MID-CONTINENT CAPITAL

CONSILIUM*

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*advice; judgment; resolution; wisdom

Never a Dull Moment (Again)

Just a week before the end of the second quarter, news broke that voters in the United Kingdom had decided that their country should leave the European Union. This unexpected result roiled equity, bond, currency, and commodity markets around the world. The ramifications of "Brexit" were discussed at great length in the media, and deservedly so - never before has a country voluntarily withdrawn from a free trade pact, and the resulting market volatility was dramatic and unsettling.

We will not add to the growing mountain of analysis attempting to address "what happens next" as numerous critical issues remain undecided:

- Whether - The referendum was, technically, non-binding and some observers are openly suggesting that the UK Parliament might not adhere to the voters' wishes.
- When - The UK has up to two years to invoke "Article 50" and additional extensions are possible. As a practical matter, there is no telling how long the process will require.
- How - As in divorce, it is impossible to predict settlement of trade terms at this early stage.

These matters are all relevant to the larger issues on investors' minds, including whether a UK recession in response to the decline in the British pound and market turmoil (reasonably likely) spills over into an EU recession (possible but not assured) that in turn pulls the US economy down (unlikely).

Keep in mind that there are potentially significant geopolitical implications with investment consequences that could be felt over a span of decades – will other members pull out? Will there have to be a significant restructuring of the EU? Are free trade zones and sweeping free trade agreements falling out of favor with voters, possibly setting back the significant global gains from trade that have emerged since World War II? Will the US dollar resume its upward ascent, once again pressuring corporate profits, emerging markets and China?

There is an ample supply of predictions. But from an investor's perspective, it is important to know that none of these questions can be answered yet, and possibly not for a long time. **Our advice is: do not "overthink" Brexit, but simply recognize that an important element of uncertainty has been injected into the mix of factors that influence the markets.** When confidence is high – when investors are very certain about the business and economic outlook – we require lower rates of return, raising the prices we are willing to pay. But when uncertainty rises, investors collectively reassess risks, and demand a higher rate of return on their investments, lowering their prices. (In 2011 we devoted an entire issue of *Consilium* to the role of "uncertainty" in investing; copies are available at www.mccllc.com).

Sources: FactSet, Baseline, The Bank Credit Analyst

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The ultimate importance of Brexit might be unknown, but it certainly isn't *unimportant*. And yet, as this is being written, the S&P 500 index has recovered fully from its two-day post-referendum selloff. Investors seem to have concluded that Brexit has not changed the US economic outlook at all, but that the global tumult will keep the Federal Reserve from pursuing its stated goal of "normalizing" (i.e., increasing) short term interest rates. Indeed, the yield on long-term US Treasury bonds has fallen from 2.3% at the beginning of the year to a record low of 1.36%. The equity market reflects expectations that the economy will be "good enough" to produce earnings growth; the bond market reflects expectations that the economy will be "weak enough" to keep the Federal Reserve at bay. Psychologists have a term for this state of affairs: *cognitive dissonance.*

The upcoming US election is another source of uncertainty for investors, and one which probably deserves more attention. (In our year-end issue of *Consilium*, we referred to it as the "800-pound gorilla" of external influences on the markets). Regardless of the outcome, a new administration will be pursuing new policies, and research has shown that the prospect of such policy change can act as a damper on spending by both consumers and businesses.

Meager growth with high valuations – critical variables we have discussed previously – have combined to produce very low returns in the US equity market for 18 months. We don't know by how much, but risks clearly have risen, and potential returns have not. This is an exceptionally difficult time to be a prudent long-term investor, and we continue to make appropriate adjustments to client portfolios to reduce unnecessary risks. Our focus on high-quality companies with durable business models allows us to remain invested for the long term despite these unusual current circumstances.