CUMBERLAND

BREXIT

The UK voted to leave the European Union in a surprising vote of 52% in favor of leaving. There are a number of considerations, so let's list a few of them: political, economic, and financial as well as a domino effect. Clearly the political fallout is the resignation of David Cameron. This will trigger a new Conservative Party leadership election; however Cameron will stay on until the fall and will wait for the new PM to trigger Article 50 of the Lisbon Treaty which effectively sets the timeline (2 years) for negotiations around UK's exit of the EU. While Article 50 is vague, it sets out the provisions for countries that want to leave the EU. The big negotiation topics are the UK business access to the EU, travel, and people from EU/UK countries working and living in each other's jurisdiction. The Article also requires all 28 member states to unanimously agree to the terms of the deal. In the meantime, Britain is still bound by all obligations and responsibilities to its EU membership. So it suggests to us that this could drag on for quite some time even beyond the two year window. It is also unclear to what extent or how this exit will take form. Is it possible that the UK could adopt other European options such as the European Economic Area solution at a slightly lower price tag that preserves access to the EU? This is clearly important for businesses based out of the UK and operating throughout Europe in particular, many large US banks.

From an economic standpoint, the UK leaving the EU introduces a level of economic uncertainty in Britain which will likely throw caution into UK business spending and hiring. The BoE Governor Carney has already indicated he will not hesitate to take measures as required to maintain financial stability including additional liquidity in case the financial markets require it. Further rate cuts are clearly back on table. From a US perspective, the UK accounts for about 3.6% of US exports so it is tough to call this a meaningful event for the US economy specifically. We do believe this likely slows down the timing of a rate increase in the US. Earlier this week in Janet Yellen's prepared testimony to the Senate Banking Committee, she did note that a UK exit could have significant economic repercussions although it was not totally clear which economy she was referring to. Meanwhile the probability of a rate hike in the US this year has fallen from about 59% to 15% in the last ten days. From an earnings perspective, perhaps a decline of 2% to 3% to S&P500 earnings seems possible which explains today's market reaction. Below we look at a study by Ned Davis which examines the performance of markets before and after a crisis event dating back to the early 1900's. As indicated in the table, the initial reaction tends to be negative with a mean and median return of –6.7% and -2.9% respectively. On average, this was followed by gains in each time period (22, 63,126 and 253 days later) as indicated below.

Crisis Event Study

	Reaction date	% gain DJIA days after reaction date			
	% gain/loss	22	63	126	253
Mean	-6.7%	3.7%	5.2%	8.9%	13.9%
Median	-2.9%	4.6%	6.1%	9.3%	16.9%

What is uncertain is whether there will be further knock on effect from other countries wanting to leave the EU and the extent this adds a contagion affect to financial markets . This is the tougher question to answer at this point in time however looking at the financial impact specifically on our North American portfolio, our exposures are well diversified and relatively small to the UK and the EU. In the International Fund our direct exposure to the UK is minor at 3.8% with the balance of our holdings consisting of a broad portfolio of diversified global companies in best of breed businesses. So in conclusion, we stay committed to our process of buying high quality companies that will be able to withstand headwinds such as this and outperform the market in the long term.

Peter Jackson, CIO
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