

## BREXIT Implications

(June 23, 2016) In a surprise to global markets, the United Kingdom voted to leave the European Union in Thursday's referendum by a margin of 52% Leave / 48% Remain. Polls leading up to the vote had showed a very tight race, but markets had expected the undecided voters to lean towards the status quo and give the "Remain" camp the victory. They were wrong. The market reaction has been sharply negative, with the British Pound falling as much as 10% against the dollar, the UK FTSE 100 declining 5%, the German DAX index falling over 7%, and U.S. S&P 500 down over 3% in Friday's trading.

Much of this reaction is due to the markets being completely caught off guard. For perspective, the developed international MSCI EAFE index had risen 7.2% over the previous 5 trading days heading into the referendum as the "Remain" vote had looked more likely. The severity of the reaction is also due to the uncertainty that now clouds the future of the UK and the entire European Union. The political, economic, and financial implications of this decision are still very unclear. David Cameron, the UK Prime Minister, announced after the results that he would be resigning as PM by October given the people's desire for new leadership. This is likely only the beginning of the political fallout from this decision within the UK and may incite similar anti-establishment movements in other EU countries.

On the economic front, the UK will now have to renegotiate trade agreements with the EU and other countries. This redefinition of institutional relationships will take time, but the immediate economic impact is negative for both the UK economy and the global economy as businesses are likely to halt investment until there is more clarity. The financial implications will also only surface in the days and weeks to come, but thus far, the Bank of England and other global central banks have somewhat calmed markets by ensuring sufficient liquidity and support. However, any time you have the type of currency and asset price volatility like we are seeing today, a tightening of financial conditions will occur and the risk of margin calls in the hedge fund space increases.

As far as the implications for your portfolio, we are monitoring this situation closely, but we will not be making any abrupt changes to our allocations at this time. Over the past 6-9 months, we have taken a more cautious view on the outlook for equities, largely because of our view that global growth is weak (and now about to get weaker) and equity valuations had not been leaving much room for disappointment. When the dust settles, however, our current view is that the UK decision to leave the European Union will have a more limited impact than feared on global growth and investment returns for the next 12-18 months. The UK economy may temporarily dip into recession, but we believe this disruption can and will likely be isolated by accommodative monetary policy in the U.S. and around the world.

The biggest risk, in our view, is that this decision becomes a precursor for other large EU countries to follow the UK and have their own referendums to leave the EU. If this occurs, the peripheral EU countries (Italy, Spain, Portugal, etc.) that really benefit from the lower borrowing cost created by the monetary union, would be in a much more precarious position financially. In short, the real risk associated with the UK's decision is the potential for others to follow and the European Union to dissolve. At this point, we would still characterize this risk as unlikely, so we would view a steep correction in equities over the next few weeks as a buying opportunity for long-term investors.

As always, please do not hesitate to contact us with any questions or concerns. We appreciate the confidence you have placed in our team at MAI to help you navigate through times like these.

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