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INVESTMENT ADVISERS, Ltd.

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Perspective

Brexit

June 16, 2016

"…this blessed plot, this earth, this realm,…this England."
-- *William Shakespeare,*
"Richard II"

A key vote is looming. Next Thursday, June 23, the citizens of Shakespeare's blessed plot, as well as the citizens of Scotland, Wales, and Northern Ireland, will vote on whether or not to remain in the European Union (EU). "Brexit," as the issue has come to be known, has worldwide economic implications, although more so for Europe than elsewhere. What exactly are those implications? We will get to those in a moment, but first, a little more background…

The UK has been a member of the EU and its predecessor, the Common Market, since 1973. Those who want to leave the EU argue that the scope of that membership has widened uncomfortably to a variety of cultural, judicial, and other areas far beyond the original economic-only scope of the Common Market. Those who want to stay, on the other hand, argue that going it alone involves sacrificing certain economic benefits, as well as a measure of security and global influence. It is important to note that, unlike the Greek dramas of 2011 and 2012, leaving the EU does not involve abandoning the euro. Long ago, the UK chose not to join the common currency movement, and instead, the pound sterling has remained and will continue to remain the coin of the realm.

Seems simple, doesn't it? As an honest, tax-paying homeowner, do I want to join the neighborhood association or not? Well, unfortunately, this one is not so simple. The complexities, most of which would have to be renegotiated if the UK leaves the EU, involve labor rules, trade agreements, immigration, and a host of financial transactions. And then, there are the uncertain and the unknown. If the UK leaves (and more important, a path and a precedent are established), how about those so-called peripheral EU countries like Portugal, Italy, the aforementioned Greece, etc.? Not only would other potential defections harm the EU, they also would put downward pressure on the euro, to go along with the already-downward pressure on the pound sterling. Which brings us to the fact that a large part of the Brexit issue has to do with currencies.

Currencies? Yes, and interest rates. The financial markets hate uncertainty, as everyone knows, so the Brexit drama is creating a great deal of demand for good ol' government debt, perceived to be the safest of all asset classes. At the same time, the European Central Bank is doing its best to get these economies out of the sluggish growth rut by buying bonds in the open market. In other words, bond demand-squared, which actually has caused the yield on the German 10-year note, the bund, to go into <u>negative</u> territory. That's right, the buyer of German government debt is loaning the German government money for a 10-year term, and is <u>paying</u> for the privilege of doing so.

There was a reason why Washington cautioned his fellow citizens to avoid European entanglements. As usual, complexities abound, but oddly, we (the U.S.) are not in our customary spot at the heart of the matter. Make no mistake, though, a Brexit "yes" vote and (maybe) subsequent EU problems will have an impact over here. First and foremost, the Fed has its own "go-it-alone" agenda in mind, i.e., getting short-term interest rates back on track. And, by all accounts, the U.S. economy is ready for some movement in that direction. But, raising interest rates here while yields everywhere else are rock-bottom (even below rock-bottom!) means that the dollar appreciates and we are less competitive on the world stage. That's why the Fed declined to raise rates yesterday, and, to a large extent, remains trapped between a rock and a hard place.

What to do? Stay very well-diversified, and that certainly includes the TPM portfolio positions in intermediate-term Treasury notes and gold. The former, while among the most overvalued of all asset classes (but, an absolute steal relative to <u>German</u> bonds!), actually will continue to do well if the Brexit fans win; and, gold will continue its 2016 winning ways (+21%) if the currency wars heat up, with or without that Brexit win. Short-term, the financial markets want some clarity, and there likely will be dislocations until the effects of a Brexit (if it comes to pass) become a little clearer. Longer-term, the performance of the financial markets – at least those in the U.S. – should be more reflective of an economy that may not be tearing up the track, but one that slowly but surely is gathering steam.

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In the annals of English/British history, June 23, 2016 may not be October 14, 1066 (Hastings), or June 15, 1215 (Magna Carta), or August 22, 1485 (Bosworth Field), or May 10, 1940 (Churchill!), but the Brexit vote will be closely monitored by all. Our view is that whatever happens next week, however, will remain a short- to intermediate-term phenomenon.

Your thoughts and questions always are welcome.

Best regards,
Doug, Jeff, and Lindsay