



OUR VIEW



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Brexit Update--Britain to Exit the European Union

Voting Results and Political Implications

Britain's vote to exit the European Union (EU) may end an era of expanding European integration, creating ripple effects felt throughout the world. After the vote, Prime Minister David Cameron announced that he will resign by October, though his resignation could come sooner. The stage is set for the Conservative party to hold a summer leadership election to select a successor to Cameron, with former London Mayor and Brexit supporter Boris Johnson the early favorite. The Brexit vote creates new uncertainty in Scotland, as Scottish First Minister Nicola Sturgeon opened the door for a possible second referendum on Scottish independence.

Vladimir Putin may be the most satisfied world leader after the Brexit vote, as the refugee crisis created in part by Russian military activity in Syria weakened already-fragile European unity. Immigration was a major issue in the Brexit vote—as concerns about EU rules that require free movement of people between member states may have been more important to voters than worries about the impact of leaving the common market in trade. JP Morgan's Stephanie Flanders called the voting result an “earthquake for the political elite in the UK.”

The vote will trigger the first exit in history from the European Union, but isn't legally binding until ratified by the British Parliament. The 2007 Treaty of Lisbon provides the constitutional basis for the EU, and provides for a two-year period for renegotiating trade and other agreements should a member depart. The “clock” starts once the UK formally notifies the EU of its departure plans. The negotiation process is likely to be contentious, as the EU will have incentive to “talk tough” in order to discourage other countries from following the UK. Interestingly, however, European politicians including Germany's Angela Merkel are pushing for early talks, while UK leaders are signaling that they want to take more time before starting negotiations. Given the fluid political situation and tensions within the Eurozone, the speed and tone of discussions may change direction in the coming days.

Investment Reaction and Implications

The UK's FTSE stock market index declined in its worst day since January, the British Pound fell sharply, and global equity markets dropped in sympathy. Markets had rallied sharply in the days preceding the vote, as polls and betting odds pointed to a narrow vote in favor of “Remain.” As votes were being counted and “Leave” became the clear winner, markets plunged. In context, however, the FTSE index is higher than it was at the February lows, and the pound is not far below the February lows. Market volatility is becoming an unfortunate fact of life in our muted growth environment.

Uncertainty is likely to continue for an extended period, as negotiations will take time and broader implications become more apparent. Brexit is a negative for the UK economy, but likely to have less impact for the Eurozone or the broader global economy. In addition, the UK departure from what is primarily a trade-oriented group may present less of an impact than a departure from a common currency such as the Euro.



More than 40% of the UK's exports are to EU countries, while only 15% of the EU's exports go to the UK. Trade volumes may not be disrupted in the near-term, but lack of clarity about longer-term trade pacts will present a major concern for investors. The UK "divorce" from the EU is likely to be messy, and creates risk of a protracted standoff that could delay needed structural reforms throughout Europe.

Analysts expect UK exporters to benefit from currency weakness, while UK importers are likely to face higher costs. Domestically-oriented businesses may suffer from depressed economic activity, and financial services companies that have used London as a gateway into the UK may decide to relocate or downsize their UK operations. Banks have been hit particularly hard in trading throughout Europe, perhaps an overreaction to the vote.

The impact of Brexit will be felt beyond the UK and the EU's headquarters in Brussels. The vote against European integration is likely to embolden critics of the European "experiment." Spain and Italy were among the stock markets that fell the most after the Brexit vote, falling in fear that they will be more likely to leave the euro.

Portfolio Implications

We think it likely that policymakers such as the Federal Reserve, Bank of England and the European Central Bank will take actions to provide liquidity to markets. Emotional reactions are common after an event like this, and markets often overreact before rebounding.

The UK represents approximately 7% percent of TFC's equity portfolios, or about 4% in the typical portfolio that includes 60% equities and 40% fixed income. The TFC investment team has had discussions about strategic portfolio changes, but wanted more definitive information rather than making a "bet" on an uncertain near-term outcome. Our view was that the outcome of the vote would be a binary one with longer-term economic implications--in that a vote in favor of remaining in the EU would reinforce our positive outlook for European equities, while a vote to leave would compromise that point of view. Given data leading up to the election that indicated better than 50% probability that Britain would vote to stay in the EU, we maintained our strategic positioning.

We will update you about changes and will continue to communicate about major developments in the markets.

Please do not hesitate to contact us or your TFC advisor with questions.

Regards,

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