Market Observations
July 2016

BREAKING UP

They say that breaking up is hard to do. Now I know, I know that it's true.
Greenfield & Sedaka

On June 23, 2016, 72% of eligible United Kingdom ("UK") citizens voted on the question of remaining a member country of the European Union ("EU"). With a simple "X" in the bottom box, 52% of voters cast their straightforward "Brexit" ballot (Exhibit I) to "Leave." UK voters and observers around the world soon learned that conducting a referendum was easy but a practical breakup will be very hard to implement. As a result, a new uncertainty factor will be affecting financial markets for the foreseeable future.

Exhibit I

Referendum on the United Kingdom's membership of the European Union

Vote only once by putting a cross ☒ in the box next to your choice

Should the United Kingdom remain a member of the European Union or leave the European Union?

Remain a member of the European Union ☐

Leave the European Union ☐

Perspective

The potential for a UK referendum on membership in the EU was announced on January 13, 2013. From announcement to actual referendum, polls indicated clear support for a "Remain" vote. During this period, however, the EU struggle with a mass inflow of immigrants from the Middle East stirred latent concerns over other intrusions on UK sovereignty. As shown in Chart I, gains for US, UK and Eurozone (all countries using the Euro currency) stocks in the days leading up to the vote suggested investors expected a "Remain" outcome. The immediate, two-day global sell-off in stocks further indicated that a "Leave" vote was not the consensus expectation. While stock markets have steadied since, some important trends have emerged.

Chart I

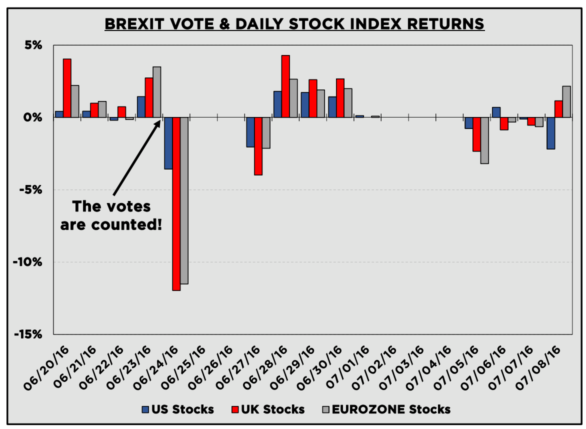

Table I provides stock market and bond market comparisons for the whole of the Brexit period to date. In the pre-vote period, US stocks far out-performed. UK stocks lagged at about half the gain of Eurozone stocks. In the post-vote period to date, US stocks have declined less than both UK stocks and Eurozone stocks. The comparable declines for these stocks suggest that investors see the "Leave" vote as equally adverse for both the UK and the EU.

At times of increased uncertainty, investors often turn to highest quality bonds. The declines in bond yields shown in Table I for both the pre-vote and post-vote periods suggest such a preference. Lower yields also reflect the interactions among economic growth, rates of inflation and monetary policies. Variances in these factors explain in part the different levels of government bond yields by country. Germany now is one of several countries where investors are paying the government to hold their assets for as long as ten years.

Table I

BREXIT STOCK & BOND MARKET COMPARISONS

	Pre-Brexit Vote 1/23/13 to 6/23/16		Post-Brexit Vote 6/23/16 to 7/8/16
Stock Market Price Changes			
United States	+38.8%		-3.0%
United Kingdom	+6.2%		-9.5%
Eurozone	+12.3%		-9.4%
10-Year Government Bond	Jan '13	Jun '16	7/8/2016
United States	1.91%	1.64%	1.37%
United Kingdom	2.08%	1.31%	0.74%
Germany	1.51%	-0.02%	-0.19%

Investment Implications

While little is known of the breakup terms for either the UK or the EU, it already appears true that it could be hard to do without an adverse, near-term impact on economic growth. A return of relative market stability in the early post-Brexit vote period is an encouraging sign of potentially limited impact. Diversified portfolios aligned with goals, horizons and risk tolerance remain the best antidotes for this kind of breakup.