June 24, 2016

BREXIT

- The UK vote to leave the European Union (EU) sets in motion a long period of political, economic and market uncertainty for the UK and EU.
- We see sell-offs in global risk assets, with the majority of that sell off due to protecting against uncertainty rather than actual change over the coming two years.
- BMM is planning on no Brexit specific trades, but it does contribute to acting on recent considerations.

We really should have been holding a lot more European assets in all of our clients' accounts. After all, the European Union accounts for about seventeen percent of total global Gross Domestic Product. Traditional investing theory argues that, depending upon your particular goals, you really should have had ten or twenty percent of your BMM investment portfolio in European assets. But you didn't. In 2014 we sold out of that exposure. I actually remember the day, sitting in the second row of a conference hall listening to a lecture given by former Federal Reserve governor Ben Bernanke, that we decided we wanted out. Over the long-term, diversification makes portfolios safer, and it's our job to make sure your portfolio is safe. But we felt that this traditional tool to keep your portfolio safe just wasn't for you. Not in the intermediate-term, at least.

And now, after the Brexit vote, ***we don't except to go back into European equity anytime soon***. In fact, if anything, we are concerned about stocks of all nations being put under pressure.

But before we get into all of that, let's quickly explain what the Brexit is. I know, I know. It's been in the news for months. So we won't bore you with the details of it – just a metaphor a 10,000 foot view (somewhat closer than the proverbial 30,000 foot view).

First, the metaphor. Then we'll get all textbook-y, and just rely on some good ole fashion copy-and-paste for that.

"Brexit" is short for "British Exit". Economically, it's just a bad idea. It's such a bad idea that nobody really thought it would happen. And, actually, it hasn't happened. The vote is non-binding. But without getting into such detail as invoking Article 50 of the Lisbon Treaty to enact said referendum, let's just presume it's gonna happen because at least one party wants it to happen. And if it doesn't happen it will just further stress the relationship and on even worse terms. And cue the metaphor.

The Brexit is a divorce of the UK and the European Union. One party said, "I want out". The other party said, "I don't think it's a good idea, but ok". Once you get to this point, it's not an invitation to renegotiate the relationship and try to get back together. The couples counseling didn't work, and you've moved into the spare bedroom. Now you spend the next two years negotiating the settlement. And while it's an uncomfortable couple of years, you can't change the legal agreements you've made. And that's the Brexit. Right now, someone said they want out, nothing has happened, it's really awkward, but you've still got two years of working together to agree upon the divorce agreement.

Just like with a divorce, there's a lot of uncertainty. Really, ***nothing has changed and all current agreements remain in place***. So for the next couple of years, I guess there is a good amount of clarity. But after that, nobody knows. ***Britain has to be economically punished by the European Union enough to warn other member nations that it's not a good idea to break off. However, Britain's punishment can't be so bad that it comes back to harm the European Union. So, don't expect Draconian measures.***

So that textbook- copy-and-paste I promised, from Investopedia:

> "Supporters of Brexit had based their opinion on a variety of factors from the global competitiveness of British businesses to concerns about immigration. Britain has already opted out of the EU's monetary union (meaning that it uses the pound instead of the euro) and the Schengen Area (meaning that it does not share open borders with a number of other European states). "Out" campaigners argue that Brussels' bureaucracy is a drag on the British economy and that EU laws and regulations are a threat to British sovereignty.
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> Popular support for Brexit had varied over time, but the June 23rd vote demonstrated that UK citizens believed that Great Britain can survive without the economic cooperation, trade agreements and partnerships that benefitted the country for the past several years. Brexit is tied in with Scotland's membership in the United Kingdom. Scotland had voted to remain in the European Union, and after the narrowly contested vote, First Minister Nicola Sturgeon said in a statement on the Scottish National Party's website that she would explore all options to remain in the EU."

What's that mean? Well, my cynical view of it is that voters, dismayed by stagnating real income, were upset with the status quo felt that they needed to send a message to the establishment by voting for radical change. Unfortunately, the cure is likely to be worse than the sickness.

We expect the UK divorce to be messy, drawn out and costly. It involves unpacking UK and EU laws, and striking trade deals with a spurned EU and the rest of the world. *We expect potential losses in services exports and investment flows to overwhelm any benefits of lower payments to EU*. ***We see a weaker euro over time and pressure on European equity shares, and pressure on government debt rates due to likely European job losses and lower growth.*** We expect limited pressure on government budgets, however, as high-quality government bonds are in demand in a low-rate world.

BOTTOM LINE

Perception is reality. And although there are two years of negotiating ahead of the UK and the EU, the perception is that the outcome will be bad. Likely over the course of a couple months this conversation will be wiped from US investors' minds and revisited in about a year-and-a-half. ***But over the course of the next couple months, stock prices (US stocks, global stocks) offer more risk than reward. Since the US stock market was, at best, fairly valued before the Brexit vote, we wouldn't rule out another correction, maybe of the magnitude of the one ending earlier this year in February that gave way to recent highs in the stock market.***

Because those corrections happen, happen quickly, can't be timed, and then are forgotten months (if not weeks later), we don't expect to make any Brexit-specific trades (except perhaps selling any European equity that is transferred over to BMM managed accounts). ***But this does contribute to internal conversations we've been having at the BMM conference table. For example, the pace of the Fed's interest rate rise has been slow so we've considered further shifting from non-dividend paying stocks to dividend paying stocks. Because the Fed is now going to be even slower in its rate rise cycle, we can now make an even stronger argument for that move.***

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The Knowledge and Experience to Build Your Wealth

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For our affiliates' everyday business purposes— information about your transactions and experiences	NO	WE DO NOT SHARE
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Questions?	Call 888-232-6072 or go to www.berkshiremm.com

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