INVESTMENT HIGHLIGHTS

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BRITISH INDEPENDENCE DAY

British citizens voted 52-48 in a referendum to *Leave* the European Union (EU) after over 40 years. It is a remarkable decision worth taking the time to understand why U.K. voters decided to exit. Membership in the EU Common Market no longer served their best interests. This decision takes a few years to implement, thus has little near-term economic impact, aside from undercutting confidence. Indeed, our outlook is quite the opposite of apocalyptic economic predictions of those that prefer to maintain the EU's status quo and collective government control.

The referendum reflects increased dissatisfaction with misguided, dysfunctional, overreaching, and costly EU bureaucracy. Uneconomic regulation has depressed productivity and potential growth, limiting economic development. Failing to address needed fiscal and labor reform has deepened economic stagnation since the sovereign debt crisis of 2012. Overreliance on ECB monetary stimulus since has been ineffective bolstering growth. Voters identified with several issues, namely: (1) restore economic productivity, (2) reassert sovereignty, and (3) reverse political deterioration. These issues reflect global anxiety of underperforming economic potential evident in rising reform-minded nationalist, independent, and libertarian challengers.

Our outlook related to this decision is distinct from consensus—we are more constructive on British and global economic growth. Falling equity prices, lower bond yields, stronger yen, and higher gold should reverse upon greater reflection. Economic productivity has declined with burdensome EU regulation and laws. Rising nationalism to reassert sovereignty and individual rights intensified with malfunctioning financial institutions (IMF, World Bank, ECB), deficient trade agreements, unrestricted immigration, and security/defense organizations (i.e., NATO, European Defense Agency, United Nations). The Middle East immigration crisis was simply the straw that broke the camel's back. The third issue was loss of confidence and trust in political leadership. Decay in imprudent legislation, ethical behavior, abuse of power, and self-dealing have led to declining political favourability. After the Financial Crisis, the financial sector was targeted by levying fines, judgements, and punitive regulation rather than accept any responsibility of regulators failing to enforce existing regulations and laws. Reforms have reduced liquidity and increased costs, passed on to consumers.

Despite many opinions inked in the last two weeks, few expected British voters to decide to leave the EU. Investors were surprised and unprepared for this unexpected outcome. Bookies were taking bets at 90% odds of remaining up until voting closed. Polls were skewed similarly. Probability of more Independence referendums has now shifted from unlikely to inevitable, particularly for countries with rising Euro-skeptic nationalistic parties. Denmark, Sweden, Austria, Italy, and the Netherlands come to mind. Germany and France have upcoming 2017 elections that may motivate referendums if politically expedient. Applications for new members to join the EU, including Turkey, will likely be put on hold.

Market and Economic Conclusions:

- Uncertainty marginally reduces global economic growth estimates in 2016, yet most adversely impacting growth in "left behind" Eurozone
- U.K. debt downgrade fears flawed with fiscal deficit of 4.4% and better growth than most EU members
- Shorten global bond duration further, favor floating rate and credit exposures
- Rotate into greater cyclical exposure, and increase equity exposure below 2016 S&P500 target of 2150.
- Delay Federal Reserve hike to October, expect two ¼% hikes instead of three, but potential for Bank of England to follow on their heels as stability returns.
- British pound was unattractive and not much upside for U.K. equities headed into the vote according to our tactical return forecasts—narrow underweights
- Avoid safe havens, low volatility, high dividend yield, global bonds, Japanese yen, and particularly gold

Economic Considerations

The decision to leave the EU can bolster potential growth over the next decade when the U.K is unshackled from uncompetitive regulation and misguided policies. Those remaining in the EU will experience further weakening of competiveness and productivity. It isn't difficult to see the benefit of regaining greater sovereign control over British laws, regulation, immigration, defense, and indirectly even fiscal policy. Eliminating EU membership expense and indirect household costs provides a fiscal boost. We were sympathetic to Britain leaving the EU given likely economic benefits and increased independence. Imagine the impact of a shining new beacon for democracy, free markets, and economic productivity.

