Lassus Wherley
Building Better Futures
...a View from the Top

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Brexit and the Financial Markets

Here are our thoughts on Brexit and other factors creating volatility and risk in the financial markets in 2016 and beyond.

We have continued to experience high volatility in the markets, and the vote by the citizens of Britain to exit the European Union has sent many of the financial markets into a pronounced downturn. Then we are dealing with our own issues in the US with a very contentious presidential election. Both of these factors have investors skittish about the direction of markets and have contributed to recent volatility, whereas concerns over China and oil prices have faded into the background.

Let's look back a few months and put the financial markets in a little different perspective. Following strong returns in March, US Large Cap stocks, as measured by the S&P 500, and US Small Cap stocks, as measured by the Russell 2000, posted positive returns in both April and May. The S&P 500 was up 0.39% in April and 1.80% in May, with the Russell 2000 up 1.57% in April and then 2.25% in May. The S&P 500 index was up 3.57% year-to-date through the end of May, with the Russell 2000 up 2.28% over the same period. Stocks overseas also posted positive returns in April with the MSCI EAFE index (developed international stocks) up 2.90% and the MSCI EM Index (emerging market stocks) up 0.54%. However, both had negative returns in May of -0.91% and -3.73%, respectively. Year-to-date through the end of May, the MSCI EAFE index is down slightly by -1.49%, while the MSCI EM index was up 4.86% over the same period. The continued volatility in global equity markets and divergence in returns we have seen between domestic and international equities continue to highlight the importance of remaining well diversified. This is further illustrated by the solid returns posted by fixed income asset classes year-to-date through

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May, with the Barclays Aggregate Bond Index up 3.45% and the Barclays Municipal Bond Index up 2.70%, both providing favorable risk-adjusted returns relative to domestic and international equity asset classes. Diversification within our fixed income portfolio has also proved beneficial, with our emerging markets fixed income fund up 8.08% year-to-date through the end of May.

The backdrop for the US economy remains one of slow growth and mixed economic data. GDP growth wasn't particularly high for the 1st quarter, coming in at 0.8%, however, compares favorably with what was lower GDP growth in the 1st quarter of 2015 and negative GDP growth in the 1st quarter of 2014. GDP growth is expected to bounce back in the 2nd quarter of this year as it has done in recent years, with estimates in the 2.0%-3.0% range. The housing market continues to gain ground, and the overall trend in the jobs market points to continued improvement. Furthermore, we are seeing signs of wage increases and the consumer has been resilient in the face of volatility. However, the manufacturing sector remains somewhat of a drag for the US economy, and a potentially higher US dollar could increase the drag from net exports. We continue to keep our eye on the pulse of the economy, and our expectation is for a continued slow growth environment. Headline risk continues to drive volatility, the most prominent of which being "Brexit."

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What is Brexit?

"Brexit" refers to Britain's vote to exit from the European Union. "Brexit" has been a focus of financial markets, driving volatility and uncertainty leading up to the vote held on June 23 on whether to leave the European Union or remain a member. As poll results prior to the vote fluctuated towards indicating that the campaign to leave the bloc was leading, markets would retreat. Polls showing momentum for the campaign to remain a member would conversely contribute to stock market rallies. With the *remain campaign* showing momentum the day before the vote, we saw equity markets rally with the S&P 500 up 1.34% on June 22, as the stock market priced in a victory for the *remain camp*.

Global equity markets received a jolt as the results of the June 23 vote were tallied and came out in favor of Britain, leaving the EU by a vote of 51.9% to 48.1%. Global equity markets retreated and the pound dropped to its lowest level since 1985. British Prime Minister David Cameron, a firm proponent of remaining a member of the EU, resigned in the wake of the vote saying that Britain needed "fresh

leadership." The bottom line is that the decision to leave translates to a long drawn-out process, with subsequent negotiations likely to be lengthy and tenuous. The vote itself is not legally binding, and it will take time for Britain to actually move forward with de-coupling from the EU. This decision has the potential to meaningfully disrupt trade and investment in Europe and lead to an extended period of uncertainty. Other EU member countries that have considered leaving will be keeping a close eye on how Britain fares with their decision to leave.

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Financial markets don't like uncertainty, which is what this decision creates. There could be an impact on the US economy from the Brexit vote in terms of trade relations going forward, potential effects on US multi-national corporations, as well as the potential to push the dollar up substantially relative to other currencies. US assets remain a safe-haven for investors during times of distress, which has the effect of pushing the US dollar up and making it more expensive for other economies to buy our exports. Illustrating this is the near 10% drop in the yield on the 10-yr. US Treasury Bond in the wake of the vote, as investors flocked to treasuries as a safe haven.

It is important to note, however, that US exports to the UK amount to only about 3%-4% of total US exports, and trade relations will likely continue on with the broader EU as in the past. Global central banks are likely to continue to be accommodative in the wake of the Brexit vote, and this result makes it less likely that the Fed will raise interest rates again any time soon. The timing for future rate hikes by the Fed has been another source of uncertainty and volatility for US markets.

If you're wondering why Britain would vote to the exit the EU with the economic and financial consequences seemingly falling on the negative side, you are not alone. The topics of immigration, Britain's overall identity, and whether Britain is ultimately better off operating with autonomy were primary considerations at hand for those that voted to leave the EU. The bottom line is that the extent of the impact on Europe and the result of what will be drawn out negotiations is still uncertain, and will likely continue to drive volatility in both equity markets and bond markets.

As we work through the impact and potential consequences of "Brexit" it is important to remember that we are long-term investors, and are not well served by making knee-jerk reactions to events such as this one. It is also important to keep in mind that we structure

portfolios to be well diversified globally, and to include a significant percentage of fixed income and defensive exposures which serve as a ballast during turbulent equity markets. As always, we continue to review cash balances as well as overall exposures in client portfolios, and rebalance where there are opportunities to do so based on recent volatility. We also continue to monitor the funds that we are utilizing and stay in close contact with the portfolio managers and analysts that run the funds, to ensure that the funds we are utilizing continue to be the best long-term options for client portfolios.

Keep in touch and remember that you are a long-term investor regardless of what happens in the financial markets in the short term.

Enjoy the summer and this great sunshine!

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