ideals (i.e., Tea Party Conservatism and British Nationalism) to center stage to promote a previously unheard of views (a US debt default and Brexit). And in both cases, bond-rating agencies quickly followed with a sovereign debt downgrade. The 2011 landscape—political polarization creating an economic maelstrom with extreme uncertainty, widespread pessimism and lack of investor confidence, all leading to a widespread market selloff and mini panic—rings eerily familiar.

Perhaps the similarities won’t end there. We do know that one month after the 2011 “summer surprise,” markets and policymakers caught up to this self-inflicted wound. Within 3 months, markets had bottomed and within 6 months, markets had recouped all of their losses. This brief history lesson is a great reminder that during times of extreme market duress, it generally is unwise to change investment goals and objectives. In a compressed 3-6-month window of high volatility, accurately timing when to sell and when to buy back in can be extraordinarily difficult.

For most investors, following Warren Buffet’s advice to “be greedy when others are fearful” can be challenging. While there is certainly a high degree of fear in today’s markets, staying invested can be exceedingly difficult—it runs counter to our instincts. If your house catches fire—you don’t sit there and finish dinner before fleeing to safety. Our ancestors survived by running away from danger. Not being eaten by the lion was a worthy goal. But investing is just the opposite. Investors need to run *towards* the fire and towards the lion. Selling may make you feel better in the short term, but it’s rarely the wise investment decision as most money is made when the investment decisions are difficult. Investing in 2009 was difficult. If everything feels good, it's probably 1999 and perhaps not the best time to increase equity exposure.

WHAT WE DO KNOW: MICRO

The UK situation will most likely keep the global economy in its current slow growth phase, resulting in a prolonged period of very low interest rates. In our opinion, this will further support our 'high cash flow' investment thesis as low Treasury bond yields will force investors into other income producing assets. Thus, the investment cycle lengthens for assets such as high dividend equities, real estate, real estate debt, and intermediate-term bonds.

Furthermore, dividends here in the U.S. look attractive as they make up an increasingly larger percentage of the return when valuations become stretched. But after the recent extended period of U.S. dominance, however, we still expect other stock markets around the globe to begin taking equity leadership as they should ultimately benefit from the trifecta of lower valuations, higher dividend yields, and stronger earnings growth.

Furthermore, we must remember history. International Developed Markets historically have led the market as often as the U.S. Since 2000, these stocks have outperformed the S&P 500 half the time with international small caps having particularly outperformed beating the developed international category more than two-thirds (69%) of the time.

Source: Bloomberg, Morningstar, and GSAM.

Developed Markets such as France and Germany may actually benefit from Brexit due to the now lower euro currency and potential global reinvestment away from the UK. Other developed economies such as Japan are awakening after decades of sluggish growth. While the road has been bumpy and the Nikkei is now in bear market territory down 24%, the risk-reward setup now appears extremely attractive. While further downside is always possible, it is rather hard to injure oneself jumping out of a basement window.

CONCLUSION

There is another way to frame recent events which we touched on this spring—it's best to fix your roof when it's sunny. After the deep swoon and bounce back earlier this year, we wrote in May (with the S&P at 2100) that "with the stock market currently hovering near an all-time high, valuations becoming more expensive and volatility still a significant concern, this may be a good time to revisit your longer-term plans and objectives and make any necessary adjustments to your investment portfolio." We recommended to reduce equity exposure and bring allocations back to neutral. We recommended to take profits and rotate to assets that produced a high amount of cash flow. We then urged investors to "consider adding a variety of income-producing assets (4-7% yields look quite attractive for the balance of 2016)." Now at the bottom of a Brexit swoon is not the time for wholesale changes.

But the good news is that we may be approaching another inflection point. Any further weakness in global capital markets will likely 'change the math' and we may soon be looking to overweight stocks once again.

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