FINANCIAL Insights

MERITAS ADVISORS

JULY

Across the Pond

If you've turned on the news in the last month, you have heard the term "Brexit." The portmanteau has been splashed all over international headlines since early June, when Britain prepared for a referendum on whether it would exit from the European Union (EU). When the U.K. shocked the world on June 23 by actually voting to leave, "Brexit" cemented its place as one of the most important words of the year.

(Unsurprising) Panic

The impact of the U.K.'s decision to leave the EU was felt immediately by the global stock market. Analysts all over the world had believed the U.K. would remain and were pushing share prices higher in the hours before the vote. When the results were announced, the reaction was a rapid—but not catastrophic—downturn across nearly every stock exchange.

As it became clear that Brexit probably wouldn't result in the end of the EU, panic dissipated and stocks returned to normal. For Americans, the disruption seemed to have passed; Brexit would be nothing more than a temporary political problem between distant countries. After all, didn't we start a war 240 years ago so that British decisions wouldn't affect us anymore?

Quid Pro Quo

Brexit still has important implications for the U.S. economy because of the British pound. The pound has a long history and is considered one of the most reliable currencies in the world. Its value has helped make London the financial capital of Europe and ensures the Bank of England is a key player in global interest rates.

But Brexit means the U.K. will be disrupting its access to the EU's massive economic power and banking needs. This could shrink the U.K.'s economy and may ruin the stability of its banks, costing the pound its place next to the U.S. dollar, Japanese yen and the euro as a top-tier currency. And that would make all the difference.

A volatile pound will drive some investors to other currencies. Since the EU and its euro are also shaken by Brexit, choices for low-risk currencies are limited and purchases of U.S. dollars and Treasuries increase.

While this further cements the United States as the economic center of the world, it does cause some problems. Although trade with the U.K. makes up less than half a percent of U.S. GDP, the appreciation of the dollar's value makes U.S. goods more expensive all over the world, hurting our ability to export. Additionally, U.K. products that directly compete with American products (e.g. luxury cars) gain a huge price advantage in foreign markets.

Brexit's bigger impact, however, may be on interest rates. The market disruption caused by the U.K. will make the Federal Reserve wary of raising short-term interest rates this summer as it had planned. High demand for Treasuries will push down long-term borrowing rates in major economies. This effect was immediately evident following the Brexit vote as U.S. mortgage rates approached historic lows. If interest rates remain this low, they could inflate home prices and make it more difficult for people to buy their first home.

The full effects of Brexit are still unknown, both economically and politically. No independent county has ever left the EU and analysts are unsure when and how (or even if) it will take place. The move could fundamentally alter trade agreements, trigger recessions in emerging economies or open space for another major country to take Europe's center stage. Regardless of what happens, it's clear that economic changes don't stay confined to a single country. Even with 3,000 miles of ocean between us, the consequences of the U.K.'s decision have already begun arriving on our shores.

