



Bradley, Foster & Sargent, Inc.

Quarterly Market Commentary

July 2016

Brexit: Uncharted Territory

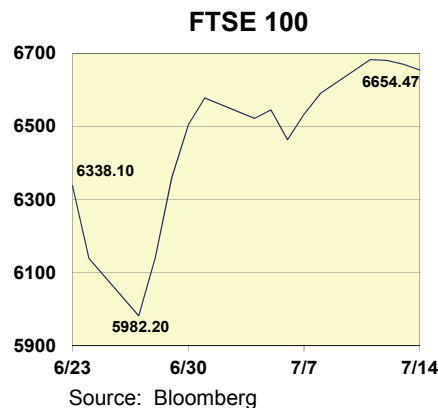
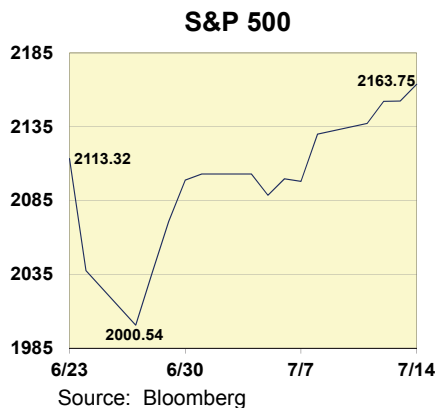
The Chinese use two brush strokes to write the word “crisis.” One brush stroke stands for danger; the other for opportunity. In a crisis, be aware of the danger – but recognize the opportunity.

John F. Kennedy, 1959

On June 23, 2016, the United Kingdom (U.K.) voted to leave the European Union (EU). The vote was 52% to leave; 48% to remain. The results of the referendum were a shock to many, as most polls had predicted a narrow victory for those wishing to remain part of the EU. Scotland and London voted overwhelmingly to remain; every “English” region had a majority for leave. Many barrels of printers’ ink have been spilled on this momentous event, not to mention the cascade of Internet offerings. *The Weekly Speculator*, issued by Marketfield Asset Management, was quoted in *Barron’s* July 1st issue, “According to Bloomberg’s News Search function no fewer than 7,819 stories contained the topic ‘Brexit’ on Friday.” With so much intellectual firepower from politicians, economists, academicians, and market pundits concentrated on this issue, we are not sure that we, at Bradley, Foster & Sargent, can come up with a new angle on Brexit or even a clear prognosis of what Brexit means for the U.K., the EU, the global economy, or U.S. investors. However, the intent of this commentary is to discuss the immediate reaction in the global markets to Brexit, what caused the majority of U.K. citizens to vote to exit the EU, what happens next, and finally, how investors might position their portfolios to minimize risks from Brexit and find opportunities in the global markets.

Market Reaction to Brexit

In the two days following the vote on Brexit, world stock markets slumped, wiping \$3 trillion from market valuations. Some stock markets in southern European countries dropped more than 10%. The stock markets in the U.S. and U.K. fared better, dropping 5.3% and 5.6% respectively in the two days following the vote. But within a week of the vote, the markets rebounded strongly. The charts below tell the story:



The behavior of investors in the U.S. and U.K. demonstrated the remarkable uncertainty of how Brexit will play out – first a knee jerk panic and then the slow realization that the economic and investment implications of this momentous political event are not at all clear.

The Reasons for the U.K. Referendum on Exiting the EU

The U.K. has historically had a deep-seated ambivalence about its relationship with Europe. This dates back to the Spanish Armada in 1588 or perhaps even earlier. More recently, the U.K., which was not a signatory to the Treaty of Rome that created the European Economic Community (EEC), the predecessor to the EU, had seen two attempts to join the EEC rebuffed by Charles de Gaulle, before it was finally accepted in 1973. Both the Labor Party in the 1980s and some members of the Conservative Party in the 1990s took steps to pull the U.K. out of the EEC and later the EU, which was created by the Maastricht Treaty of 1993, but both attempts failed.

