Commentary – July 1, 2016

Until very late this past month I was struggling to write this quarter's commentary, as the interim was relatively quiet, with little market action noteworthy. Fortunately (for the purposes of this missive) on Thursday June 23rd citizens of the U.K. unexpectedly voted to depart the European Union and the capital markets reacted violently. The S&P 500 Index and the Dow Jones Industrial Average lost 3.6% and 3.4% respectively of their value on Friday, June 24rd and YTD gains were quickly erased. (NY Times Saturday June 25th 2016). Monday June 27th the carnage continued, and the two-day drop was 5.4% and 4.9% for the S&P 500 Index and DJIA, respectively. (NY Times Tuesday June 28th, 2016)

The European Union was formed after WW II to promote peace through economic cooperation. Over time it became a common market, allowing goods and people to move freely around 28 member states as if they were one country. Naturally some are quick to perceive Brexit (British exit) as a harbinger of sustained bad tidings, calling for equity losses not seen since 2008-09. Unlike 2008-09, Brexit is a political and not a financial crisis. The direct immediate economic impact to European GDP is small, with an estimated contraction of 1% prevalent. The U.K. is not going to remove itself from the global economy and stop trading with the rest of the world. The effect on the U.S. GDP is even lower. It is important to be aware that the U.S. stocks remain more insulated from global developments than any other major equity market, as American companies generate 70% of revenues domestically, which compares favorably with 58% of Japanese and 49% for European enterprises, based on a recent Morgan Stanley report. Nonetheless, Brexit is a strong threat to global growth. Slower growth, or even the fear of slower growth, means less borrowing for individuals and institutions alike. The end result will be lower interest rates, both in Europe and the U.S. The Brexit vote has all but eliminated any chance of an interest rate boost by the Federal Reserve this summer or fall, and probably for all of 2016.

The stock market hates uncertainty, and an event like Brexit creates great uncertainty among investors. How will Brexit affect the UK's access to the single EU market, as this represents nearly 50% of its exports? Will countries like Germany & France make the divorce painful to dissuade other EU members from considering this path? Other unknowns include the future composition of the European Union itself, the timing and spirit of the separation and the terms of the trade agreements that now must be negotiated between England and the EU and its member countries.

The term *uncertainty* has been used quite often this past week. An appreciation of uncertainty as it relates to investing is important during a period of market turbulence. Any time an individual puts money at risk for the chance of profit there is an inherent level of risk. When new threats to the status quo arise, the level of uncertainty increases. The "risk" element is riskier, and prices fall to reflect the enhanced uncertainty. A common stock represents a claim on a company's future earnings. Many companies typically predict sales and production trends for money managers, analysts and financial advisors to follow, assuming normal conditions. Only by having accurate information are these investment professionals then able to project future profits, and discount those earnings back to the present to determine a current valuation. If companies can no longer estimate with a degree of precision future profits due to an escalated element of uncertainty i.e. risk, stock prices will fall, because investors will not pay as much for earnings which are suspect.

The in-house experts employed by brokerage firms are expected to issue declarations intended to compel the ordinary investor to act in some fashion. A volatile market drives trading activity, an important source of revenue for these firms, while complacency is not propitious to the bottom line. Often the worst decisions are made on impulse with recent events extrapolated to the distant future. As of the close of trading on June 30th, the losses described at the start of this piece have been almost offset by the gains of the past three days. Having a sound investment strategy with a clearly defined risk tolerance level will help prevent an individual from making emotional decisions and selling amid weakness and the proclamations of doomsayers whose motives may not be what they seem.

I invite and encourage clients to contact me with questions and/or concerns and am available to meet at your convenience.