"UNCERTAINTY"
The Market Hates This Word

After Britain's vote to leave the European Union on June 24th, opinions about the future ranged from this being as significant as the 2008 financial crisis to nothing is going to happen for the next two years.

We'll concede that it was a significant event, but having observed how Europe has handled several crises in the last few years, we tend to agree with Ned Davis Research that summarized it by saying,

"Brexit will be dealt with in typical European fashion: with a compromise that changes nothing, satisfies no one and kicks the can down the road."

That said, the event has called into question a number of factors that are influencing the market from Central Bank policy to economic growth. So it's probably worth spending a little time sorting out what is fact and what we can and what we cannot expect going forward.

But first, let me address the market's reaction to the news and how you can reconcile the market collapse on the two days following the vote with a full recovery by the end of the week. Most of it, in my opinion, can be attributed to market psychology which often overreacts to the news.

A theory of "endogenous risk" developed at Stanford University pretty well sums it up. One of its main findings was "the more correlated the forecasting mistakes of the individuals in a market are, then the greater the market correction (and hence volatility) will be in the market once the Truth is learned.

A "correlated" mistake structure is one in which investors share a common forecast that proves to be wrong. An "uncorrelated" mistake structure is one where investors' forecasts are unduly spread out symmetrically around the Truth that emerges. When forecasts are uncorrelated and distributed symmetrically around the Truth, then once the Truth is learned, for every seller there will be a buyer and market price does not change. There is no volatility. In the case of a correlated structure, the reverse is the case; everyone becomes either a buyer or a seller in unison, resulting in sharp changes in price.

In this case, the Brexit expectations were about as far off the mark as The Chicago Tribune's 1948 election headline "Dewey defeats Truman". Even the bookies got it wrong and caught too many investors leaning the wrong way when the results started coming in. In my opinion, it gave us a dose of volatility that was inconsistent with the magnitude of the news event and was consequently reversed by the end of the week.

That said, I don't mean to dismiss the Brexit vote as a nonevent. It isn't. But let's look at what we do know and then some of the unknowns that will get resolved in the future. Until that happens, there will be a fair bit of uncertainty which the market hates. But markets bottom at the point of greatest uncertainty and more will be known each day as some of the issues get addressed. The second quarter earnings season starts in July and senior executives are likely to reflect on what Brexit means to their company during analyst conference calls.

The Knowns

- The mechanism for the UK to withdraw from the European Union is contained in Article 50, a 261 word section of the Lisbon Treaty. It states "*The Union shall negotiate and conclude an agreement with the state, setting out the arrangement for its withdrawal, taking account of the framework for its future relationship with the Union*."

  It further states that the agreement will cease to apply to the state in question from the date of entry into force of the withdrawal agreement or failing that, two years after the notification…unless the European Council, in agreement with the member state concerned unanimously decides to extend the period.

  Until the departure treaty is signed, which requires assent from Britain and a majority of the remaining 27 states weighted by population – Britain remains, in principle, a full member of the EU but will be excluded from discussions affecting exit terms. In other words, Brits remain EU citizens and business continues as before.

- Prime Minister Cameron has resigned as leader of the conservative party and says that Article 50 will not be evoked until a new leader is chosen which will not happen before September 9th. The resulting power vacuum leaves unresolved who will be responsible for implementing Brexit.

- This is a political event and not a financial event where contagion can spread through the banking system. However, as a political event, the Central Banks have very limited ability to control the spread of isolationist thinking.

The Unknowns

How will the EU handle the separation negotiations? There is the "Brussels Consensus" group that believes Britain must be made an example of to discourage others from leaving. However, it is human nature to threaten the worst circumstances as a negotiating position but then to negotiate pragmatically so that undue damage is not done to oneself.

Will Britain really withdraw from the EU? Right now politicians are saying that the citizens have spoken. However, there is some suggestion that under devolution rules, the parliaments of Scotland, Northern Ireland and Wales are required to consent to any withdrawal from the EU.

There is also the possibility that after the leadership convention, there will be a general election asking the electorate for a new mandate on whether to leave the EU. This is a possibility as the referendum to leave is not legally binding on the government. However, the new leader will be chosen by ballot of the party's 150 members who are disproportionately white, retired and from the management classes – mostly backers of Brexit. The other possibility is Parliament doesn't vote to invoke Article 50 as new polling information may provide the political cover not to proceed.

Furthermore, according to a report from the House of Lords, the law allows England to change its mind after evoking Article 50.

Regardless, Scotland may have another referendum to leave the UK as two thirds of the Scots voted to remain in the EU.

There is also a possibility of separatist contagion to other EU countries. In fact, this is an issue that has global implications as the vote for nationalism is also a rebuke to the establishment. Donald Trump, a U.S. presidential candidate, announced while in Scotland that Britain had just "taken back their country" in the same way that he is inviting Americans to do.

However, the British vote was less about protectionism and more about liberty, free trade and about trying to manage globalization better than the EU has been doing from Brussels.

There is also concern about an immigration system that prioritizes unskilled workers from within the EU over skilled workers who come from outside the EU.

This socio-economic split is showing up elsewhere as graduates face off against the working class and metropolitans disagree with the countryside.

In April, the polling firm IPSOS MORI took a survey in nine EU countries and asked if they would like a referendum on membership. 45% said yes while 33% said they would vote to leave.

Far right populist parties are gaining ground in an number of countries and Brexit will likely further their cause, although a Spanish election the Sunday after the British vote reconfirmed support for the Conservative Party.

