Market Commentary

HARBOUR ADVISORS

"Independence Day"

Contrary to market positioning, Britons voted yesterday to leave the European Union (EU). "Remain" champion Prime Minister David Cameron has announced his resignation. Equity markets, particularly in Europe sold off hard, bond yields have fallen and both the U.S. dollar and gold are rallying.

The Harbour Balanced Funds were well positioned for this outcome. In spite of the equity markets melting up over the last week, prejudging that the vote outcome would be "Remain", we sat tight, broadly underweight equities, underweight Europe, underweight financials, hedged on the pound and overweight gold. This defensive positioning is working for our clients today.

The British decision opens a proverbial can of worms, and while stocks are cheaper this morning and the backdrop for equities is still supported by low rates and few compelling alternatives, we are not feeling the need to be too hasty in deploying capital. The hard-to-get-excited-about, low growth environment that we've been in just got a bit murkier and even less exciting than it was before.

Our thought process at this stage is to consider the multitude of second order impacts that flow from the "Brexit" decision, and consider their potential impacts on asset markets. Our objective is not to speculate on outcomes but to understand causal relationships – and ensure that we've given every consideration to how our clients could get hurt from further changes in the environment. At Harbour, we care about "cost", not "opportunity cost", and "protecting the downside on our clients' capital" comes before "decisions to take on more risk."

Some of the things that we are watching include:

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Currencies

Currency movements have become the primary sovereign tool in global competiveness and exert a significant impact on investor returns. The “Brexit” decision is a “risk-off” event and in the short term it drives strength in the world’s preferred safe haven currencies, namely the U.S. dollar, the Japanese yen and to some degree the Swiss franc. The pound sterling and the euro are both weaker this morning and the global playing field is once again jolted. Central banks are coordinating to try to minimize the imbalances through this dislocated period but broadly speaking, the U.S. dollar is rising. This U.S. dollar strength saps liquidity globally and is a negative for globally competing U.S. companies (like Apple) that see their relative competiveness eroded. U.S. dollar strength negatively impacts S&P earnings since many of America’s largest companies generate significant revenues and profits abroad.

Interest rates

“Risk off” means lower interest rates everywhere, as in an interlinked world, a rate shock in the U.K. suppresses European and then U.S. rates by association. The U.S. 10-year bond yield traded to 1.40% overnight – an 18% move from before the vote, matching its lows of 2012. After all of Janet Yellen’s efforts to convince us that she really was about to increase rates, the market is now assuming that it won’t happen. The current implied probability of a U.S. rate increase is now zero until December, with a 14% chance implied at that meeting. More significant is that the market is now implying a greater than 10% chance of an interest rate cut in the U.S. this fall. That is new thinking.

Growth

The action of British voters is nationalistic and ultimately a step away from open markets and toward protectionism. This is not positive for growth in the U.K. and in Europe by association. In a developed world challenged by excess leverage and poor demographics, adding greater political complexity and trade costs make it hard to see how the 1.5 to 2% growth, we currently have, is going to get materially better anytime soon.

Politics

Front and center. Numerous European regions have exit initiatives of their own and we should be prepared for an onslaught of “exit” prefixes (“Swexit”, “Frexit”, “Czexit.”) A lot of it will be noise, but the trend is negative from a protectionism and burgeoning bureaucracy perspective, and there are lots of unknowns. Will Britain now try to negotiate with the EU to stay in? Maybe, but don’t bet on that being an easy process or a likely outcome. Corporations don’t like uncertainty, and will curtail capital investment decisions in areas where political change may make future returns less clear. You wouldn’t build a new plant, for example, in a country that might end up taxed unfavorably in its export relationships with key

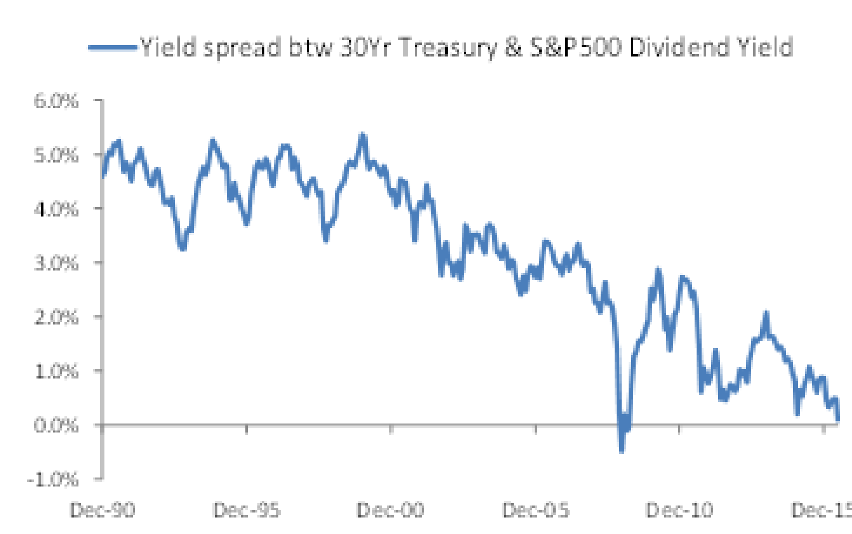
customers. Low growth, economic stress and polarized societies are leading to unpredictable political outcomes. "Expect the unexpected" means that equity risk premia is likely to increase.

The financial services sector

Just not the place it used to be. The "Brexit" decision hits London hard, and the global banks will be shifting people elsewhere (not good for the London real estate market.) Uncertainty doesn't work well when combined with financial leverage, and that's what a bank looks like. With many unknowns, European bank equities are selling off hard and CDS spreads are expanding. A European banking sector that doesn't look healthy is an additional unwelcome roadblock to growth.

So is it the end of the world?

No, but it's not helpful. Growth just became a little more challenged and uncertainty is a little higher. In this environment there are no silver bullets: a diversified approach to asset allocation can reduce volatility and add defensiveness while still providing the opportunity to grow capital. In this context, equities still play a role. The chart below shows the spread between 30-year treasuries and the S&P 500's dividend yield. Today those numbers are 2.43% and 2.23% respectively. Essentially, investors are getting almost the same yield to own stocks as they are to



Source: Bloomberg

hold long duration bonds, and the small difference in yield represents what they are paying for the growth that equities should provide. At almost parity, equities are essentially pricing in zero growth (or multiple contraction.) In spite of the headwinds that abound in the global economy, this spread has rarely been so

low. We believe that careful security selection, in the context of a conservative allocation, can continue to create value for our clients.

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