Market Insights

JUNE 24 2016

Whittier Trust

INVESTMENT & WEALTH MANAGEMENT

THE DAY AFTER BREXIT

The United Kingdom voted to "Leave" the European Union (EU) in a historic referendum on June 23. The 51.9% vote to Leave was influenced by four primary factors: pride of sovereignty and desire for autonomy, flexibility in negotiating new bilateral trade relationships, better economic use of funds contributed to the EU and greater control of borders and immigration.

While we were expecting a "Remain" outcome in line with the consensus, we have also assessed the potential negative impact to the UK from Leaving the EU. These effects include an economic slowdown in the UK from restricted access to its biggest export market and any subsequent spillover to the Eurozone and other economies.

In the end, populist emotions beat out objective economics. It is interesting to note that a new poll by YouGov.com found that young voters were firmly in favor of Remain.

Not surprisingly, risky assets all around the globe have sold off in the immediate aftermath. As the markets rummage through the initial debris from the fallout, we observe the following from our perch as a long-term investor.

KEY TAKEAWAYS

1. **Not a crisis—yet.** This is more a political crisis and not a financial crisis at this point. Even as stocks, currencies and commodities have fallen by -4 to -8%, a meaningful portion of those declines simply reverse out gains from a prior run-up when markets mistakenly priced in a Remain outcome. Market liquidity is adequate so far and few signs of systemic risk have emerged at this point. We are keeping a close watch on the financial sector and currency imbalances for signs of increased contagion risk. We believe that Brexit is unlikely to mutate into an event like the Global Financial Crisis of 2008 or the Tech Bust of 2000.
2. **US in a good spot…** The US economy remains on a solid footing with steady job growth, good gains in wages and consumer spending and a resilient housing market. US companies derive only 6% of their revenues from the UK and US banks are the best-capitalized ones within the global sector. Renewed weakness in oil and a stronger dollar could slow down US corporate profits in the near term. We expect Brexit to have a limited impact on the US in the short

Age Group	Median Age	**REMAIN**	**LEAVE**	Life Expectancy	Average number of years they have to live with the decision
18–24	21	**64%**	24%	90	**69**
25–49	37	**45%**	39%	89	**52**
50–64	57	35%	**49%**	88	31
65+	73	33%	**58%**	89	16

Those who must live with result of the EU referendum the longest want to remain.

Polling Data = YouGov. 1652 people. 17–19th June 2016. Life Expectancy based on ONS pension planner life expectancy estimator. Average 65+ year old was estimated to be 73 using ONS age distribution data. Those who were undecided or wouldn't say have been excluded.

"We expect Brexit to have a limited impact on the US in the short term and even less so over time."

LOCATIONS

Southern California
Los Angeles
1600 Huntington Drive
South Pasadena, CA 91030
626.441.5111

Orange County
3200 Park Center Drive, Suite 980
Costa Mesa, CA 92626
949.216.2200

Northern California
505 Montgomery Street, Suite 620
San Francisco, CA 94111
415.283.1850

Nevada
100 W. Liberty Street, Suite 890
Reno, NV 89501
775.686.5400

Northwest
520 Pike Street, Suite 1415
Seattle, WA 98101
206.332.0836

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term and even less so over time. Persistent or prolonged weakness could even present buying opportunities.

3. **…UK and EU more vulnerable.** The UK and European economies will bear the brunt of Brexit. We highlight the following observations for this region.

   a. Economic growth will slow down—more so in the UK than in the Eurozone with a rising probability of at least a mild recession.

   b. The £ and € are likely to continue to weaken, central banks to intervene and ease more aggressively and European banks to come under more pressure. UK and European stocks offer asymmetrically more downside risk.

   c. The UK and EU will eventually work out reasonable trade agreements. We already have precedents of countries like Norway and Switzerland which have survived and thrived outside EU and Euro memberships.

   d. The triumph of populism in the Brexit outcome sets the stage for sustained pressure on the long-term survival of both the EU and the €. The European Monetary Union has not progressed further to fiscal integration or uniform structural reforms and is now at greater risk of unraveling over time.

   On a lighter note, Brexit could well sow the seeds for outcomes like Departugal, Oustria, Italeave, Finish, Czechout and Byegium.

4. **Valuation support from low rates.** With growth now likely to be slower for longer, interest rates will also be lower for longer by extension. We expect US stocks to find valuation support from low interest rates. After all, it is only the third time in history that the S&P 500 dividend of 2.1% is above the 10-year bond yield of 1.5%.

SUMMARY

We view this more as a bump in the road than a break in the highway to our destination. Our emphasis on broad diversification beyond just stocks and bonds, preference for US stocks over international ones and focus on high quality businesses are helping us and our clients ride this storm out.