Yet there is a growing separatist movement in a number of countries.

France has the ultra-nationalist, anti-EU party, the Front National. The party is led by Marine Le Pen who is anti-immigration and anti-Islam and is a leading Presidential contender with 28% of the projected vote.

Germany has its own right-wing party, the Alternative Für Deutschland that is also anti-EU and is taking a strong line against Islam. However, the party is only polling between 10% and 12% popular support.

Italy has the anti-establishment Five Star Movement Party whose leader just recently proposed a referendum on Italy's membership in the Eurozone. Italy's current prime minister has called for a referendum to streamline their political system. Although the reforms make sense, the referendum could be used to call a mid-term anti-government vote.

The Netherlands has the Dutch Freedom Party that wants to have their own referendum to leave the EU and whose popularity surged earlier this year.

And finally the Austrian Freedom Party recently lost an election by a narrow margin after running on an anti-immigration platform.

Although these parties don't currently seem to have enough support to win an election, they are gaining ground.

Yet, with these countries sharing the Euro as a common currency, we expect the support for a referendum in these countries to be lower and separation to be much more complicated. Furthermore, they will have an opportunity to see the consequences of separation in the UK which could be a warning.

However, even if the more extreme parties don't get in, the pressure on mainstream governments will likely cause policy adjustments towards more protectionism with limits on immigration.

In order to monitor this backlash against the establishment and globalization metastasizing into a general rejection, we will pay careful attention to sovereign governments bond spreads. Increases in the yields of Italian and French government bond yields relative to German yields would be a negative for the Eurozone and symptomatic of rising separatist movements.

One should also appreciate that this protectionist thinking isn't solely a Eurozone issue. It is gaining global support as we are seeing in the U.S. presidential election. This broader adoption would not be good for global trade.

Consequences

Indecision will impair business spending and planning. In anticipation of the Brexit vote, a large number of business decisions were put on hold, resulting in a slowing UK economy and lower earnings estimates.

Some suggest the vote could lead to a UK recession. However, many companies will benefit from the weaker pound. It should help tourism, exporters and international companies that are based in the UK that convert foreign profits into pounds at a more favourable rate. The negative is that inflation may squeeze the UK consumer. Consensus says GDP slows to 0.9% in 2017 from 2.1%. Longer term prospects will depend on the trade negotiations on exiting the EU.

In the meantime, there are specific risks to the London financial community in that the EU could insist that trading in the Euro or in EU trade finance should only be done by those subject to EU regulations and supervision.

Overall the economic consequences to Brexit are estimated to be a hit to Western European growth of 0.4% bringing annual GDP down to 1.5% from 1.9%. Although Deutsche Bank's Chief Economist sees growth as low as 1.1%, global GDP expectations are being reduced by only 0.2% to 2.8 - 3.0%.

The U.S. exports to the UK amount to about 0.7% of U.S. GDP and most economists estimate the impact of Brexit will cost the U.S. GDP about 0.2% so the direct impact is fairly limited.

However, there are indirect consequences. The Federal Reserve's interest rate hike is probably on hold at least until the end of the year. And currency fluctuations will potentially have the biggest influence as a strong U.S. dollar will hurt both the economy and corporate earnings.

In fact, some of the strongest reactions to the Brexit vote were seen in the currency markets.

The British pound dropped 10% to $1.34, and has continued to weaken, a 30 year low. The Euro also declined 2.4% while the U.S. dollar and Yen were the beneficiaries.

From our perspective, the currency markets will be one of the most critical areas to monitor because their message is not only immediate but reflects investor sentiment and will be the main median for transmitting adjustments.

It is true that the currency markets can be manipulated by the Central Banks but historically countries have only been able to control and fix either interest rates or their currencies. With interest rates pegged at virtually zero, the currency markets are a better indication of economic and political stability.

The immediate appreciation of the U.S. dollar and Yen were reactionary and can be attributed more to the weakness of the pound and Euro than their attractiveness, which means the strength can be easily reversed.

If their strength persists, it would be a cautionary flag for growth expectations in both the U.S. and Japan. It would also be damaging to U.S. corporate earnings and consequently the market. Furthermore, it could lead to the spread of a currency war as it provides cover for the Chinese to again devalue the Yuan. Such protectionist measures would only aggravate the nationalistic sentiments that are gaining popular support.

Summary

The likely outcome of Brexit is that the UK will negotiate a free trade agreement with the EU that is not as favourable as the current preferential access they enjoy. In the interim, uncertainty will compromise their economy although very little else will change except for the significant decline in the pound and its positive influences on trade.

The reality is that different countries within the EU have varying levels of trade with the UK making a united negotiating position very complicated.

Our expectations of the stock markets have changed very little. Although Brexit has to be considered a negative for no other reason than the uncertainty that it introduces, the U.S. economy is still expected to reaccelerate in the second half of this year and into 2017. This should be good for economically sensitive companies and redirect investor bias towards cheaper "value" companies and away from "growth".

On balance, the market appears fully valued on 2016 earnings but should improve as 2017 comes more into focus. Nonetheless, stock and industry selection should provide more performance than a general market advance.

The two critical variables to watch, besides the U.S. presidential election, will be currencies and European sovereign government bond spreads. As we said, a rising U.S. dollar will not be good for either the U.S. economy, multinational company earnings, or commodity prices. And widening sovereign government spreads will be one of the first indicators that the separatist and nationalistic movements are gaining support which would not be good for global GDP.

GRC/amh
July 4, 2016

Credits: Ned Davis Research
Yardeni Research
Woody Brock