GUIDANCE

POINT OF VIEW: BREXIT

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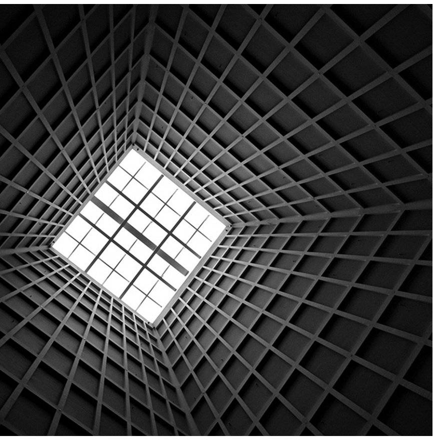
A Wintrust Wealth Management Company

JUNE 24, 2016



The Brexit referendum is certainly a notable event; however, it is the beginning of a lengthy process, which will take up to 2 years to develop and an untold timeline to implement. Therefore, the market will be processing this same issue multiple times in the next few years as more details emerge.

Despite an unexpected vote to leave the EU by the UK, this decision is not likely to be the beginning of a global financial crisis.

- Importantly, markets are functioning normally and rationally.
- Today, there are short term dislocations due to margin calls and volatility is exacerbated, but expected to stabilize.
- Today is also the annual rebalance date for the Russell indices which typically sees increased volatility and volume as index funds rebalance.

While the vote has economic consequences—namely that likelihood of a recession in the UK has increased—the event has broader near-term geo-political ramifications than it does economic, with most economic impacts further off and dependent on the eventual negotiation.

The outcome of the referendum was a classic policy misstep. Prime Minister Cameron misjudged the electorate by calling for the vote, and it has cost him his position as Prime Minister. Because it did backfire, it does indicate that global sentiment may not be as predictable in the current environment. Therefore, markets will likely continue to react severely in the event of further policy mistakes globally. For instance, global central banks will be scrutinized to a greater degree, signs of weakness in China may lead to larger corrections, and the continued impact of negative interest rates in the EU and Japan will fall under a more critical eye. The fact that one event was so surprising means that increased volatility will likely continue.

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Because of the possibility of more macro-economic changes affecting markets on a disproportionate basis, there will likely be a benefit to diversification going forward. The outcome of the referendum was essentially a "three standard deviation event." It was a true surprise, unusual and not the norm.

From an equity market perspective, a couple of things are happening:

- Valuations have compressed today. With rates touching new lows and earnings not materially changed, valuations have become more compressed.
- Sentiment has turned negative. Sentiment essentially is the psychological element of the market assessing whether current fundamentals and current valuations will remain constant or not. Sentiment is the quickest element of the three market elements to change—fundamentals, valuation, sentiment. That is why markets go down faster than they go up.
- With negative sentiment, the market will be focused on where the deterioration of earnings will be. We know that currency valuations have already changed and will likely stay re-positioned. Therefore, companies which will be affected most by the currency shift will likely go down further in price as those changes in fundamentals occur.

The fact that the UK is likely leaving the EU underscores the fact that different economies and economic blocs are behaving differently from one another. This means that there should continue to be correlation differences between markets, further underscoring the benefits of diversification.