In 2012, the U.K. Prime Minister, David Cameron, rejected calls for a referendum, but announced a year later that if his Conservative government was re-elected in 2015, a referendum would be held. Re-elected with a substantial majority in 2015, Prime Minister Cameron duly announced that there would indeed be a referendum on exiting the EU in June, 2016. And for Cameron, who was firmly in the Remain camp, it was a profound mistake, leading to his resignation as Prime Minister. German Chancellor Angela Merkel, arguably the leading politician in Europe, was an outspoken critic of Cameron's decision to hold the Brexit referendum, suggesting that the referendum was called primarily to settle internal turmoil in the Conservative Party. She was quoted as saying, "The principle should always be: Country, party, person. Cameron did it the other way around. And when you do that, things go wrong."

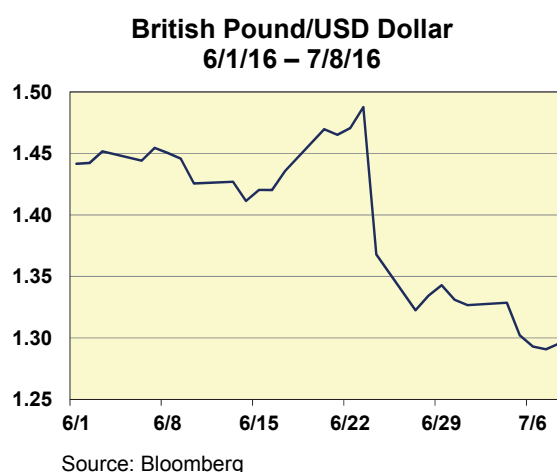
Brexit was a political event. It had little to do with economics. Britain's economy has rebounded nicely since the global financial shock of 2007-2009, with its GDP at a higher level at the end of 2015 than before the global financial meltdown began in 2007. Brexit was primarily about immigration. The best shorthand way to describe the key foundations of the EU is the Four Freedoms:

- Free movement of goods without tariffs
- Free provision of services across borders without restrictions
- Free movement of capital without controls
- Freedom of movement for workers without needing work permits

Brexit was, first and foremost, about the migration of workers into the U.K. and the fact that the rules and regulations about immigration into the U.K. were not made in the U.K. but rather in Brussels. For those who voted to Leave, there was a pervasive feeling of loss of sovereignty – that U.K. citizens could no longer control the culture and character of Britain. This was evidenced by the way different age groups voted in the referendum. It was the older residents – especially the working and middle classes who saw the U.K. changing in ways that they did not like and felt powerless to stop – who provided the majority of votes for Leave. Those under 35 were strongly in the Remain camp.

What Happens Next in the U.K.?

Shortly after the vote, four things happened in quick succession in the U.K. The first was David Cameron's announcement that he would resign as the leader of the Conservative Party and therefore as Prime Minister of the U.K. and his setting of the vote for the new leader of the Conservative Party for September 9, 2016. The next general election in the U.K. does not have to take place until 2020 unless the government were to fail a no confidence vote, which is unlikely given the strong Conservative majority. Second, Boris Johnson, the former Mayor of London and leading proponent of the Leave faction, declared that he would not seek to lead the Conservative Party following Secretary of State for Justice Michael Gove's withdrawal of support of Johnson as leader of the Conservative Party. Third was Standard & Poor's downgrade of the U.K. sovereign debt by two notches, from AAA to AA. The last shoe to drop was the precipitous collapse in the value of the pound sterling, reaching a level against the U.S. dollar not seen since 1984, as shown below:



During the first several rounds of voting within the Conservative Party, one main contender for the leadership of the party emerged – Home Secretary Theresa May. The other leading contender, Energy Minister Andrea Leadsom, subsequently dropped out of the race, throwing her support behind May. Thus, on July 12, 2016, Theresa May became Britain's new Prime Minister after her meeting with Queen Elizabeth II, who asked her to form a new government. Prime Minister May was a moderate in the Remain camp, but she has stated that there will not be a second U.K. referendum. Her boldest Cabinet appointment was Boris Johnson as Foreign Secretary. It is expected that the new Prime Minister will wait until September to invoke Article 50 of the Treaty of Lisbon – the article which governs the withdrawal of a member state from the EU. Article 50 provides for a two-year withdrawal period during which time negotiations would take place to deal with the terms and conditions of withdrawal. Although the Scottish Nationalists are demanding another referendum or they will seek to take Scotland out of the U.K., a second referendum is highly unlikely, as is Scotland's withdrawal from the U.K.

