

NATIONAL WEALTH ADVISORS Inc.
Business & Personal Financial Planning

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SUMMIT FINANCIAL RESOURCES, INC.

Commentary: UK Referendum

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COMMENTARY: UK REFERENDUM

On June 23, 52% of UK voters chose to withdraw from the European Union (EU). The outcome, essentially a debate between immigration issues (favoring exit) and economic issues (favoring status quo), was ultimately driven by small, rural, industrial areas that have generally been hurt by globalization. Although such a referendum is only advisory in nature, it is generally viewed that the government must move in the direction of the people's will. The fact that British Prime Minister David Cameron has resigned from office suggests that will indeed be the case.

Based on polling results and stock market gains leading up to the vote, the protectionist win was highly unexpected. Such a disappointing outcome, coming on the heels of an errant relief rally, caused investment markets to sell off heavily. In essence, the unwinding of unwarranted previous day gains served to accentuate a market downdraft that might have been far less spectacular otherwise.

Despite capital market losses and a 10%+ decline in the British pound, the UK stock market remains well above its February low — when "Brexit" concerns first gained traction. And the pound, albeit at a multi-decade low, is only marginally below where it traded earlier in the year. Moreover, aside from the obvious hit to confidence, nothing will happen overnight. The process

for the UK to extract itself from the EU will be a gradual divergence taking place through a multitude of negotiations over a matter of years.

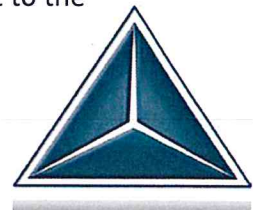
Economic impact

UK - The pound has weakened and the economy will experience a material drag over the short-term. GDP growth, presently running at a pace of about 1.5%, will likely drop close to flat. The possibility exists for a negative quarter or even a shallow recession. Inflation is likely to run higher over the next year due to the weak pound, and added monetary stimulus is plausible. Interest rates will remain lower for longer and longer-term UK growth will be somewhat lower than it otherwise would have been.

On the positive side, a weaker currency will enhance global competitiveness. Likewise, the UK is not heavily indebted to other countries, so debt induced financial instability is unlikely.

EU - The UK referendum will be significantly less impactful to the EU as a whole, but will be marginally noticeable for an economy growing at only a 0.3 to 0.4% pace.

U.S. & Global Economy - Accounting for only 4% of global GDP, UK challenges will have minimal direct impact to the



U.S. and the global recovery is not at risk. That said, the Federal Reserve may take a more cautious stance. A July rate increase is less likely and longer term policy goals will take longer to unfold.

Contagion

Political - Policymakers are likely to pay greater heed to populist views and separatist movements. Likewise, in an effort to avoid setting a precedent, or rewarding the UK for exit, the EU will take a fairly hard negotiating stance during the exit process. These events will not be made pleasant for the UK.

As for euro zone nations in particular, their ability to exit the economic union is far more challenged due to their use of a common currency. Quite simply, having its own currency affords the UK greater latitude and a smoother transition out of the EU.

Capital markets - Shocks to the capital markets are often unforeseen and unknowable ahead of time. Such was not the case with the UK vote. Unprepared markets are far more susceptible to shocks and contagion across markets is harder to contain. In this case, the potential for disruption was telegraphed to markets. The timing was well known. Central banks, trading desks, and investment firms were well staffed and prepared for any outcome. Despite extraordinarily high volumes,

capital markets have been universally described as orderly, smooth, and very liquid.

Investment Implications

As a result of this event, investors have reevaluated the potential for, and implications of, unanticipated events. The ultimate outcome of this exercise is a higher risk premium being placed on risk assets. In layman's terms, investors will need to be compensated with higher returns in order to take [recalibrated] risk. The downside of such a modification is lower market prices, which is what has transpired. The upside, of course, is greater expected future returns. Are these likely to come near term? This is unknowable. It will be heavily dependent on the exit path for the UK and any evidence of economic, political, or capital market contagion from this event.

In the meantime, we caution against any attempt to predict the price movements of fluid, unpredictable, volatile markets. Concentrated bets should also be avoided, and major portfolio shifts, often driven by emotional reactions, can be catastrophic to long-term investment success.



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