Palisade
CAPITAL MANAGEMENT

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BREXIT: UNEXPECTED REALITY

Given the extraordinary and historic decision by the Queen's subjects to leave the European Union, I thought I would share some thoughts on what may likely happen to the financial markets over the next several days. Early on Thursday evening it became clear that the vote was not going in the direction all the experts and bookmakers thought it would go. By midnight, the three major British media outlets all called for the United Kingdom to leave the EU. This outcome was not priced into the market and as a result, immediately created significant global market uncertainty. Although I do not think that this is a repeat of the 2008 financial crisis, I do believe that it is a major event that will create market uncertainty until lawmakers assess the next steps for Britain's ultimate exit from the European Union. We expect (and are planning for) the immediate impact to be as follows:

1. *Currency Markets are in turmoil and could remain that way for the next several weeks:* The British pound immediately dropped 10% versus the USD and rose slightly versus the Euro. The Euro is down versus the USD and the yen "safety trade" drove the currency higher. Currencies simply do not move this much in a day and I will be looking for traders and financial institutions that are on the wrong side of the trade to see if the losses are significant.
2. *Equity Markets will wipe out all recent gains:* Look for the Dow Industrials and S&P 500 to drop by at least 5% over the next few days. Commodity markets, like oil and metals, will drop sharply and gold, the "fear asset" trade, will trade higher at least over the next week or so.
3. *U.S. Treasuries will have a significant rally:* Look for the yield on the 10-year to drop to 1.5% or lower as investors will seek the safety of U.S. government bonds.
4. *The future of the Euro currency could be in jeopardy:* The drop in the pound may only be the beginning. The Euro's dissolution could be next, which is bad for the only economy that matters in Europe- Germany. This could tip Europe into recession, which is also bad news for China since they are an important trading partner with Europe.
5. *Uncertainty will likely persist:* While the vote is in, the divorce is going to take a long time and will be messy. Trade agreements, changes to regulation, and many other key policies will have to change but it is unclear who will be at the negotiating table. Prime Minister Cameron has resigned since he put his reputation behind keeping the UK in the European Union which was unpopular within his own Tory party. Will all of this be enough to throw the UK and Europe into recession?

6. *Central Banks may inject huge amounts of additional liquidity and will intervene in currency markets:* Since lawmakers have been mostly absent, Central Banks may have to do more to keep liquidity in place. The bigger question to ponder is whether this will have any impact.
7. *Fed hike will not happen this year:* In my opinion, there is now a zero percent chance that the Fed raises rates in July. The last thing the U.S. needs is a stronger dollar and higher rates would make U.S. exporters less competitive.
8. *The U.S. Presidential election could also be a surprise:* Given how badly professionals predicted this outcome, why should they be any more accurate in predicting the U.S. election? It's clear that polling does not work in an environment where you have an angry and unpredictable electorate.

In summary, I believe this is a buying opportunity for U.S. equities, but one must be patient. The psychology is so important and every word from policy makers will be critical. While I do not believe this is a disaster for global growth, it is an unnecessary distraction for a fragile recovery in the U.S. With that said, with European markets in turmoil and economic growth in question, investors will eventually re-focus on the relative stability of the U.S. economy and equity markets. Our investment teams will continue to pursue buying solid growth companies at a value investor's price.

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