Economic uncertainty may slow U.K. foreign direct investment in 2016, but financial service exports are unlikely to be affected much. Downgrading growth based on sentiment concerns is a spurious rationale. Currency devaluation increases export competitiveness and positive earnings translation. It may take a few quarters to ensure economic stability, but this volatility will soon pass and forward looking investors will see the wisdom of this decision. Better potential growth should attract greater investment in the long run.

Multi-lateral trade agreements are inefficient---simply, "too many cooks" compromise the soup. It is intuitive that multi-lateral agreements, such as NAFTA, are flawed given incompatibilities between dissimilar countries. Canada, Mexico, and the United States have different needs, industrial composition, and economic drivers. Large countries such as the U.S. and the U.K. should prioritize bi-lateral trade agreements and fast-track others that accept similar terms. Unnatural groupings have compromised trade agreements, and thus undermined public opinion about free trade. Groupings of similar countries would be more manageable than complex attempts like the Trans-Pacific Partnership. Japan, India Korea, and China should only be dealt with bi-laterally.

Free trade bolsters innovation and competition leading to better products, economic development, new markets, productivity, and prosperity. The ubiquitous principle of *comparative advantage* provides that goods and services must be produced in the most productive way. As the U.K. resets its terms of trade, it will have a unique opportunity to seek rational agreements among natural groupings. The idea the President would send an orphaned U.K. to the "back of the queue" is insulting and immature. A U.S.-U.K. trade agreement is desirable and can be done in parallel with other deals.

Foreign investment may stall for a few quarters, but the U.K. should benefit from improved potential growth with greater competitiveness and reduced regulatory overhead. Companies may seek to move to the U.K. to evade EU regulatory burdens. Discarding a 40-year multilateral treaty is not without consequences, but long-term benefits of increased fiscal control, economic productivity, and sovereignty outweigh the transitional costs plus reputed advantages of a common market. Starting from scratch, the potential for improved terms of trade should be constructive for the U.K.

The Bank of England should not need to ease monetary conditions as bond yields plunged and the currency weakened, but the central bank will express its willingness to act if liquidity is needed. Real growth of 1.5-2.5% should continue with inflation rising from 0% to 1.5% this year. Economic stability and devalued currency provide an opportunity for the central bank to follow the Federal Reserve's lead normalizing interest rates. Our conviction in several broad themes remains steadfast, including the need for normalizing interest rates and global asynchronous expansion. The U.S. should still lead the world in hiking interest rates at least twice this year, and now the U.K. can follow suit.

London, Frankfurt, and Amsterdam stock exchange volumes are unlikely to change much as a result of EU exit. A pending Deutsche Bourse-London Stock Exchange merger is likely more consequential than whether Britain is in the EU. Relative exchange volumes take years to evolve, but recent exchange mergers and new products, such as ETFs, had an impact. Investors are shrewd about differentiating fair markets---the approval of IEX exposed deficiencies in fair dealing on American exchanges. Tax and regulatory policies have the greatest impact on investor preferences, not common market or monetary union membership. Attempts to impose financial transaction taxes are a bad idea. Competition between Frankfurt and London has hinged on this issue, thus independence gives London an advantage if the EU continues to pursue this ill-advised idea. Incentive compensation is another EU regulatory anomaly that London can retake advantage. Relative decline of commercial and investment bank stocks seems unwarranted and assumes unlikely shifts in volume or naïve understanding of financial services.

Geopolitical Response

Voters are frustrated and concerned about their future, thus are holding elected officials to higher standards. Uncontrolled immigration, soaring fiscal deficits, rising debt burdens, corruption, self-dealing, deteriorating national security, and yet still weak economic growth contribute to resurging nationalism. No political incumbent is safe. Job loss attributed to outsourcing is blamed on compromised trade agreements, but protectionism fails to acknowledge persistent forces of innovation-driven creative destruction needed to drive productivity. Labor intensive production shifted to lower wage countries, but now smart automation is closing the labor intensity gap, driving manufacturing onshore. Shifting worker skill needs is now limiting job growth.