Negotiating Positions of the EU and the U.K.

Before discussing the likely negotiating stances of the U.K. and the EU, a brief primer on the various steps to the U.K. withdrawal may be helpful:

- The U.K. invokes Article 50 of the Treaty of Lisbon by October, 2016
- The U.K. and EU have two years to work out exit terms
- Once the terms of withdrawal are settled, the consent of the EU bloc is needed. If no consent is given, the U.K. automatically exits two years after Article 50 is triggered, i.e., October, 2018
- During these two years, the U.K. and EU need to forge new agreements on issues such as trade, migration, and security which will come into effect after the U.K. exits
- U.K. parliamentary sources estimate that over 150 new laws may be necessitated

In its negotiations with the EU, Britain will seek to maintain extensive ties with Europe while limiting the free movement of people and easing the EU's bureaucratic and legislative requirements. Britain will seek to maintain its position as the financial center of Europe, which it has held for centuries, and it will want to maintain its current EU "passporting" rights (cross-border financial products and services originating in Britain and sold in the EU without the need to establish branches or subsidiaries in each EU country). The EU leadership will have an almost diametrically opposed incentive, which is *not* to give Britain better terms than it enjoyed as a full member of the EU. If terms are too easy for Britain, it could well embolden other EU countries to exit as well, thereby causing a slow disintegration of the EU. As Henry Kissinger wrote recently in an op-ed in *The Wall Street Journal*, "a punitive element is likely to be inherent in the EU bargaining position."

Shortly after the Brexit vote, President François Hollande of France warned that transactions in euros would no longer be able to be cleared in the City of London, as is currently done. This is an important source of business for London. This shot across the bow by the French has caused much speculation about London's possible loss of its position as the financial center of Europe and the subsequent migration of financial professionals and jobs to Frankfurt, Paris, or even Dublin. Upon reflection, it seems improbable that any of these cities could replicate the remarkable infrastructure and professionalism of the City of London, all carried out in English – the world's business language.

German Chancellor Merkel's remarks were less confrontational than President Hollande's. She indicated that the remaining EU states' interests would take priority in the negotiations with the U.K. and then said that the leaders of the EU "need to ask ourselves what our interests are." The U.K. is Germany's third largest export market (after the U.S. and France). An example of the importance of the U.K. market for Germany is that more than 800,000 German automobiles are exported to the U.K. each year. Germany's role in the forthcoming negotiations should provide needed balance to some EU leaders who might seek harsher treatment of the U.K. The President of the European Commission, Jean-Claude Juncker, commented that a former member state would not automatically have the same access to the single EU market that it had as a member state, but that "this is a matter for further negotiation."

In reflecting on how negotiations will play out over the next several years, it is clear that the U.K. has a strong hand. The U.K. has the fifth largest GDP in the world. Its economy is growing modestly but is in better shape than most countries in the EU. Unemployment in the U.K. (4.9%) is lower than in all the other major EU countries with the exception of Germany. Its position as one of the major financial centers of the world is unlikely to be altered. In other words, the U.K. is in much stronger condition than the EU, which has its hands full with problems in Southern Europe and Greece and a sclerotic economy. Thus,

the odds appear good that the EU will agree to a fair and balanced agreement with the U.K., which will keep the EU's borders open for U.K. goods and services, yet allow some restrictions on the movement of people into the U.K. The danger, however, is that a good deal for the U.K. will cause the unraveling of the EU, as other Eurosceptic countries (Denmark, France, and the Netherlands among others) seek a similar deal. France, for example, has a presidential election next April and May. Fear of the disintegration of the EU could lead EU negotiators to seek to punish the U.K. rather than reforming the EU. This could result either in no agreement or one which causes economic damage to both the EU and U.K.

