The Investment Counsel Company

Investment Management Consultants

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The Investment Counsel Company's Quarterly Insights is intended to provide our perspective on current economic conditions in order to help those we care about improve as successful investors.

Will Brexit, Britain's decision to leave the European Union, represent unprecedented uncertainty with possible profound economic, financial and political consequences or a false alarm? Financial markets react negatively to uncertainty, of course, and the world just became less certain. There is tremendous speculation about Brexit's implications for our world, but what do we really know? A severe market sell-off would seem to be an appropriate response. History provides clues about the recent behavior of the financial market from many previous political and financial crises. Although Brexit is unprecedented, market reactions to unusual events tend to be similar. The reaction to Britain's pending EU departure was consistent with other crisis events of the past, triggering a rapid market sell-off initiated by panicked investors. However, like most crises, early speculation often proves exaggerated, inaccurate, and costly. Global financial markets began rebounding two days later, nearly fully recovering within a week and resulting in sellers' remorse, albeit further volatility should be expected. Similar shocks occurred when Iraq invaded Kuwait in 1990 and after the World Trade Center and Pentagon Terrorist Attacks. In those cases, too, there was a sharp reactionary decline followed by a substantial rally, proving that panic selling is not a wealth preservation strategy.

Brexit is expected to impact the U.S. economy in at least three key ways: (1) upward pressure on the U.S. dollar versus the British pound and Euro currencies; (2) dampen business and consumer confidence; and (3) slow financial conditions. The U.S. currency stabilization earlier in 2016 was welcome news. The Brexit vote, however, boosted demand for the dollar together with the Japanese Yen, as safe haven currencies for many foreign investors, with their value rising not only against the British pound, but against most other major currencies. Although American companies exporting to Europe, especially manufacturers, may be disadvantaged due to their prices increasing relative to lower currency exporters, the stronger U.S. dollar means American consumers can buy more British and European goods with their dollars and travel overseas at a lower cost.

Furthermore, U.S. direct trade with the U.K., the world's fifth largest economy, is relatively small. In 2015, exports to the U.K. were $56.1 billion or 3.7% of total U.S. exports while imports were $58.0 billion or 2.6% of total U.S. imports. Similarly, the world's second largest economy, China, sells less than 5% of its exports to the U.K. So while we recognize that Britain's exit from the European Union has longer-term contagion potential, implications are guesses at best. To paraphrase former Defense Secretary Donald Rumsfeld, right now we're in one of those points in history where there are a lot of "unknown unknowns."

The general business response to rising uncertainty from similar events is in keeping with an idea that former Federal Reserve Chairman Ben Bernanke articulated as a graduate student, recently told in The Wall Street Journal: Companies face a trade-off on the timing of their investment decisions. Investing now allows them to start reaping returns earlier, while waiting allows them to invest with more information in hand. However, when they suddenly face uncertainty, as with Brexit, the benefit of waiting for more information far outweighs its costs. So spending declines. Conversely, when there is more certainty spending snaps back quickly.

Crisis events also hold down interest rates and, in this case, influence the Fed to avoid raising short-term rates in the foreseeable future. Moreover, investors' increased demand for the safety of U.S government bonds have driven yields down and prices up. The result is cheaper mortgages for U.S. home buyers and homeowners looking to refinance. In addition to lower home financing costs, fading prospects for global growth and a stronger dollar push energy prices down, helping consumers save more at the pump, creating more disposable income that has a stimulative effect on the economy.

So there are many silver linings to the Brexit story. An obvious benefit is the increased appeal for stocks over lower yielding bonds. While risks yet to materialize may weigh on economic growth this year, it is doubtful they will result in tipping the U.S. economy into recession. If Brexit's detrimental ramifications to the global economy are obvious, then how do investors explain the reaction in commodity prices? Oil and other commodity prices held stable rather than declined, signaling that the financial market's sell-off was more of an emotional response instead of reverting back to recession. The U.S. economy has weathered repeated storms from Europe's debt crisis over the past four years, yet remains relatively healthy. Powerful offsetting forces include a robust real estate market and improving labor conditions.

We would not be surprised to see the U.S. stock market continue its upward trajectory and reach a new all-time high in spite of increased uncertainty. The greatest market related risk is when it is priced for perfection, not when concerns are strong and baked into the price of securities. Given the weight of the evidence, we feel that a positive outcome is more likely. Nevertheless, we recognize that caution and prudence are always required in sustainable wealth preservation and growth and we are grateful for the responsibilities entrusted upon our firm.

We appreciate the opportunity to express these views and sincerely hope that you find value in this perspective. Our Firm remains steadfast in its commitment to gain our clients every advantage possible through implementing industry best practices in investment research, portfolio construction, regulatory compliance and the highest standard of client service.

Sincerely,

Randy Garcia
Chief Executive Officer

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