Brexit: Too Much Written Already

The volume of information written on this subject is already a bit overdone. Not that the event isn't important, but it is like watching CNBC (which I don't). If you listen for 2 hours, you have no idea what to do because you have listened to 20 different opinions—half being bullish and half being bearish! Advisors feel compelled to write about these events, and we should. Putting it in context, the euro area collectively has about the same GDP as the U.S. The United Kingdom is, by itself, the fifth largest economy in the world with a GDP at about $2.9 trillion dollars in a $67 trillion global economy. The referendum does not automatically entail legislative action as to when and if parliament will vote to leave the EU. Markets obviously took this as a negative in the short run. Let us caution you that markets—especially in the U.S. — are overpriced, so any news that has a negative bent will exacerbate the reaction to the downside. The growth in the euro area is continuing to struggle against a long period of high unemployment. GDP in the U.K. has fared a bit better in real terms in pounds.

- The first point is that gilts should stay well bid as the Bank of England keeps monetary policy accommodative to stimulate the economy as much as possible
- Second, the pound will stay relatively weak, which is good for exports and the multinationals' profits.

Great Britain ranks at the lower end of the spectrum as to its dependency on the EU. Therefore, leaving has potentially more social implications than actual economic issues. Many of the companies listed on the FTSE 100 are global companies and operate within a large geographic region. A lower pound actually benefits them. The U.K. does not have to deal with currency redenomination because it is not a member of the euro area.

- The biggest issue is who's next? The unraveling of the euro area is a bit overplayed in our opinion. For 80% of the countries in the euro area, unwinding becomes a very complex ordeal. We think it is unlikely that a go-it-alone strategy works for many of the countries. The possibility of another referendum vote from another country has risen, however. Geopolitical volatility will increase much as it has here in the U.S. By no means does the U.K. leaving the EU undermine global order.

It isn't very interesting to have a middle-of-the-road measured opinion. It is more exciting to be Bernie Sanders or Donald Trump. Gary Johnson just isn't interesting. He may be the right guy for the job, but he doesn't make headlines. Our point is this: React based on value, not how you feel emotionally about Brexit.

For risk assets, focus on profit margins and future growth of profits. Look at what people are willing to pay for those. Geopolitical events can change that but only to a point.

So where do we stand?

1. We still will maintain our underweight stance on risk assets.
2. Equities are more vulnerable, but this shouldn't be a surprise to our clients. Just more people are on board with our view. As that view gets a little crowded, we will see where valuations have gone.
3. Treasuries are getting expensive below 1.5% for the 10-year.
4. Our overweight EAFE relative to U.S. stocks is still in tack, but clearly near term we have less conviction.

We will write extensively in our third quarter outlook about current valuations.

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