MANAGED ASSET PORTFOLIOS

Britain votes to leave the European Union…Now What?

June 24, 2016

The Vote

Yesterday, nearly 52 percent of the votes cast were in favor of the United Kingdom leaving the European Union (EU). Although the polls were close going into the election, most showed the voters leaning toward staying. Most investors, including ourselves, thought the vote would be to stay. Even exit polls that were released after the polling stations closed gave the lead to the "remain" camp.

The final results have surprised investors, putting the world's financial markets in turmoil. Many European markets are experiencing their worst one-day performance since October 1987. The British pound fell to a 30+year low before rebounding slightly, and gold is rallying along with bonds.

The primary reason for the sell-off is the fear of the unknown. Investors and businesses despise uncertainty. Yesterday's vote kicks off a two-plus year period of volatility as negotiations begin for Britain to exit the EU. The British will need to elect a new prime minister, as coincident with the leave vote; David Cameron has announced his plans to step down in a few months. The new prime minister will lead discussions with other European nations to agree upon new trade agreements, which typically take an extended period to hammer out. As an example, it took Canada seven years to work out a trade agreement with the EU and it still is not ratified.

What's Next?

During this period, we anticipate a lot of uncertainty, which will likely lead to less spending and business investment, thereby putting pressure on economic growth. In order to spur spending and investment, consumers and investors need to have confidence. We do not believe yesterday's vote spurs confidence; rather it creates just the opposite.

The anticipated weakened economic growth will likely force most central banks to remain in their current accommodative mode, meaning that interest rates will likely remain at historically low levels for the foreseeable future. In a somewhat timely move, last week, St. Louis Fed President, James Bullard said the Fed may only need to raise rates once between now and 2018. This forecast may be more accurate than even he thought. It should be noted that Bullard is typically viewed as a "hawk," meaning he has historically leaned toward raising rates. While low interest rates are symptomatic of a sluggish economy, we believe they should be viewed as a long term positive for the financial markets.

Who Wins…Who Loses?

We believe this is one of those times where what you don't own is probably more important than what you do own. As our clients are aware, we are and have been **overweight** the consumer staples sector (i.e. food beverages, tobacco, etc.) and **underweight** economically sensitive sectors such as manufacturing, financials, home builders, etc. We have been positioned that way because of two primary structural issues. The first being the excessive amount of debt the world's financial systems and the second being

Managed Asset Portfolios

the shift in employment demographics from manufacturing to service, which has limited the amount of disposable income many Americas have to spend. The “Brexit” election outcome will likely raise the level of uncertainty, thereby creating another headwind for global economies to confront.

We believe U.K. companies that are large exporters will benefit from the weaker pound. Companies that we own, such as Diageo (beverages) and Imperial Brands, (tobacco) have faced headwinds as the pound rallied. This currency reversal will aid their results. Additionally, with the British pound dropping to its lowest levels in over 30 years, we expect to see companies domiciled in countries with stronger currencies to become opportunistic acquirers of British companies, once the dust has settled.

Another economically sensitive sector that we are currently **underweight** is the financial sector. Financials stocks will likely be hurt as cross border transactions become more difficult. Perhaps more importantly, the performances of financial stocks, and specifically money center banks (JP Morgan, Bank of America, Goldman Sachs etc.) will be hindered as interest rates are likely to remain low for a longer period of time than anticipated, thereby compressing their margins.

Finally, economically sensitive sectors such as builders and manufacturers may also be hurt as economic uncertainty delays purchase decisions; hence our underweighting of this sector.

In short, we do not anticipate making any material changes to our portfolios as a result of the election. We continue to believe defensive sectors will outperform economically sensitive ones due to the heighted level of uncertainty.

While we understand that heighted volatility is unsettling, it is important to view things rationally and not emotionally. It is important to note that we believe much of today’s volatility is fueled by the element of the surprise election outcome and is not grounded in fundamentals. Our portfolios are currently positioned well for the environment we are facing. That being said, we will seek ways to take advantage of the opportunities that this volatility will ultimately create.

We sincerely appreciate the opportunity to serve you. It is a responsibility we do not take lightly. Please contact us with any questions or concerns.

Managed Asset Portfolios’ Investment Team,

Michael Dzialo, Karen Culver, Peter Swan, John Dalton and Zack Fellows