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The Impact of Brexit on Global Markets

In a historic referendum last night, Great Britain has voted to leave the European Union, but what does “Brexit” mean for the broad capital markets? We will present our global outlook in detail in our upcoming second quarter letter, but we wanted to share some broad thoughts on global economies and asset classes now that the vote is behind us.

First and foremost, we believe there is a low probability of contagion. Central banks all maintained dovish stances ahead of the vote, and the emergency liquidity facilities from the global financial crisis and European sovereign crisis are still available to European banks. Evidenced by market movements on Friday, the British Pound, the Euro, European equities and UK equities are the most vulnerable to the UK leaving the EU, but volatility in global equity and currency markets will remain elevated. We foresee global growth declining modestly, but a global recession will likely be avoided.

In the US, apart from adverse currency translation and reduced EU sales, the short term direct impact on US corporations is limited, but we can expect a Brexit hangover to reduce the risk seeking appetites of investors. In a couple of weeks, the US corporate earnings calendar begins and Q2 data will start to be released, and investors will need to turn their attention back to fundamentals at the micro and macro level. In our opinion, the path of the US markets will be data dependent.

The next steps for Brexit will take some time, and political risks will increase uncertainty which will dampen UK and European growth prospects. Great Britain will invoke Article 50 of the EU Treaty, which gives the legal framework for withdrawal. However, with Prime Minister Cameron stepping down, the process of leaving the EU will be delayed until a new Prime Minister is chosen in the fall. Article 50 provides for a two-year negotiation period once it has been activated. Great Britain needs to renegotiate trade deals with the EU states, as well as with their other major trading partners globally, a process that may exceed the two-year window. The EU leadership will make this particularly difficult to dissuade other EU countries from leaving. Wolfgang Schauble, the German Finance Minister, has already indicated that arrangements with other non- EU countries, Iceland, Norway and Switzerland, will not be adopted in the British case. These arrangements allow free movement of goods and labor across borders and a level of trade with the EU comparable with that of a EU member. Additionally, Scotland may vote to leave the UK and join the EU soon. This is particularly troubling since, as a result of Prime Minister Cameron's announced departure, the future composition and leadership of the UK government is uncertain. The uncertainty around this process will keep our asset allocation positioning more conservative.

Our Views:

The Fed

Prior to "Brexit-mania", the Federal Reserve had embarked on a tightening path and absent a poor May employment report, data warranted additional interest rate hikes in 2016. Chairwoman Yellen turned dovish in the face of global volatility and uncertainty, and now with Brexit concerns front and center, the FOMC members need to balance fundamentals with a changing European landscape. This will likely delay our previous forecast of one or two rate increases in the next six months into 2017, although if the US dollar continues to overshoot on the upside, the currency impact of further rate hikes is minimal.

The US Dollar

The flight to safe haven assets will put upward pressure on the US Dollar and with the ECB and BOE increasing their liquidity, interest rate differentials between Treasuries and Gilts/Bunds make the US Dollar more attractive. The previous catalyst for forecasted US Dollar strength, the Fed tightening cycle, will be delayed and overshadowed by risk aversion. An appreciating US Dollar will negatively impact commodity prices, emerging market equities and multinational corporations; however, we do not foresee a strengthening similar in magnitude to 2015.

Global Security Markets

Ahead of the vote, US equity markets were trading at the higher end of the recent trading range leaving them vulnerable to shocks in the market. We believe volatility will decrease in the coming weeks, and US equities will return to the trading range of the last 18 months. Earnings will drive equity prices in the second half of 2016, and growth forecasts should improve due to a stable US Dollar and oil prices that are relatively unchanged year over year.

European equity markets should trend lower for the time being, but will regain their footing well before the UK and EU agree on an exit plan. The uncertainty should extend the softened aggregate demand and modest top line growth and delay domestic capital expenditure. Previous ECB easing measures appear to have positively impacted loan growth and eased deflation concerns for now. Europe is undergoing quantitative easing ("QE") which first occurred in the US five to six years ago. The final impediment to ECB direct bond buying has been removed by the German high court and comprehensive QE has been given the go ahead. In aggregate, ECB actions and future easing measures should increase consumer demand, providing a safety net to the European economy. We look for future data releases to confirm the recovery that appears to have been underway in the first quarter, though its intensity will likely be diminished.

Eurosceptic elements and pro-Leave political movements will be emboldened by the Brexit vote. While major Eurozone departures do not appear imminent, Europe's practical steps to signal "more Europe," such as fiscal union, will be constrained. Investments that benefit from a perception of greater Eurozone integration, such as weak country government bonds and banks backed by weaker sovereigns, are likely to come under additional pressure. For this reason, we are cutting back on our low quality global bond exposure.

Emerging markets continue to face headwinds. Despite expectations of growth well in excess of developed markets and already depressed currencies, stability of Chinese growth remains unproven and the outlook for commodities is not robust. The Chinese Yuan ("CNY") has quietly weakened amongst the Brexit noise, and a weaker CNY will keep downward pressure on EM currencies, particularly those of Asian countries.

Conclusion

While Brexit media coverage will wane, the 2016 US Election, post oil-crisis earnings, Chinese growth, and Federal Reserve policy will cloud the outlook for investors. Along with an estimated 1-2% decline in UK GDP growth and a 0.50% decline in European GDP growth, we expect global growth to decline by approximately 0.25% with a global recession unlikely. Returns on most asset classes will be modest, and we will maintain our traditionally conservative asset allocation with a focus on avoiding downside risks.

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In Summary:

- Global equities will continue to remain range bound with volatility remaining elevated.
- There will be downward pressure on yields in safe haven countries.
- The US Dollar will strengthen modestly and the Japanese Yen will remain strong.
- Oil and commodities will be challenged due to a below trend U.S. and global expansion.

If you have any questions or concerns, please do not hesitate to contact us.

Sincerely,

James L. McCabe Erich M. Hickey

<u>Important Information</u>

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