Global Investment Management Special Market Update

June 2016

Britain's Exit

--- Global Investment Managment Team

The 'leave' campaign, a victory for the pro-Brexit voters, was quite a surprise to markets and the world. The United Kingdom, based on a referendum of all eligible citizens, voted to leave the European Union (EU) 52 to 48 resulting in the first country to vote to leave the union since its formation. The effects of the referendum vote are already being felt in the political spectrum and the financial markets; however, the structural changes will take some time.

Politically, there have already been aftershocks. U.K. Prime Minister David Cameron has resigned in the wake of the final count; the referendum was a 2015 campaign promise by Cameron, although he was a staunch supporter of union membership. It is uncertain who will be chosen to lead parliament through the next phase of the process. There is still room to maneuver for the U.K. government as the referendum is not a legally binding agreement as we understand it; however, going against the will of the populous would likely be detrimental to any politician involved. The structural process will be a slow one. The British parliament will require votes to enact the exit from the union, it then must notify the European Council of the intention to withdraw, and finally start a process of negotiations for its departure that could take upwards of two or more years. It may be expected that the EU negotiators, seeking to protect EU interests and also to dissuade other participants from leaving the union, will not make this a painless process.

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Financial markets, on the other hand, have not and will not take two years to digest this revolution. The markets had considered Britain remaining within the EU to be a high probability, which had propped up equity markets and pushed the British pound to notable highs just before the vote. As a result, the pound has plunged over 8 percent versus the U.S. dollar in trading as of noon Pacific time. Market participants are also seeing dramatic swings in other asset prices as investors reevaluate risks from the vote in Britain, one of the world's largest economies.

Riskier assets, particularly equities, have already seen declines varying by region. The S&P 500 Index has lost close to 3 percent in early morning trading, which is a relatively calm drop when compared to some European stock markets which have experienced declines upwards of 10 percent. Safe haven assets are expectedly on the rise. The price of the 10-year Treasury climbed steeply on the news as investors search for safety; the yield on the debt has fallen to approximately 1.56 percent.

While the exit was unexpected, the Global Investment Management (GIM) team had already been tactically reducing equity risk in our strategies in the previous months. Additionally, policymakers from the Bank of England and European Central Bank (ECB) made it clear they were preparing to take action to stabilize markets and provide liquidity, if needed. Admittedly, however, policy measures that reassured financial markets in the past may be more muted today due to the diminishing returns of continued stimulus and the current easy monetary policy environment.

Our expectation is that the existing risk-off sentiment is an initial 'kneejerk' reaction, which is transitory in nature and should subside over time. We believe the U.K. economy, which has been teetering just above negative growth, may fall into a mild recession over the near term due to impacts from the financial markets as well as the likely negative effects from changes in business and trade agreements with the EU. The impact of the secession will likely have a much stronger impact on the U.K. than Europe or the rest of the world. We anticipate the global economy will keep growing and we remain fairly positive on the domestic growth outlook, however policymakers will likely be much more cautious in the near term. The GIM team has and will proactively make strides toward protecting capital and adding value to client portfolios.

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Among other risks, fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Alternative investments contain heightened risk, including market, political, regulatory and natural conditions, and may not be suitable for all investors.

International securities involve additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets.

Diversification and asset allocation does not ensure a profit or guarantee against loss.

Index performance is shown for illustrative purposes only. You cannot invest directly in an index.

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Glossary

A **10-Year Treasury note** is a debt obligation issued by the United States government that matures in 10 years. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity. An advantage of investing in 10-year Treasury notes, and other federal government securities, is that the interest payments are exempt from state and local income tax. However, they are still taxable at the federal level.

Bank of England (BOE) is the central bank of the United Kingdom established on July 27, 1694. Since May 6, 1997, its Monetary Policy Committee (MPC) has had operational responsibility for setting interest rates to meet the government's inflation target.

Bloomberg is a major global provider of 24-hour financial news and information including real-time and historic price data, financials data, trading news and analyst coverage, as well as general news.

Brexit is an abbreviated term for "British exit" used to describe the possibility that the United Kingdom will leave the European Union after the UK's referendum on EU membership takes place on June 23, 2016.

European Central Bank (ECB) is the central bank responsible for the monetary system of the European Union (EU) and the euro currency.

European Council, also known as the summit, is a forum for setting priorities, discussing new initiatives and giving political direction to the EU. The EC heads of state or of government decided at the Paris Sumit in December 1974 to hold regular meetings as the European Council. The European Council has no legislative powers, and consists of the EU member states' heads of state or of government and the president of the Commission. The European Council takes decisions by consensus. Summits are held in the country which is holding the presidency of the Council of Ministers at that time.

European Union (EU) is a group of European countries that participates in the world economy as one economic unit and operates under one official currency, the euro. The EU's goal is to create a barrier-free trade zone and to enhance economic wealth by creating more efficiency within its marketplace.

Pound is the British primary currency unit.

The S&P 500 Index is a capitalization-weighted index of 500 stocks traded on the NYSE, AMEX and OTC exchanges, and is comprised of industrial, financial, transportation and utility companies.

One cannot invest directly in an index.