



“Brexit”

The research team at Capital Advisors is as surprised as anyone that British voters elected to leave the European Union (EU). We do not pretend to know how this remarkable outcome might shape the global financial markets in the near term, but here are the primary issues we are considering:

- A sharp decline global risk markets is to be expected because most traders were positioned for the opposite outcome than the one that occurred. In the very near term, investors should interpret the message from this unwind as a reminder that markets gyrate when investors get surprised by a binary shock, rather than a signal of impending doom for the global economy.
- The major European stock markets advanced 7%-8% over the past week-and-a-half, so today's action has (so far) merely reversed that advance.¹
- In order for this event to trigger a lasting decline of 15% or more in the U.S. stock market it would probably need to trigger a recession in the domestic economy, which we view as unlikely, though not impossible.
- We believe the primary drivers of a more lasting negative impact in the U.S. would be a sustained rise in the dollar and a return of the strong dollar/weak commodity dynamic that nearly reached a boiling point in February this year.
- We will be watching the behavior of the U.S. dollar, credit spreads, European bank stocks, and Japanese equities for signs of more enduring stress in the global economy.
- Although we believe the risk of a U.S. recession is low, we expect the UK referendum vote to have a number of enduring effects on global risk markets.
- First and foremost, it should raise uncertainty among investors and business leaders sufficiently to dampen risk taking and productive investment. The magnitude of surprise associated with the Brexit vote is likely to cause everyone to re-calibrate their internal “betting odds” on a number of geopolitical events that trigger anxiety among decision makers, including the odds of a Trump presidency, the likelihood of other anti-establishment political movements to make an impact around the world, and the odds of other countries in the EU allowing a similar referendum in the years to come.
- The UK divorce process is likely to be messy and costly, involving the navigation of myriad UK and EU laws in order to strike new trade deals with the EU and the rest of the world. Economists disagree about the magnitude of the potential impact of this process on the global economy, but virtually all agree that the direction of change will be lower.
- The prospect for slower global growth and higher uncertainty probably means central bankers around the world will keep policy rates lower for longer.
- Near term, we plan to “buy the dip” for new clients who have been averaging into the equity markets. We don't plan to go all in, just continue the process to take advantage of lower prices.
- For established equity portfolios (i.e. those not averaging in from a cash position) we will be on the lookout for selective opportunities to increase certain positions and/or add a new position if such an opportunity presents itself.
- Longer term, we believe this event reinforces our existing expectation that global financial markets are priced to deliver low returns over the next 5 to 10 years. Sluggish global growth and elevated investor uncertainty is not a recipe for higher price-to-earnings ratios (P/E) in the stock market. Without a rising P/E ratio, stocks are limited to earnings growth and dividends as the source of long-term return.

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¹ Source: Bloomberg

Disclosures

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