KALOS *Market Commentary*

July, 2016 (Brexit)

Focus Shifts to Largely Unchanged Fundamentals as Fear Subsides After Brexit

Following the United Kingdom's vote to leave the European Union (Brexit), surprise and uncertainty drove global markets down sharply, with some markets declining more than 10%. Yet within a matter of days, most of the same markets recovered a large percentage of their losses, and within a week, many markets, including the FTSE 100, an index composed of the 100 largest companies on the London Stock Exchange were trading above their values lodged the day before the vote.

Still, the British economy will take a hit. Loss of confidence in the UK by investors and governments, particularly in Europe, will impact countless plans and negotiations ranging from trade to hiring to capital investment. Ratings agency Standard & Poor's stripped Britain of its highest level AAA credit by lowering it two levels. The move will increase Britain's borrowing costs and various other financing costs.

Ongoing uncertainty will adversely impact England's attractiveness as an English speaking gateway into Europe. The fragile European recovery will need to cope with an unexpected new challenge. And, the uncertainty will continue because the vote itself does nothing other than signal the UK's intention to leave the EU. The two-year exit process doesn't even start until Britain officially notifies the EU via Article 50 of the Lisbon treaty, a process they are purposely delaying.

Yet, as markets seemed to have quickly ascertained, all the changes and excitement probably will not inflict the pain originally feared. In the US, growth may slow a tenth or two over the next year and half, but underlying economic conditions remain unchanged and talks of recession seem vastly overblown. Uncertainty will likely cause US companies to delay or scale back capital spending and a stronger dollar will likely hurt total exports a bit. But, our total UK exports account for only 0.3% of U.S. GDP. While a weaker EU isn't great news for anyone, the U.S. has not been boosted by a strong EU economy for some time. All the uncertainty will likely keep interest rates lower for longer, helping various US economic sectors, and the US should again benefit from becoming more attractive as a safe haven.

Even in Europe, Brexit should not create a recession this year, although odds likely increase for 2017. We believe economies will adjust as the initial shock continues to wear off. Key for both Europe and the UK will be their ability to reach common ground that both discourages future exit campaigns while not injuring trade to the detriment of both sides. EU leaders will be tempted to punish the UK, yet overly stringent restrictions could hurt the remaining 27 countries as much or more than the stronger and more globally diverse UK. The break-up also creates ample opportunity for much needed reform which could benefit all of the EU. There is risk that countries threaten, or even hold, similar referendums. But, even if this happens, it will unfold over months and years, and should remain more of a sideshow than a fundamental economic driver.

Beyond Europe, we see no chance of a global recession. China's growth remains above 6%, and the already mentioned US economy should trudge forward steadily. Most emerging markets that already enjoy stronger growth than Europe should remain relatively unaffected.

Looking beyond Brexit, within the US, economic growth slowed in the first quarter but not as sharply as previously estimated, and there are signs of a pickup in the second quarter. Rising retail and home sales in April and May has helped the economy regain momentum.

Jobs growth remains solid, although monthly employment growth will likely begin to slow with fewer people looking for jobs. Sustaining 200,000 new jobs a month indefinitely isn't possible given our current population growth. Normally, 150,000 new jobs are created by a healthy economy, and the number of Americans filing for jobless benefits in early June remains consistent with solid employment growth.

Housing continues to buoy the economy. The National Association of Home Builders housing market index rose to a seasonally adjusted level of 60 in June, up from 58 in May. A reading of 60 is quite high given that any measure over 50 generally means most builders see conditions in the single-family housing market as positive.

Consumers continue to shore up their personal balance sheets which not only helps current levels of confidence, it also bodes well for future spending. The percentage of Americans with "subprime" credit scores declined to 20.7% in April, the lowest level since 2005 when Fair Isaac Corp (FICO) started tracking the data. Improved credit scores could also boost bank lending and as a result, the overall economy. The decline marked the sixth consecutive year of year-over-year decline.

The protracted slide in industrial metals prices may finally be ending. Prices of iron ore, copper, aluminum and other base metals have been declining for years because of oversupply and concerns about slowing demand in China, the biggest consumer of most metals. While prices probably will not start moving up permanently for another year or two because of continuing high supplies, a few metals such as zinc, lithium and palladium could buck the trend because of specialized applications resulting in tight supply. Price stabilization and eventual increases will help countries with big mining sectors such as Canada, Australia and South Africa.

In all the excitement over Brexit, **the long awaited opening of the larger Panama Canal** on Sunday, June 26th was mostly ignored. The culmination of the 9-year project enables the Canal to handle much larger ships and increases total capacity. Its opening should add to global growth with the US receiving a disproportionately large percentage of the benefit. Long-term, this is probably a more meaningful development for the U.S. economy than Brexit.

After the so-called "fear trade" rose markedly after the Brexit vote, markets appear to have rapidly settled. Now, as always, investors are likely to be rewarded by focusing on their personal investment objectives while resisting the human urge to make long-term portfolio decisions based on short-term market movements.

We wish you a great Fourth of July!

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