HELM INVESTMENT MANAGEMENT

Thomas Jay Barrett, Jr.
Jay Allan McCormick
Peter John Quinn

BREXIT TURMOIL

UK voters threw out the concept of a united Europe last night in a vote that has 51.9% of British voters cheering and global financial markets groaning.

Once it became clear that the UK is going to invoke article 50 of the European Union treaty to leave the EU, market reaction was immediate. The British Pound plunged 7.5% to $1.36-per-Pound, an almost unprecedented drop for a major currency. UK stocks dropped 3%, though some UK bank stocks were down more than 20%. German stocks dropped 7% and French stocks plunged 8% the day after the news. US stocks fell 3.6%. The Japanese Yen and the dollar both strengthened against other currencies.

In addition to the short-term reaction, we believe there will be some important intermediate- and long-term impacts resulting from the UK decision. These include:

- US interest rates will remain low.
- The US dollar and Japanese Yen will stay strong against the Euro and the Pound.
- Investors will again question the strength of the European Monetary Union.
- Central banks around the world will work to try to offset damage from the vote, including further measures to ease monetary policies.
- The UK economy will be under pressure for a sustained period.

While some of the rapid changes in the markets immediately following the vote represent substantive issues, other reactions might prove to be more fleeting. The drop in the British Pound puts that currency at its lowest level against the US dollar since the mid-1980s – that's a big move. The drop in US stocks set them back close to the level they were one month ago and down very slightly for the year – not all that big a move, despite the one-day drama. US interest rates are lower – the 10-year US Treasury yield fell briefly near its all-time low and closed the day at 1.58%, continuing a global trend of very low interest rates in countries considered to be safe havens.

Over the longer term, there are a number of potential trends and events that could affect investments. Though some commentators predicted an economic "hell" for the UK upon an exit vote, the Financial Times' Lex analytical column predicts something not as severe but much longer-lived – a sort of economic and financial purgatory for the country that could drag on for years. In addition, the UK now runs a more distinct chance of becoming less united. Scotland's recent vote to stay in the UK was premised partly on a belief among Scottish voters that the UK would remain part of Europe.

Scottish voters voted solidly to “remain.” Now a new vote in Scotland is likely and has a higher chance of leading the Scots to depart the UK and join the EU. Given the drop in the Pound, England may be a much-improved place to visit, but you wouldn’t want to live there (or be walking around with Pounds in your pocket).

The British Pound vs. the US Dollar since the beginning of June:

Source: Bloomberg Finance LP

Despite the dire nature of the news short term, the market drop brings some short-term and long-term opportunities. Well-known economist Jeremy Siegel notes that while the Brexit vote is important, “This is not an economic disaster.” Large parts of the world are in relatively good shape and many global banks are much better capitalized than in the mid-2000s. The actual divorce of the UK from Europe will likely take more than two years to negotiate, so the change will be more gradual than today’s market volatility indicates.

As a result, we expect the drop and recovery in US stocks to be somewhat ‘V’ shaped. Even stocks in the UK and Europe likely will recover some from their sharp sell-off – though we believe lingering political and trade-related uncertainties will weigh on European shares, especially of the UK stocks. Japan likely will work to weaken the Yen again against the dollar to improve its export-oriented economy (something noted by Siegel and other global investment experts), which could lead to a rally in Japanese shares. Emerging markets likely will be mixed – those with close ties to the UK (such as India and South Africa) suffering a bit and those who trade more with other regions continuing to grow – leading to a rebound of stocks in some markets.

Finally, the news of the UK-Europe breakup means that the Fed very likely will not raise rates in the short term and possibly not at all this year. That’s good news for borrowers and issuers of debt. But it’s mixed news for investors in fixed income – good in that their current bond holdings are worth a little more but bad in that the expected yield of fixed income investments will continue to be paltry for some time to come.

In short, the likely result of this vote is that the UK will suffer more than Europe, even though more trouble lies ahead for Europe and the monetary union. Most of the rest of the world can be expected to work its way past this event and get back to the sort of solid but slow growth that has been typical of the past few years. As for Helm, we prefer to avoid knee-jerk reactions to fast market moves. But we are studying the ongoing economic and financial market shifts and will consider allocation changes in the equity indexes in the future. In the meantime, portfolio fixed income holdings got a boost from today's market reaction. The income securities portion has done its job – preferred stocks held their own, utilities edged higher, MLPS sagged (the price of oil was down 5%) but generally not as much as the market, and some of the blue chip stocks gained.

As always, please call any of us in you have any questions, concerns, or want to talk in more depth about Brexit and the world market reactions to that vote.

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