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BREXIT COMMENTS

The *political* decision of the British to exit the European Union sent tremors through the financial markets last week prompting commentary, we believe, to have been over-exaggerated. Beyond the intra-day volatility, market moves, while a bit shocking, were consistent with a normal process of discounting the heightened risk of slower global growth, higher inflation and some tightening in credit conditions occasioned by the "leave" vote.

Clearly, the 10% overnight dip in the British pound, the biggest ever one-day decline, or the three trillion dollars of lost market value of equity securities were noteworthy. However, in reality, the financial market moves we saw were not particularly remarkable given the high degree of uncertainty surrounding the outcome of the referendum. It should also be noted that a significant portion of the decline was only a reversal of strong rallies over the prior 48 hours. That said, we can expect heightened volatility as the decision to exit the European Union is likely to lead to considerable political upheaval with calls for Scottish independence, a possible collapse of the 1998 Good Friday agreement between the British and Irish governments, and a surge in other EU-related independence initiatives.

From an *economic* standpoint, the consensus "leave" scenario suggests a potential 3.0 – 4.0% reduction in baseline UK GDP growth and 1.0 - 1.5% off EU GDP growth in the next three years. Global GDP growth could be reduced by 0.2 – 0.3% per annum over the same time span. UK inflation could rise to 3.0 – 4.0% in 2017/18 due to higher import prices. We expect the European Central Bank to continue easing if the Euro rises too sharply. The Federal Reserve will be watching closely and may defer its next interest rate increase until December given the global uncertainties. Liquidity is likely to be challenged and we may experience further market volatility in the days and weeks ahead as the markets adjust to the new reality. Markets will undertake a period of price discovery in which they factor in the greater risk of a downside shock to the UK or European economies, and the increased risk of higher inflation.

At this point it is extremely hard to predict with any certainty what the *economic* outcome will be. Not until we see the nature and pace of trade negotiations and the outcome of months, and possibly years, of political wrangling, both in the UK and Europe will we be able to better assess the longer-term outcomes.

So we expect the markets to remain unsettled. It is less clear that this will turn into the kind of systemic meltdown that some commentators were forecasting in the immediate aftermath of the referendum. In fact, in recent days investors appear to be making a distinction between a non-Euro member (i.e. England) exiting of the EU (a political union) versus an EU country abandoning the Euro. The former can occur without massive disruption given the existence of independent central banks and currencies. There is also an evolving sense that "Brexit" may not wind up happening. There are myriad permutations by which the UK and EU could negotiate a post-Brexit relationship similar to the current one whereby the UK could be granted additional concessions from the EU, in particular around immigration, such that membership becomes more palatable. Also, keep in mind that banks are the transmission mechanism by which discrete events, such as the UK referendum, take on macro proportions. Owing to their balance sheet strength, global banks are acting in this instance as a "firewall" against this *political* situation spawning a financial crisis.

With global GDP now expected to slow only moderately, as US GDP growth is likely to escape with only a negligible hit, and little likelihood of a significant financial market crisis, we are maintaining existing portfolio structures. Clients' accounts remain fully invested in the expectation of a rebound in US growth from the anemic pace of the first quarter. In our view, stocks remain reasonably priced, particularly when viewed against their fixed income alternatives.

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