RBC Wealth Management

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I am writing this one week after the UK voted to "Brexit".

I wonder whether the word "exit" will join the words gate and apocalypse, as the latest suffix to describe imminent doom or corruption. I was sad to watch Novak Djokovic make his third-round Brexit at Wimbledon this weekend. I'm a fan.

Before the referendum, the Dow Jones was trading just above 18,000 and today, the Friday before Independence Day – our Independence Day and a week after what Nigel Farage described as Britain's Independence Day– the Dow Jones is trading just below 18,000. The British pound has been reduced by several ounces, trading at a 31 year low. Analysts forecast that the devalued pound will probably decrease growth in the US by a quarter point or less and will delay any increase in interest rates by the Federal Reserve. The falling pound will make our exports more expensive in Britain, increase the trade deficit and slow inflation. The good news is that maybe now you can afford to buy that Rolls Royce.

The British economy is now the seventh largest economy in the world. A week ago, it was ranked sixth. There are several articles in the business press bemoaning London's soon-to-be lost status as the pre-eminent financial capital of the world – one of those articles suggested that London would soon become the Cayman Islands of Europe, nothing more than a tax haven for millionaires and billionaires who want to avoid paying taxes in their own countries. James Stewart's column in today's NY Times (7/1/16) handicaps which European capital will take over as the financial capital. Amsterdam, Frankfort, Vienna, Dublin and Paris are the top contenders.

Brexit is not good news. However, it is not a catastrophe similar to 2008, when central banks on both sides of the Atlantic failed to recognize the mounting disaster. We can debate how much regulations have tamed the speculative excesses of finance, but few would argue that there haven't been improvements. "The financial systems of the US and Europe, including the UK, are far more capitalized and less leveraged than they were in 2008," said Adam Posen, a former member of the rate setting committee for the Bank of England and now president of the Peterson Institute for International Economics in

Washington, "The proclivity to panic in ways that create financial instability are much more limited." The Bank of England and the European Central Bank have an important tool to mitigate any damage. They can print money and lend it out as needed.

It is unlikely that the US economy will slip into a recession as a result of the British referendum. Britain is the seventh largest among America's trading partners. American exports to Britain totaled $56 billion or just over 0.3 percent of GDP. To give you a little more perspective, extracting sand is a $70 billion a year business. We extract 40 billion tons of it a year. Sand makes it possible to build cities. Concrete is sand and gravel mixed together – and we use more sand to build those great cities than either air or water. Asphalt uses sand. Not all sand is created equally. You can't use desert sand in construction because it's shaped by the wind and not by water. The world supply of sand is diminishing and there are no adequate substitutes. In the US, we limit or prevent the extraction of sands from our beaches, so sand has to be trucked in from farther away and since sand is so heavy, this increases construction costs. We can create new sand by recycling construction materials, but that's a costly alternative. So, it might be fair to conclude that any disruption in our access to sand might have a greater impact on the American economy than the UK leaving the EU.

"I don't have any money in the stock market, so what's it to me," said Scott Walker, a retired construction worker from Sutherland, England. He was among the sixty-one percent of his neighbors who voted to leave the EU. Sutherland is an old port town. The shipyard is gone, but it was replaced thirty years ago by a Nissan plant, which provided jobs to many of the displaced dockworkers. It couldn't exist without free trade.

What's curious about Brexit is that it represents a revolt of the working class against globalization and free trade. Since the fall of the Berlin Wall in 1989, the smart money, the market pundits, the free-marketers have favored trade deals like NAFTA, the introduction of the euro and the acceptance of China into the World Trade Organizations. The "experts" told us it would be good for us and that we would all benefit from globalization. Twenty-five years later, workers who have lost jobs and lost their economic status want their old lives back. There is a deep distrust of all institutions, which explains why there is clearly a populist backlash on both sides of the Atlantic.

Another facet of The Brexit vote is the desire to limit or control immigration. It's a vision of the country as a club where you want to make certain that you only accept the right kind of people. Groucho Marx claimed that he'd never want to be a member of a club that accepted him as a member, but Groucho Marx would never be confused with a nationalist. Certainly, Brexit has elements of the "us versus them" battle that seems to be taking over the world. Brexit is also about people feeling that they have no connection to their elected officials or to their government or the institutions that are supposed to look after their interests. This isn't about expanding the role of government or giving people more stuff –like free health care or free tuition – it's more about making things work and fixing things that don't work. Voters on both sides of the Atlantic want to return to the original meaning of "status quo", which is a shortening of the original Latin phrase: "*in statu quo errant ante bellum* -- The state in which things were before the war." (War can be replaced with globalization, in this case.) War may be an overstatement, but there's an ever-widening gap between those who have benefited from free trade and the great technological advances and those who've been left behind.

Speaking of global economics, we have our own issues here…….

The New York Times had an interesting story this week (June 27th) on the gridlock at the Export-Import Bank. Senator Richard Shelby is preventing the Ex-Im Bank from operating because he refuses to allow a vote on President Obama's nomination for the bank's 5-person board. Without it, the Ex-Im Bank cannot approve transactions of over $10 million. And there are some pretty big deals pending for Boeing, GE, Caterpillar, Westinghouse and John Deere. After the President's recent trip to Vietnam, Vietjet contracted with Boeing for 100 aircraft. Westinghouse negotiated a multi-billion dollar deal to build six nuclear reactors in India. This gridlock affects companies that we own in your portfolios.

The Ex-Im Bank was created during the Depression as the lender of last resort for exporters that couldn't get commercial loans. Sixty countries have similar Export Credit Agencies. China's is the largest. 98% of the applications are for loans less than $10 million. Yet, two-thirds of all assistance goes to deals exceeding that amount.

Global companies operate in many countries. GE builds gas turbines in South Carolina and in France. If it can't depend on loans from our Ex-Im Bank after it makes a deal to sell those turbines to another country, it will manufacture those turbines in France, because the French Ex-Im Bank is more than happy to provide financing to GE. This means a loss of high paying manufacturing jobs in South Carolina. This is one of the consequences of globalization.

Stay tuned for more on the Ex-Im Bank debate.

So, you ask, what did the markets do over the quarter in light of this backdrop? Not much. The Dow Jones returned 2.07% for the 2nd Qtr and 4.31% YTD. The S&P 500 returned 2.46% for the 2nd Qtr and 3.84% YTD. Investors have been fleeing from the more aggressive tech names in the NASDAQ, which was down -0.22% for the Qtr and returned -2.61% YTD. Currently, the market is favoring the safety and dividends of the utility, telecom and energy sectors. The laggards over this quarter were the high flyers, which were much loved last year. We expect this volatility to continue and we stick with our mandate to buy quality names on market dips, look for rising dividends and always have cash on hand for those of you with monthly cash needs. With much on the horizon both domestically and internationally, we will monitor this closely for any changes to be made in your portfolios. However, with regards to owning stocks as a vehicle for long-term growth, the latest catch phrase on Wall Street is TINA: "There Is No Alternative Asset"…..We agree.

Best wishes for a lovely summer,

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