CM's Perspective on the Brexit Vote

After months of headlines about the so-called Brexit vote, last Thursday, June 23, the United Kingdom ("UK") voted 52% to 48% to leave the European Union ("EU"). The issues fueling the frustration and unhappiness of so many British citizens with the previous status quo are three-fold:

1. For many in the UK, the lack of self-governance or the ability to change the decisions by the governing body of the EU was frustrating. It was like being ruled by a foreign power immune to the normal political process.
2. Through its tariffs, laws, and treaties, the EU, in many instances, is highly protectionist. This often results in higher prices for consumers, as well as less competitive businesses on the world stage. The "leave" vote highlights the UK's interest in free trade with the rest of the world and, if possible, with the EU.
3. They lack control over immigration from its 27 close neighbors, not to mention the refugees the EU is trying to allocate to its member states. While championing the benefits of sensible immigration, many British citizens have been upset with the strong-armed migration policies being mandated by the EU.

The UK's departure from the EU will likely take years to facilitate, which means most of the process should be slow and fairly transparent. However, Britain's biggest EU trade partners sell more goods and services to the UK than they buy, so they will likely do what they can to expedite a free-trade agreement between Brussels and London.

The UK, unlike other core EU members, has retained strong financial autonomy in two very important ways even after joining the EU. First, it has continued to maintain its own currency, the British Pound. Second, it has its own central bank, the Bank of England, which, like the U.S. Federal Reserve, is officially responsible for maintaining price stability. Importantly, this means that the UK has the power to act as a lender of last resort by extending credit when no other institution will. This is not true of other core EU members, making it considerably more challenging and financially difficult for other members to leave the EU.

With that said, in the short run, the uncertainty of what happens to the growth rate and finances of the EU and UK economies could weigh on various stock markets, bringing with it increased volatility. We believe this uncertainty was the catalyst behind the $56 rise (a 4.4% increase) in the price of gold on Friday. Gold closed at $1,319 per ounce, though it reached an inner-day high of $1,362. Our portfolio's allocation to gold mining companies was a direct beneficiary of this move in the price of gold.

We believe a meaningful part of Friday's selling pressure, which led to a 3% to 4% decline in U.S. markets, was greatly influenced by large hedge funds and institutional investors that had made oversized bets that the UK would vote to remain part of the EU and that the British Pound would rise. When this did not happen, many of these bets, which were implemented over days and in some cases weeks, were then reversed in short order. This added further downward pressure on markets Friday and could continue over the next few days or so.

For the U.S. economy, we believe the largest impact of the UK leaving the EU, at least in the short run, is the strengthening of the U.S. dollar. An increase in the value of the U.S. dollar could lead to tighter financial conditions, though we don't believe this will be enough to push the U.S. into a recession.

For those concerned that the UK exit from the EU will slow the U.S. economy due to a potential decrease in U.S. exports, here, too, we see no cause for alarm. The good thing about the American economy is that it is fairly self-contained. The chart below highlights that according to the Bureau of Economic Analysis, at the end of 2015, total U.S exports of goods

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and services to the entire world was $2.26 trillion, or just 12.6% of the total U.S. GDP. As for the 28 countries that made up the European Union (prior to the UK leave vote), collectively they represented 22.1% of total U.S. exports but just 2.8% of U.S. GDP. And taking a closer look at the UK by itself, it represented only 5.5% of total U.S. exports and just 0.7% of U.S GDP. All told, exports to these countries represent a very small part of total U.S. GDP.

Taking this one step further, when you consider that total U.S. GDP is currently growing roughly between 2% and 2.25%, even a 10% decline in exports to the EU, which we believe would be huge, would only reduce U.S. GDP by 0.28%. And a 50% decline in exports to the UK would only reduce U.S. GDP by 0.35%. Even if we hypothetically eliminated all U.S. exports to the UK, it would only reduce U.S. GDP by 0.7%. Therefore, even if these extreme export reductions did occur, by themselves we do not see them putting the U.S. into a recession or having any material lasting effects on the U.S. economy, especially if we look out over any reasonable period of time.

	U.S. Exports of Goods and Services To:	Year 2015 Totals	Percent of Total U.S. Exports	Percent of Total U.S. GDP
-	The World	$2,261,163,000,000	100.0%	12.6%
-	European Union (EU)	$500,734,000,000	22.1%	2.8%
1	Canada	$337,765,000,000	14.9%	1.9%
2	Mexico	$267,337,000,000	11.8%	1.5%
3	China	$165,145,000,000	7.3%	0.9%
4	**United Kingdom (UK)**	**$123,462,000,000**	**5.5%**	**0.7%**
5	Japan	$108,315,000,000	4.8%	0.6%
6	Germany	$79,821,000,000	3.5%	0.4%
7	Korea, South	$64,907,000,000	2.9%	0.4%
8	Brazil	$59,654,000,000	2.6%	0.3%
9	France	$50,063,000,000	2.2%	0.3%
10	Hong Kong	$47,786,000,000	2.1%	0.3%
11	Singapore	$42,581,000,000	1.9%	0.2%
12	India	$39,684,000,000	1.8%	0.2%
13	Taiwan	$38,334,000,000	1.7%	0.2%
14	Saudi Arabia	$29,628,000,000	1.3%	0.2%
15	Italy	$25,389,000,000	1.1%	0.1%

Source: Bureau of Economic Analysis: Department of Commerce June 3, 2016 tables. Export data and U.S. GDP data are year ended 2015.

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What we do believe is that the Fed, as we have said for the last several years, will continue to have a hard time raising interest rates. While it has been trying to normalize rates in earnest for some time, continued mixed results from various data points in the U.S. economy, along with another potential tightening of financial conditions brought upon by the Brexit vote, will continue making this difficult to do.

The market does not see interest rates going up anytime soon either. As of Friday, June 24, according to Bloomberg, the futures markets are no longer pricing in any rate hikes in 2016 or 2017, though many economists still see the possibility of a rate hike in December. As a point of interest, on Friday morning, the futures markets were actually pricing in a 19% possibility of a rate cut before year-end.

While the uncertainty from the surprise outcome of the Brexit vote has rallied the U.S. dollar, we believe this will be relatively short-lived as the Fed will likely be forced to continue its easy monetary policy. We see this as bullish for commodities such as gold, oil and other hard assets over the long run, all of which are strongly represented in our current CM portfolios.

Thank you for your continued trust and confidence.

Arnold Van Den Berg,
Founder, Portfolio Manager

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Disclosures

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