# Brexit

## Commentary on Markets' Response

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Whenever the global financial markets react sharply to a news event, my first reaction is to ask who got caught on the wrong side and why. In the case of Brexit, it would seem that because the polls favored the "remain" camp, those speculators betting on Great Britain voting to remain were caught overleveraged and long the pound and perhaps the euro and short gold. I personally did not have a view either way, but I became leery of the polls because I had concluded that the pollsters might not get the real answers or reasons driving the voters' choices.

I believe the simple fact is this was not a vote about being part of the European Union as much as it was a vote about immigration, controlling neighborhoods, housing costs, welfare for immigrant-refugees, and jobs. Perhaps it was a fear that the UK would, with continued open borders, become like France, awash with immigrants that had not assimilated into French society and have no apparent desire to do so. If I am correct, then it is most important to watch the rest of the EU members to see if there is any chance that the desire to close the borders may begin to spread. My personal guess is that this is just the beginning of a long series of country-by-country popular demands for a referendum on first, the open border policy, and second, on the issue of remaining in the EU.

The second look at the Brexit vote must place some credence on the argument that the Brussels bureaucracy had become expensive, overwhelmingly complex, and increasingly, a hindrance to commerce. No business likes to walk through a minefield of regulation; the growing regulatory nightmare in the EU and the US favors large enterprises that can afford the legal staff and systematically discourages small business. However, small businesses are the ones that foster new ideas and create jobs. Now, new bilateral trade agreements must be negotiated between the UK, the EU, and other trading partners. My guess is that the fallback position will be to return to the tariff structure that existed before the EU was born; of course for new products, there will have to be negotiations. These negotiations will undoubtedly take time, but business will go on.

The third look at the Brexit vote requires an analysis of how this decision affects the physical security of Europe with respect to an increasingly adventurous Mr. Putin. There is little doubt that the UK was the third leg in the three-legged stool, consisting of the UK, France, and Germany, that supported a militarily strong Europe. I am not sufficiently knowledgeable in this arena, but my tendency is to believe that NATO will be unaffected by this event and continue to be an important force in Europe. Indeed, NATO may take on added importance.

It is in many ways sad that the concept of open borders, one currency block, and the free flow of ideas, people and commerce is now, perhaps, at risk. To the extent that the EU was run by an unelected bureaucracy, this outcome may have been inevitable. The single currency was already causing stress between Germany and the weaker countries of Spain, Portugal, Italy and Greece. The massive waves of immigrant-refugees out of North Africa and the Middle East was, I believe, the triggering event that caused the UK people to vote the way they did. There will, I believe, be many unintended consequences, both bad and good. The question from everyone is "bad" for whom and "good" for whom. I believe it is too early to come to any conclusions, and it may be many months before the picture clears.

Investment portfolios holding US, UK, and European equities have been negatively impacted by both declining stock prices and a declining British pound and euro against the US dollar. Portfolios holding dollar-based fixed income have benefited as well as those holding gold. I do not believe selling on the Brexit news is wise. The sudden increase in volatility is no doubt caused in part by all those investors holding leveraged speculative positions betting on the UK people voting to remain in the EU, as indeed the polls had indicated. This type of washout typically takes three to five days with the bulk of the action in the first three days. If the lower value of the pound and euro is maintained going forward, it will help make these countries' export industries more competitive while US exports will continue to suffer from the strong dollar.

The concern in some quarters is that this event is the beginning of a global financial crisis and meltdown. Anything is possible, of course, but I believe it is unlikely. Of greater concern, and worth a careful watch is the possibility that the already weak European and American economic recovery will be pushed into recession as consumers and businesses pull back to take a wait-and-see attitude. The US stock market has been pretty flat since early 2015, perhaps reflecting historically excessive valuations, declining corporate profits, and a slowing economy. Non-US stocks, particularly European equities, continue to be at relatively inexpensive valuations.

A key point to remember is that your Towneley portfolio has been designed to conform with our belief that while we cannot manage the markets, we can manage risk. To that end, your portfolio is:

- Allocated based on your unique goals and risk tolerance
- Globally diversified
- Not leveraged, and
- In most cases, contains a small allocation to gold to help protect against calamity.

Provided you are living within your budget, the controllable factors were all under control before the market dive on June 24. Unless you have changes in your goals, income, or future plans, we recommend sticking with your plan through the current environment of volatility.

If you have experienced such a change, or if you have questions or concerns, please contact your Towneley portfolio manager.

We conclude that while Brexit may be a significant event in history, the full ramifications will not be known for many months if not years. Of greater concern is the risk that it may cause business and consumers to reduce spending and tip the already weak European and US economic recoveries into recession. The equity markets may be already discounting this risk.