

Your weekly market update

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Market Update

30 June 2016

It's official: UK voters decided to leave the European Union.

Brexit was a seismic and unexpected result, which caught global investors off guard (more on that later). The big question: What happens next? As noted in Brexit Q&A, the "Leave" win means that the UK government must decide when to invoke Article 50 of the Treaty of Lisbon, which outlines the legal process by which a state can withdraw from the EU.

Prime Minister David Cameron announced that he would step down in October and suggested that the next Prime Minister should initiate the Article 50 process. Once it does, the withdrawal negotiations would begin. At a minimum, it would take two years, but that time frame could be extended by unanimous agreement among the remaining 27 member nations. During the process, the UK would obey EU treaties and laws, but not take part in any decision making.

The biggest issue is how trade would be handled between the EU and the rest of the world. According to law firms Davis Polk and Sullivan and Cromwell, two powerhouses that advise multinational corporations, there are three basic options for the UK's exit, based on existing models. Leaders of the Leave movement did not advocate a specific alternative during the campaign, so it is unclear which model they will follow.

Total exit: the UK leaves the EU and does not continue to benefit from any part of the single market. The UK either relies solely on



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the rules of the World Trade Organization (which include rules governing the imposition of tariffs on goods and services) as the basis for trading with the EU or negotiates a new bilateral trade deal with the EU.

The Norwegian model: the UK leaves the EU but joins the European Economic Area (EEA). The EEA is made up of 28 EU member states and three countries, which are not EU member states (Norway, Iceland and Liechtenstein), and extends the free movement of goods, services, capital and persons beyond the EU to those three countries. Under this arrangement, the UK would not benefit from or be bound by the EU's external trade agreements. It would have to make significant financial contributions to the EU and continue to allow the free movement of persons, two of the Leave camp's main criticisms of EU membership.

The Swiss model: the UK leaves the EU and does not join the EEA, but enters various bilateral agreements with the EU to obtain access to the internal market in specific sectors, rather than the market as a whole. Switzerland has negotiated a large number of sector-specific bilateral agreements with the EU and has access to some parts of the single market, but is excluded from the single market in some major sectors (for example, the financial services sector).

Brexit impact on American companies: The choice of model exit will impact American companies that have a large presence in the UK. One sector in particular that is left hanging is financial services, because under the "Total Exit" or "Swiss" models, there would be no right for UK-authorized firms or individuals to provide financial services in the EU on a "passport" basis. This is critical because most American financial institutions currently use a UK authorized person and/or entity to provide financial services elsewhere in the EU. Without passporting, the companies would need to obtain authorization from an EU member state by either establishing an authorized branch or subsidiary in that state.

Loss of passporting would create legal, compliance and infrastructure headaches, not to mention steep costs to US firms.

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Additionally, many US banks make London their hub across the pond because of the access to talent, support services and the use of English as the global language for financial services. So while many Wall Street operations and legal departments are scouting locations in Dublin and Frankfurt, they are hoping that they will not have to move the majority of their people and offices. As you can see, corporate strategists have already taken into account which EU nations will receive the lion's share of the financial services sector. Chalk a win for Ireland and Germany. Nearly 47% of the British economy consists of the financial services sector. This sector alone was the main drive that pulled the economy of recession back in 2009. This does not even deal with Scotland's wish to clearly remain in the EU with or without Britain.

So, why the market up swing? As much as the leave vote shocked the world, right now all eyes are focused on America and the Federal Reserve. "What will Janet Yellen do next?" By guaranteeing to provide liquidity to the Bank of England just a few short days ago and propping up the British pound as currency speculators were drawing blood, calm has taken over. The Fed has effectively engaged in another round of quantitative easing (QE IV) outside its borders by coming to England's aid. The American dollar has weakened and it puts the Federal Reserve on hold with interest rates. Investors can breathe a sigh of relief as interest rates in Europe and the UK will head deeper into negative interest rate territory. The American dollar is down against most other currencies except the Yen, Swiss Franc and the Euro. Just prior to the Brexit vote, the investment world was bracing for an interest rate increase in America starting in July. Current sentiment is that an interest rate hike will not be likely this year. This will give the markets time to re group and gain lost ground till year end. However, I suspect once the Fed acts it will be more aggressive with rate hikes.

Given all the populist sentiment around the world and wild election out comes, protectionism is becoming a common threat of political platforms. Protectionist ideas over took the UK and now look to re ignite even greater division between Scotland and England. As I have discussed before, protectionism only serves the largest

consumption machine in the world America. Why? In order to gain access to the world's largest market you must pay a fee (tariff). The fact that the rest of the world is in economic reform and or recession, it will serve America and North America well as long as NAFTA is adhered to.

We remain strong in our North American centric strategies as the rest of the global economies excluding Australia need to continue the path of heavy fiscal reform before any progress will be materialized. We are driven by absolute returns for clients while preserving capital, earning a monthly yield and capturing future growth.

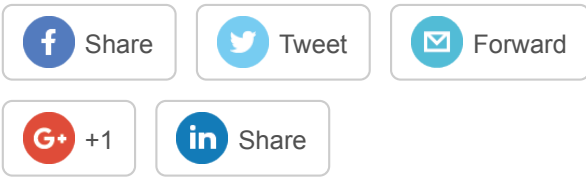
The exit of Britain represents material change coming in many shapes and size. Britain once again will look to its past colonial partners including Canada to make up for the lost opportunities in the EU. This could not have come at a better time for Canada as we look to develop and expand trade relations.

The EU is determined to go on with or without the UK maybe even gain Scotland in its fold. European leadership in Brussels is also very eager to draft new partnership and trade deals in their favor. If this was Prime Minister David Cameron's way of bluffing the EU and ECB into high stakes all or nothing negotiations, well it blew up in his face and cost him the top seat in government. The heavy handed approach with Britain was designed to exterminate any possible copy cat attempts from other member states.

Canada and North America in general look very attractive to foreign investor right now and will only grow as the details of the UK fall out start to crystallize. High inflows of investment dollars means on thing asset prices will go up. Location, location, location!

Happy Canada Day!

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