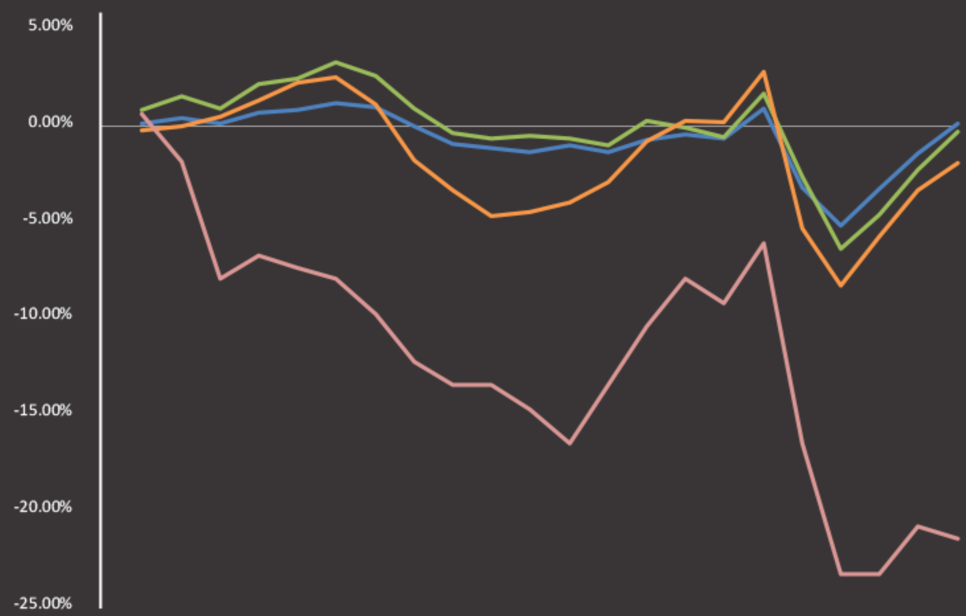
the market at a glance
JUNE

U.S. Large Cap
(S&P 500)
2,098.86 (0.09%) ▲

U.S. Mid/Small
(Russell 2000)
1,151.92 (-0.25%) ▼

International Large
(NYSE International 100)
4,652.98 (-1.68%) ▼

U.S. Treasuries
(U.S. 10-Year Treasury Yield Rate)
1.49 (-19.02%) ▼



Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly.

The market in action

- The U.S. Department of Labor reports the worst jobs numbers in more than 5 years. The report reveals that payrolls increased by just 38,000 jobs in May (compared to 164,000 anticipated) and revised down the payrolls for the previous two months by 59,000. Despite this weakness, the unemployment rate fell to 4.7 percent in May—its lowest level since 2007.
- Swiss company Nespresso announces it will begin selling Cuban-produced coffee in the United States this fall. It will be the first Cuban product available at American retail stores in over 50 years.
- German auto giant Volkswagen AG agrees to pay up to $15.3B in penalties and settlements for the diesel-emissions scandal uncovered last year—the largest settlement in automotive history.
- IEX Group wins approval from the SEC to open a new U.S. stock exchange. IEX has differentiated itself from other exchanges by implementing a 350 microsecond delay on all trades, disrupting computer "flash trading" that reportedly drives up stock prices for individual investors.
- The world's largest uncut diamond (1,109 carats) fails to sell at its London auction after the $61M highest offer does not reach the minimum reserve price set by the Lucara Diamond Corp. that uncovered it last year.
- The German 10-Year Bond yield falls to a negative level for the first time in history and U.S. mortgage rates hit three-year lows. The drop highlights strong demand for low-risk assets amid the uncertainty surrounding the U.K. "Brexit" vote.
- Microsoft Corporation acquires the business-networking social website LinkedIn for $26.2B.
- Online pseudo-journalist group Gawker Media files for Chapter 11 bankruptcy protection after losing a $140M lawsuit over privacy invasion. Gawker Media owns several popular blog sites, including Deadspin, Lifehacker, Kotaku and Jalopnik.
- Strong appreciation in home values pushes the wealth of Americans to new high of $88.1T in Q1 2016.
- Xerox Corp announces plans to split, spinning its business services off into a new company called Conduent.

A Market High – But Is It A Market Top?

In case you hadn't noticed, the S&P 500 index reached record territory on July 11th, and the Nasdaq briefly crossed over the 5,000 level before settling back with a more modest gain. At 2,137.6, the S&P 500 finished above the previous high of 2,130.82, set on May 21, 2015.

We've waited more than a year for the markets to get back to where they were before the downturn this January, before Brexit, before a lot of uncertainties in the last 12 months. The market top itself is an uncertainty; after all, many investors regard market tops warily. When stocks are more expensive than they have ever been (so goes the thinking) it may be time to sell and take your profits. However, if you followed this logic and sold every time the market hit a new high, you'd probably have been sitting on the sidelines during most of the long ride from the S&P at 13.55 in June 1949, which was the bull market high after the index started at 10. New highs are a normal part of the market, and it is just as likely that tomorrow will set a new one as not. In fact, overall, the market spends roughly 12% of its life at all-time highs.

To further emphasize the point, the S&P has set new closing highs on July 12, 13, 14, 18, 20, and 22, since its first new high in nearly 14 months on July 11th.

We all know that the next bear market will start with an all-time high, but we can never know which one in advance. Market highs do not necessarily become market tops. Let's see if we can all celebrate this milestone without the usual dose of fear that often comes with new records.

-Bob Veres

Sources:

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