Britain's PM David Cameron tendered his resignation, recognizing that stumping for *Remain* weakened his ability to execute Article 50 of the Treaty on European Union governing EU withdrawal. The Conservative Party still has two years before calling an election due to the Fixed-term Parliaments Act, so a new Prime Minister will be chosen to manage an orderly transition to Independence. Times like this remind us of the rise of Thatcherism and Libertarianism during 1975-1990. The world will watch Britain declare Independence from an unaccountable EU regime that has increasingly failed its constituents.

Scotland voted to *Remain* on the heels of their own referendum in 2014, but they may come to realize Independence from the EU is a better deal than from England. After voting 62% for *Remain*, the decision could increase effort to call another vote, but Scotland simply doesn't have the ability or resources to govern independently. Northern Ireland also voted to *Remain,* so this could increase desire to reunify Ireland.

NATO has been neglected with focus on an ineffective European Defense Agency (EDA). Stitching together $220 billion/year spent by 28 countries with different priorities has left Europe exposed and defenseless, if not reliant on the U.S. Free from the EU, Britain could help revitalize NATO, adapting to evolving threats in partnership with the U.S. It is rational given ISIS emerged unchallenged over the last four years. While spending 1/3rd of the U.S. defense budget, EU nations can only muster 15% of comparative operational defense capability, and unable to deter rising terrorism.

U.K. voters rejected EU collective control to reassert sovereignty, free market capitalism, and individual liberty that will restore economic productivity. Social democratic politicians must recognize that their political and economic beliefs supporting state intervention, increased welfare, and social justice is failing again. We have reached a global tipping point and investors should be more pragmatic about understanding logical economic consequences of geopolitical issues. How many times must we take the wrong road ignoring empirical history? The U.K. should be better off over the next decade than it was in the EU.

Final Thoughts

Britain has decided to take back sovereign control and rejected EU central planning over basic civil rights, democratic freedom, liberty, and self-determination. The people declared their independence in reasserting sovereign control over British laws, regulation, defense, and immigration. Britain may be the first of several countries to leave the EU and risk of dissolving the EU has never been greater. *Remain* support increased with fears of turmoil and uncertainty, although many also embraced the critical issues of restoring economic productivity, reasserting sovereignty and reversing deterioration of political leadership. Independence should encourage EU reform, but an entrenched EU mindset has turned its back on the U.K.

Economic and currency uncertainty may persist until new agreements begin to fall into place, but starting from scratch may be better than fixing what is broken. Realistically, not much will change for businesses and household is expected for at least a year, except planning for this monumental undertaking. Concerns about destabilizing growth or increasing risk of a global recession are mistaken and unfounded—we failed to uncover a rational explanation for faltering growth, other than fear of the unknown. Politicians that dismiss this vote as unique risk further Independence Days. In the weeks ahead, the European Parliament and Council of the European Union must assess how to reform itself and its policies. To survive, it will need to radically change to better serve the common market.

Uncertainty combined with thinly traded summer markets inevitably results in market volatility, but broad global market impact should be transitory. Global fiscal and monetary divergences will drive economic and capital market divergences, increasing tactical opportunities and international diversification. Uncertainty will eventually moderate with selling of expensive safe havens (i.e., gold, bonds, U.S. dollar & Yen) and buying cheaper cyclical investments. Challenges to confidence are predictable and typically misguided---sell cyclicals and financial services, while buying defensives and safe havens. Thus, sentiment driven dislocations typically correct over a few weeks. We were particularly surprised by Japanese yen appreciation versus the U.S. dollar given its reliance on strong global growth and unsustainable debt.

Shifting geoeconomic assumptions require investors to reset economic assumptions. Reversing progressively infectious social democracy restores advantages of free markets, virtuous trade, liberty, and capitalism. Improved competitiveness and productivity restore natural potential growth. Geopolitical change provides opportunities for disciplined tactical views. Countries still matter at a time of greater economic dispersion and increasing international diversification. In this case, boring is good, but sometimes change is better!