Brexit Aftershock

Portfolio and Outlook

Earlier this year in anticipation of heightened risks and well in advance of the United Kingdom referendum, we had, for most clients, reduced allocation to risk assets, maintained only a small exposure to international equities and negligible exposure to foreign currencies, modestly extended duration in municipal bond portfolios in response to a lower for longer interest-rate environment, and held some cash as a hedge against risk.

In the aftermath of the British referendum, increased uncertainty bodes for maintaining this defensive posture as the current risk/reward balance appears to be asymmetrical; that is, the upside is limited by slow economic conditions and the risks are magnified by economic and political uncertainties in the US and abroad.

Brexit

After 52% of the population of the UK cast votes in favor of leaving the European Union, politicians, economists, and pundits all sought to define the causes and consequences of the UK's eventual divorce from the EU. The divorce analogy was put forth by Jean Claude Juncker, European Commission President who observed that the UK membership (never adopting the Euro and having markedly different sensibilities and political values from many if not all of the other members) was more of an affair that has run its course than a secure marriage.

In the days that have since followed, many observations and explanations of this historic event have been proffered:

- Those that benefited from globalization and the "one market EU" voted their own economic interests for REMAIN, and those that did not derive such economic benefits voted LEAVE hoping for improvement in their personal economic situation. The vote broke down along generational and educational lines with the economic disparity fueling polarization within the UK.
- The immigration issue also intensified both social and economic fears in the LEAVE camp. Loss of jobs to immigrants residing in the UK and corresponding pressure on wages became a central theme.
- Control of the UK borders became a heightened concern in the wake of the refugee crisis in the Middle East and was also a central issue in the LEAVE campaign.
- Politicians in favor of LEAVE voiced their concerns over EU decision-making on virtually all matters including trade policy, monetary policy and regulatory matters that were governed by an unmanageable bureaucracy.
- In the United States, commentators drew parallels regarding domestic polarization among those benefiting from globalization and those who have been damaged by it.

- Editorials and columns have been written that caution that political discourse by both the far left and far right on social issues, immigration, and globalization presented dangerous risks both domestically and abroad.
- Finally, talk of further referenda on EU participation continues in other member states including France and the Netherlands, although we anticipate that it is infinitely more difficult for a Eurozone member to undo its political and economic relationship with the EU.

The timing of the UK unwind will likely be protracted as Article 50 of the EU Treaty of Lisbon may only be triggered by the withdrawing member state, and the current UK prime minister has indicated that he will resign and turn over Article 50 notice and negotiation to the new government. To complicate matters, Scotland, whose majority vote was to remain in the EU, may seek anew to separate from the UK and remain in the EU. Meanwhile, populist petitions to reverse Brexit are being circulated in the UK.

The uncertainties resulting from the LEAVE vote will be reverberating through international capital markets and EU member states' politics and culture, and will impact views on immigration and international trade for the foreseeable future. We will, however, focus herein on how Brexit impacts our economic and investment outlook and leave the analysis of the social and political issues to others.

Market Reaction

The LEAVE vote resulted in much market volatility and recalibration, focusing on:

- concern over recession or further slowing in both the UK and EU,
- further contagion among member states,
- whether exit negotiations will expose heretofore unrecognized issues and economic risks.

While the capital markets have not immediately evidenced concerns akin to imminent systemic failure surfacing during the financial crisis, worldwide equity markets declined heavily. It has been reported that approximately $3 trillion of value had been lost in the first two trading days following the vote (before today's gains).

European bank shares fell dramatically in the wake of these uncertainties. Shares in the domestic banks felt the pressure but did not sustain as severe losses. Given the European uncertainties and the Federal Reserve Chair's outlook for a low neutral interest rate for the indefinite future, domestic and international markets are anticipating lower interest rates for longer (i.e., a "new low normal neutral" rate corresponding to a protracted low growth GDP environment).

Overall, European equity markets have declined between 4% and 12% (approximately) after recovering some ground today. For unhedged US investors, currency losses compounded the losses resulting from share price decline in local currency terms.

Sterling and the Euro both traded down against the Dollar, as did the Chinese Yuan. The Japanese Yen strengthened against Sterling, the Euro, and the Dollar prompting talk of currency intervention by the Japanese central bank (resulting in a firming of the Japanese equity market). Sterling and the Euro were down post referendum 11.2% and 3.4%, respectively, against the Dollar.

Equity markets in Japan have declined by 2.7%. China's Shanghai Composite Index initially fell 1.7% before recovering to close up 1.9%. US equities declined approximately 4%. These declines are after adjustment for equity gains earlier today.

For the second quarter of 2016 through Monday June 27th, the Dow Jones Industrial Average declined -2.44% (-.29% ytd); the S&P 500 and Russell 1000 Indices declined -2.38% (-1.06% ytd) and -2.37% (-1.22% ytd), respectively. The MSCI EM Index declined -4.26% (-1.21% ytd). The Russell 2000 Small Cap Index declined -1.89% (-3.39% ytd) while the S&P 400 Mid Cap Index declined -1.62% (+2.11% ytd). The MSCI EAFE Index declined -6.88% (-9.68% ytd). The MSCI All Country World Index declined -4.02% (-3.79% ytd), and the MSCI European Equity Index declined -10.03% (-12.28% ytd). Today, equity markets regained approximately 2% - 3% of their value in Europe and approximately 1.5% - 2% in the US.

Perspective

Going forward, a stronger Dollar would adversely impact both US exports and future earnings of US multinational corporations. In the United States, the stronger Dollar would also likely be deflationary for both commodity prices and imports. Thus far, the price of oil declined as the Dollar strengthened.

While Brexit and its alternative aftermaths are undoubtedly historic and impactful events, rife with emotion within the UK and EU, it wasn't too long before cooler heads surfaced. German government officials are calling for swift negotiations with a goal of making the UK an associate partner of special importance rather than pursuing an acrimonious and protracted divorce negotiation strategy. We are also mindful that economies and markets crave stability and that even staunch political adversaries may reverse course and work toward a compromise that does not result in the UK leaving the EU. Time will tell.

June 28, 2016

The above commentary represents the economic and market views of our firm. We remind you, however, that each client's portfolio is managed individually. Please speak with your KLS advisor with respect to your personal circumstances and individual portfolio performance.