DANN ASSET ADVISORS, LLC

Brexit – What Does It Mean?
June 24, 2016

Britain's vote on Thursday to leave the European Union caused a flight to perceived safe investments today, with gold, the Japanese Yen and bonds rising (yields, which fall as bonds rise, fell to record low levels in many leading developed countries) and stocks and commodities falling. To put today's 3.6% stock market decline in perspective, the market is now flat for 2016 and about unchanged from November 2014 levels. Bonds have had a significant move up, with the 10 year treasury yield having fallen to just over 1.55% from 2.17% at the beginning of 2016.

The British vote is the first step in a disengagement process. The next step likely will be the appointment of a new prime minister. Once the British government gives the EU formal notice of its decision to exit, the two sides will have a two-year period (which can be extended) to negotiate the exact political and economic terms.

Britain is the fifth largest economy in the world and the EU is roughly tied with the U.S. as the world's largest. Given at least two-plus years before Britain leaves, we believe the biggest near term negative economic impacts will be: 1) businesses becoming more cautious (reducing investment) due to uncertainty over the exact impact and 2) currency movements affecting trade flows and the competitiveness of different countries' products/services across the world.

Beyond economics, Brexit is a clear sign of the general dissatisfaction of large portions of populations in developed countries that have not participated in the benefits of globalization. Bernie Sanders and Donald Trump in the U.S. and the increasing influence of nationalist parties in Europe are similar signs. Immigration was a significant issue in the Brexit vote and is likely to remain front and center for the foreseeable future.

We have no special insight into what happens next. Even before Brexit, we'd been feeling uneasy about the Fed's recent admission (our perception) that they don't have a better handle on the future of the U.S. economy than anyone else and that slow growth, at best, may be the new normal. Britain's exit and the possibility of nationalistic policies increasing in other countries can't be positive for world economic growth.

Investments. Moving away from today's emotional market, the key for stocks in our opinion will be how the U.S. and other important economies fare over the next few years. We're not economists, but even before Brexit we didn't see a path to near-term, consistently strong growth. Without economic growth it becomes increasingly difficult for companies to increase earnings and without earnings growth (absent further multiple expansion) stocks will have a tough time appreciating.

Our clients who have what we call "diversified" portfolios – some combination of fixed income and stocks – had their fixed income investments appreciate Friday. With respect to fixed income, we've focused largely on shorter duration investment grade bond funds, but longer duration bonds have been the standouts in 2016 with the significant decline in rates. We'd have a tough time committing to longer duration bonds at current levels.

Stock holdings across diversified and equity-only portfolios went down today in what was a day of nearly indiscriminant selling. The stock sectors that did best were those that are perceived to benefit from lower interest rates (utilities).

Most equity-only portfolios hold a combination of indexed exchange traded funds (ETFs, baskets of stocks that track a specific index) and actively managed mutual funds where a manager is picking stocks he/she believes will do well over the long term. For some clients we also hold individual stocks.

In addition to ETFs that track broad market indices (the S&P 500, small cap stocks) we hold sector ETFs focused on consumer staples, healthcare and high dividend paying stocks. We expect staples and high dividend payers to do relatively better in down markets. 2016 has been a tough year for healthcare, but downside protection also has been a reason for holding the healthcare ETF – plus we believe innovative healthcare products will be a higher growth area longer term.

With respect to the four actively managed, U.S. focused mutual funds that are significant positions for many clients, each of the fund managers focuses on higher quality businesses that tend to have strong financial characteristics and the ability to withstand tough economies. These types of stocks will go down in a broad market downturn but we believe they'll come out stronger on the other side. We've spent a long time vetting these particular funds and are confident in their strategies and prospects.

The foregoing is really our way of saying: 1) stock market declines are unpleasant – but normal and part of investing, and 2) we believe in what we own and are not planning on making changes based on what's currently happening in markets.

Please don't hesitate to get in touch if you have questions or thoughts you'd like to share.