KALOS *Market Commentary*

June 2016 (Brexit)

Perspective on the United Kingdom's Exit from the European Union

Yesterday, United Kingdom voters shocked the world by voting to leave the European Union. While the vote was projected to be close, the "Remain" vote had been in the lead for nearly all the election run-up, and various polls projected voters to affirm their ongoing membership in the EU. Today (Friday, 6/24/2016), after the surprising "Leave" outcome, global markets are down sharply, and the pound sterling has plummeted against both the euro and the U.S. dollar, reaching a low against the dollar last seen in 1985.

Much of the reason for the sharp moves derives from the vote's unexpected outcome. The day of the vote, global markets were nearly all up sharply in anticipation of a "Remain" vote, so some of Friday's losses are simply erasing recent gains. Once the shock of the event is over, we believe markets will quickly calm down, particularly as investors have more time to understand the new circumstances.

U.K. voters were asked a very simple question. *"Should the United Kingdom remain a member of the European Union or leave the European Union?"* Those arguing for Britain to leave the EU – "Brexit"– had argued that the U.K. would benefit by ridding itself of burdensome and costly EU regulations. Furthermore, much was made of the potential for Britain to restrict immigrants from entering the country. Brexit opponents warned that abandoning the EU would damage the U.K. economy through limiting trade and voiding various agreements that enable free flow of people and capital in the 28-nation union.

Today, many investors seem to be assuming a more immediate and dire outcome for the vote than is likely. The vote in favor of Brexit isn't a simple decision to leave the EU, but rather the start of a two-year process of negotiations about what Britain's new relationship with the EU will become. In the meantime, trade between the EU and the UK, Europe's second largest economy, will continue.

A bigger question in front of markets is the implication that Brexit will have on the future of the European Union. Political movements in other countries have raised similar "Leave" proposals, and they will likely be emboldened by the success of the Brexit campaign. As a worst case, the market appears to be further interpreting this event as perhaps the beginning of the end for the European Union. While this seems highly unlikely, even if it were to happen, it would take years to unfold. If the EU were to disintegrate, it's likely that many of the advantages of the more integrated trade bloc would remain while many of the inherent disadvantages would be more successfully addressed. The process would be messy, but it could be positive rather than negative.

Brexit also has the potential to propel the EU towards a greater and more functional political and fiscal union. The exit of a major player in the Union could be the catalyst for change needed to spur improvements in various economic and governmental structures that impact the remaining 27-member bloc.

For Britain, their immediate future may be a bit messy, but because they have their own currency, many adjustments to spur growth and make other macro adjustments to their economy will be facilitated by a depreciation of the British pound. Britain will also be helped by the international nature of its economy, which is one of the most globally diversified in the world. Within the MSCI Europe index, almost 50% of revenues are from outside of the Europe, and within the UK FTSE 100, the percentage is even higher.

Nearer-term, as of this writing (Friday, June 24, 2016), most U.S. indices are down around 3-4%, while European indices are down around 6-8%. Stocks may continue to go down on Monday after investors spend the weekend mulling possibilities, or a better assessment of the situation may propel markets back up.

Regardless, some perspective may help. In the U.S., pullbacks falling within the 5%-20% range – of which there have been 103 since 12/31/1945 – historically experience recovery periods of one to three months.[i] While we're not at this level, we could be soon, and Europe is almost uniformly experiencing losses greater than 5%. In general, pullbacks of this type are not typically associated with severe economic deterioration, and have usually punished investors who reduce their equity exposure.

Often times, these types of pullbacks offer an attractive buying opportunity for some portfolios. It is our opinion that the Brexit change, which will unfold over an extended time, seems unlikely to have the lasting dire impact on markets that appears to be assumed today. Once the shock of the change is absorbed, investor fear should subside, and attention again turns toward fundamental creators of value which remain effectively unchanged.

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[i] Source: Ned Davis Research, Inc

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