Economic Impact of Brexit

Corporate executives (like investors) hate uncertainty. They can deal with bad news, but uncertainty throws them. Brexit means several years of uncertainty. So it is likely that some corporate initiatives and investments in the U.K. and EU will be postponed. Also, the uncertainty surrounding the free movement of people will affect job creation in some cities. But to try to translate these general statements into firm economic forecasts is really problematic. That being said, here are some estimates of the likely economic fallout from Brexit:

Currencies

- Weak pound sterling (£/\$ at 1.29 is already at the lowest level since 1984)
- Stronger U.S. dollar against many currencies including the euro
- Modest weakening of the Chinese yuan
- Some competitive currency devaluation globally to enhance exports

Interest Rates

- Brexit will likely cause the Federal Reserve to delay raising interest rates
- More quantitative easing by the European Central Bank will probably lead to even lower interest rates in the EU
- Negative interest rates for sovereign debt for many EU countries

Economic Growth

- Modestly slower U.S. GDP growth due to stronger U.S. dollar
- GDP growth in U.K. drops below 2%
- GDP growth in EU drops below 1%
- Possible recession in EU in 2017/2018 as investment is curtailed

What are the Implications of Brexit for Investors?

At Bradley, Foster & Sargent, we are generally bottoms-up stock pickers. We pay great attention to geopolitical events and macroeconomic trends, but we do so primarily insofar as they influence companies and industries. Moreover, we do not reflexively allocate a certain percentage of assets to international equities nor to emerging markets. Our international exposure in equities results largely from owning

leading U.S. companies which have a significant portion of their revenues and operating earnings emanating from abroad. Examples would be companies such as Apple, Microsoft, Google (Alphabet), and Johnson & Johnson. We also selectively invest in great international companies such as Schlumberger and Nestlé. Accordingly, an event such as Brexit would not normally cause us to make significant portfolio changes for a number of reasons. First and foremost, it is not at all clear how Brexit will play out, and second, the process will unfold slowly over the next two years. So there seems to be time to make appropriate adjustments to portfolios, as necessary. This approach mirrors the judgment of U.S. and British investors as the shock of the vote initially sent shares in the U.S. and U.K. down 5%+, followed by an immediate rebound bringing shares back to a level well above where they were before the vote.

An atmosphere of uncertainty also pervades the markets in the U.S. which currently has its own issues of populism. The U.S. presidential election is causing much anxiety and worries for investors, and it is unclear what the results of the fall elections will mean for the economy, trade, and taxation. More broadly, the Brexit vote may reflect, in part, an expanding level of dissatisfaction with the status quo in the developed world and the potential for other dramatic changes. This may cause a heightened level of volatility in U.S. and global markets over the remainder of the year and beyond, and in this context, investors may want to shape their investment strategy to deal with an elevated level of risk.

First, we believe that the U.S. continues to be the “best house in a bad neighborhood.” This is due to the U.S.’s deep and liquid capital markets, the rule of law, innovation, and more robust economic growth than that of other developed nations. Investors understand that a relatively small portion of the U.S. economy depends upon trade (about 15%) so it is more insulated from Brexit than are many countries. Accordingly, it is likely that Brexit will not affect the U.S. economy in a major way. For this reason, we believe Brexit will mean a stronger U.S. dollar for the foreseeable future, as overseas funds flow into the U.S. in search of a safe haven and to capture U.S. bond yields, which, although low, are higher than in most developed nations. Thus, at BFS, we believe that it makes good sense at this time for most U.S. investors to invest the great majority of their assets in the U.S. capital markets. Second, some investors may want to maintain higher levels of cash reserves and short-term fixed income instruments and/or choose to own gold stocks or ETFs as a hedge against heightened volatility. Third, many high-quality U.S. stocks have more robust dividend yields than the bond market, and these stocks should attract foreign investment as well. Thus, we believe that owning these strong companies with great brands, good balance sheets, strong cash flow, and proven management will continue to help minimize current geopolitical and market risks and also will lead to wealth creation over the longer term.

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