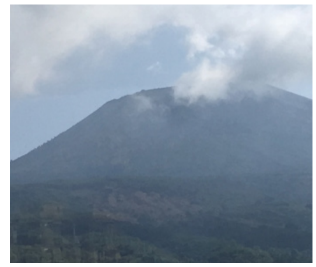
Brexit Was No Mount Vesuvius

Written by Drew M. Schneller, CFA, Portfolio Manager



Located in the Gulf of Naples, Italy, Mount Vesuvius is the only active volcano in mainland Europe and has produced some of the continent's largest volcanic eruptions. Vesuvius is most famous for the 79 AD eruption which destroyed the Roman cities of Pompeii and Herculaneum. Vesuvius' last eruption came in 1944. Volcanologists suggest that another eruption is not a matter of if but when; in other words, an eruption is overdue. For that reason, the Vesuvius Observatory monitors seismic activity, gas emissions and other indicators 24 hours a day to know at the earliest point when it may blow.

In June, an eruption of sorts took place as the result of the U.K.'s referendum to exit the European Union (EU) became clear that the so-called Brexit vote would favor "Leave" versus "Remain". By a final margin of 52% to 48% the outcome caught pundits by surprise as the polls just prior to the vote had begun trending in favor of the U.K. remaining in the EU. The financial markets had taken their cue from the polls with stock indices moving higher in the days leading up to the vote. The day after the vote, financial markets did an about-face. Over the next few days stock indices fell by as much as 6%, the British pound fell to its lowest level in 30 years, the U.S. 10-year Treasury note yield fell to 1.56% and gold rose 5%. By the end of the month stocks had recovered somewhat and volatility fell to below Brexit levels. Interestingly, the U.K. stock index FTSE 100 ended the 2nd quarter higher than at its pre Brexit vote level, revealing just how important the market perceives a weak currency.

Even before the Brexit vote, the market had plenty to digest. As the year began, expectations were raised by the Federal Reserve that perhaps four rate hikes were coming in 2016. Although the market was baking in only two rate hikes, there was downward pressure on risk assets, particularly emerging markets equities which fell 12% in the first few weeks of the year. Then, a series of economic data points that suggested the U.S. economy was stalling lowered expectations of an early move by the Fed. This pushed down the dollar and interest rates and pushed up risk assets. By the end

Index	Q1 2016	H1 2016
S&P 500	1.3%	3.8%
MSCI EAFE	-2.9%	-4.0%
Euro Stoxx 50	-8.8%	-10.8%
Nikkei 225	-11.2%	-17.4%
MSCI Emerging Markets	5.7%	6.5%
WTI Crude Oil	3.5%	30.5%
Gold	16.1%	24.6%
U.S. Aggregate Bond Index	3.0%	5.3%
U.S. Dollar	-4.1%	1.7%

source: Bloomberg

of the first quarter U.S. stocks were back in positive territory for the year and emerging market stocks were outperforming developed market stocks. Commodity prices began to rally as the U.S. dollar weakened. Non-U. S. developed market stocks continued to struggle because much of the global economy, particularly in Europe and Asia, remained sluggish. In the second quarter many of the first quarter trends continued, as U.S. and emerging market stocks and commodities rose and non-U.S. developed market stocks and interest rates fell. Only the U.S. dollar reversed course, rising on both its safe haven status and better economic data in the U.S.

The U.S. economy seems to be resuming its slow but steady growth path of the past few years. Housing continues to be a source of strength; in June, housing starts increased 4.8%.

Sales of existing homes also rose 1.1% to their highest level since February 2007, according to State Street Global Advisors. Given both the below average monthly supply of homes available and ultra-low mortgage rates, it's likely the housing sector will continue to provide a tailwind to the U.S. economy. Meanwhile, employment appears to have steadied after a brief scare in May. Unemployment claims are hovering near decade lows. Although there continues to be debate about the underemployed and the participation rate, there's little doubt that job gains are pushing many employers to increase wages (Wal-Mart, Starbucks, and J.P. Morgan Chase to name a few).

Unlike the relative strength exhibited by the U.S. economy, growth outside the U.S. continues to be a struggle. In an effort to jump-start growth, policy makers are employing aggressive measures to help stimulate their respective economies. Over the past three months, China has announced an additional $700 billion in fiscal stimulus and Japan is planning a stimulus package later this month in the amount of $190 billion. Additionally, central banks, particularly the European Central Bank and the Bank of Japan, have driven down interest rates below zero on trillions of dollars of sovereign debt. This has contributed to the fall in rates in the U.S. despite the Fed's desire to raise them at some point.

Whether or not one believes such historic levels of stimulus is helping or hurting the real economy, there is little doubt it has helped elevate the valuations of risk and non-risk assets. The value of a company is best determined in the long run by its ability to grow earnings. The multiple that investors are willing to pay for said stream of earnings tends to rise as interest rates fall. So, it's no wonder the earnings multiple on the stock market is hovering above its historical mean. U.S. companies have struggled to lift earnings in the past year for various reasons including the rising dollar and falling energy prices. Given that more recently both the dollar and oil prices have stabilized, earnings may resume their upward trend, all things equal. It could be that the market is already sniffing this out, providing the recent uptick in stock prices.

Looking ahead, the U.S. holds its presidential election in November which could create a few volcanic plumes. And, in October, Italy is holding its own referendum which, depending on its outcome, could potentially bring the anti-Euro opposition party into power. Though still a low probability event, the hint of a departure by Italy from the European Union would send seismic waves across markets possibly making Brexit look like just a hiccup. At least if we need to invoke Vesuvius again, it's only reasonable the origin should be Italy. Fortunately, there are plenty of observatories monitoring events. Let's hope they do better than Brexit next time around. We'll certainly be keeping a close eye on events.

Sources:

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6. Barron's
7. The Economist