



By now you are aware that the United Kingdom (UK) voted Thursday, June 23rd to exit the European Union (EU) and end its membership to the EU since 1975. Voters rejected the known status quo, and Prime Minister, David Cameron, announced his resignation following the outcome. I couldn't help but think of the British rock band, Pink Floyd, and their song “Another Brick in the Wall (Part 2)”, a protest song against rigid schooling in general and boarding schools in the UK in particular.

*“We don't need no education
We don't need no thought control
No dark sarcasm in the classroom
Teachers leave them kids alone
Hey! Teachers! Leave them kids alone!
All in all it's just another brick in the wall.
All in all you're just another brick in the wall.”*

The song talks about how the kids had a personal wall around them from the rest of the world, and the teachers were just another brick in the wall. In the case of the “Brexit”, the “leave” camp (51.9%) voiced their dissatisfaction with EU economic and immigration policies. They wanted to take back control and not be “another brick in the wall”.

In the days leading up to the vote, global markets had run-up markedly – largely based on opinion polls and betting markets. Global markets were shocked by the vote, and stocks sold off anywhere from -3.6% (S&P 500) to -12% (UK FTSE priced in US dollars) on Friday, erasing the gains from earlier in the week and little more. Global equity markets surrendered roughly \$2 trillion in market value on Friday. The 10-year US Treasury note finished with a 1.56% yield, near the low for the year.

The UK appears to have the most to lose, at least in the short-term, owing to the disruption of trade and the large scale of its exports flowing to Europe (approximately half of UK trade is with Europe). Foreign direct investment could potentially shift out of the UK, as businesses relocate to other EU members in order to retain access. Financial institutions will be hit, and lending may tighten. Simultaneously, companies may defer investments during the uncertainty. A slowdown in economic activity is likely in the UK, but a weak currency (the pound sterling had a record 10% drop) will help offset some of the slowdown by bolstering the competitiveness of exports. In addition, emergency liquidity provisioning from central banks is likely, and further quantitative easing is possible. Over the medium- to longer-term, a less-regulated, freer-trading economic environment outside the EU and new trade agreements with faster growing regions (i.e., China, Russia, etc.) could lead to increased economic dynamism. However, the more the UK seeks freedom from EU rules, the harder it will likely be to maintain market access to the union. Further, the UK Office for National Statistics estimates that population growth under a “zero-migration” scenario could come down (hurting growth in the long-term), and a tightening of the labor supply could create wage pressure and thus inflation leading to a “stagflation” (low growth and high inflation). In addition, the Brexit vote might lead to a break-up of the UK down the road as Scotland and Northern Ireland voted to remain in the EU, and may declare referendums to secede. This would put British energy and naval advantages in jeopardy, and political tensions could flare up.

The EU referendum does not automatically entail legislative action, so an act by the British parliament will be needed to enact a Brexit. Article 50 of the EU governing treaty, the Lisbon Treaty, requires that any member must notify the European Council of its intention to leave, and the EU rules will apply for a maximum of two years. In addition, with Mr. Cameron's resignation, a new prime minister will likely not be in office until October, and the new

prime minister will have to trigger Article 50. These steps to withdrawal from the EU plus the renegotiating of 120+ trade deals will take time.

The U.S. economy's main concern will be a tightening of global financial conditions and a stronger dollar, which would hurt exports. The Federal Reserve is likely on hold for raising the Federal Funds rate until at least later this year (December). The U.S. economy will likely continue chugging along as consumers continue to support growth. Also, keep in mind that the Eurozone and the UK account for only 16% and 2%, respectively, of global growth. Growth will likely slow in these regions but they will continue to trade with the rest of the world. The main engines of global growth will continue to be the U.S. and the emerging markets (specifically China and India).

The breakaway of a member calls the foundation of the EU project and the future of the euro into question. This will create an uncertainty of "Who's next?" and political stresses will remain high elsewhere in Europe. Stock markets don't like uncertainty, and we expect volatility to continue until this all gets resolved, which will take time. The global stock market sell-off on Friday was likely pricing a lot of this uncertainty up-front. It often takes a crisis to get policy makers to act, and maybe the EU bureaucrats will heed these warnings seriously and implement reforms.

BFS Wealth Management was prepared for the Brexit, and raised cash before the vote for clients needing it over the next six months. We will closely monitor portfolios in light of the developments, but are not rushing in to any investment decisions. Stocks remain attractive relative to bonds. According to Bespoke Investment Group, more than 60% of stocks in the S&P 500 index carry a dividend yield higher than the 10-year Treasury note. Stock markets in Europe, Japan and emerging markets carry even larger dividend yields than the S&P 500, and valuations are much more attractive overseas. We will continue to maintain diversified global portfolios, and we will be rebalancing portfolios, as necessary over the next few weeks (we held off on quarterly rebalancing until after the vote) and will look to take advantage of buying opportunities.

If you want to discuss any specifics regarding your investment portfolio, please don't hesitate to reach out to us. Thank you for your continued confidence!

Sincerely,

BFS Wealth Management

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