Second Quarter 2016 Commentary

The big news this quarter, which occurred in the last week of June, was the United Kingdom's departure from the European Union. The media has dubbed this "Brexit," and there has been all manner of wailing and gnashing of teeth going on by the talking heads on CNN, BBC, Fox News, and other news channels.

Stock markets around the globe saw sharp declines on Friday June 24, the day the Brexit was officially announced. All told, a little over $2 trillion in stock market value was wiped away on that last Friday in June. Most pundits had been predicting that UK voters would choose to remain as members of the EU, and the surprise result was clearly a shock to the system.

Most global markets appeared to stage a sharp rally the next week, though, more than offsetting the declines on the day of the announcement, although the month of July has seen a return of that original choppiness.

Amidst all this uncertainty, U.S. stocks generally managed to register gains for the quarter. The S&P 500 was up 2.5% (including dividends), while the Dow Jones Industrial Average advanced by 2.1%. The tech-heavy NASDAQ bucked the upward trend, posting a modest decline of 0.2%.

Silver Linings

In all the panic created by the Brexit vote, though, we noticed a couple of oddities and silver linings.

As strange as it may sound, that week which ended on June 24 was actually one of the best weeks in a while for the UK stock market. As measured by the FTSE 100 index, British stocks advanced 2.0% that week. That is to say, for the first four days of the week (June 20-23), the British market increased by 5.3%, giving back most but not all of that gain on Friday June 24. Net it all out, and that 2.0% gain was good enough to be the fifth-best week in the first half 2016.

Also, though you would never guess it from the sensational way it was covered in both the financial and mainstream media, we U.S. investors were actually significantly better off at the market close on Brexit Friday than we were just a few months back. From the low point the S&P reached in February 2016, the S&P 500 returned 13.5% through the end of the day on June 24. But with headlines blaring things like "Brexit Fears Realized, Dow Plummets," how was the casual observer to know?

What, Me Worry?

One question we wonder is what exactly American investors should be so concerned about regarding a Brexit? Sure, the odds of a recession in the UK in the near-term are now higher, but would that immediately translate to trouble here at home? According to Factset, the 500 companies which make up our most widely followed stock market benchmark, the S&P 500, currently have an aggregate revenue exposure to the UK of 2.9%.

Additionally, as we have written about several times before, GDP growth is not always simultaneously correlated to stock market moves. That is, some of the best years in the stock market have occurred during times of economic contractions, and some of the worst years have been during expansions. Sure, sometimes economic recessions are concurrent with stock market pullbacks, but there is no financial law that says that the two must occur together.

We also think back to the other market turmoil of the last few years, and we look at how stock markets around the world reacted to them. For instance, the deadly Fukushima earthquake and tsunami in early 2011 sent Japanese stocks tumbling in the short-term aftermath, but the Nikkei 225 index is now about 50% higher than where it stood before the devastation. Or here in the U.S., do you remember how in 2013 we narrowly averted driving our country over the fiscal cliff, but then ended up experiencing a shutdown of the federal government as Congress negotiated its way out of our debt-ceiling crisis? Those political missteps certainly caused some rocky days in the stock market, but the S&P 500 currently stands about 30% higher than it was at that time.

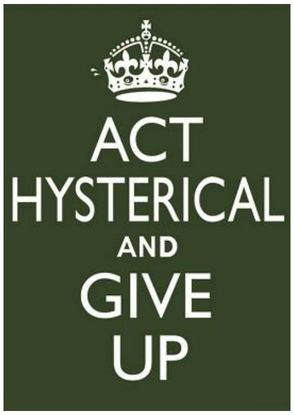
We are in no way trying to equate those examples with the current situation, nor are we trying to deny that there will be a gargantuan amount of work necessary to make the Brexit actually happen. Trade agreements will need to be renegotiated, immigration rules must be established, a new prime minister must be elected, and on and on. Further, there could be more fallout yet to come. Scotland, and possibly Northern Ireland, may decide that they want to stay in the EU and therefore they would need to leave the United Kingdom to do so. Other EU countries may begin thinking like Brits and decide that they, too, want to go it alone and leave the EU.

The bottom line is that none of us knows exactly what's going to happen. Many "experts" thought they knew what was going to happen in the Brexit referendum, only to be proven disastrously wrong. And if there's one thing a stock market detests, it's uncertainty. Which is exactly why we're seeing some downward pressure on stock market prices right now. When that uncertainty begins to abate, markets should return on their normal path again.

Keep Calm

So what's an investor to do in a time like this? Our current feelings, based on all we know so far, are best summed up by those World War II-era British propaganda posters which say Keep Calm and Carry On:

The original intent of the British government was to display these posters throughout the United Kingdom following German air raids during the war. Though never actually used for their intended purpose, the sign has become quite popular in recent years. You may have seen one of the many take-offs of the original that have proliferated over the last few years:



But back to our point. We say to our fellow investors, keep calm and carry on. Note that we are not necessarily saying keep calm and do nothing. For investors such as us that buy individual stocks, times like these can be great opportunities to pick up bargain issues which will hopefully reward us over time. The stock market, and indeed the world itself, has successfully lived through many panics, crashes, earthquakes, tsunamis, and various other calamities over the years. We believe the odds are good that it will weather this storm as well.

Thank you once again for your confidence, support, and referrals. We look forward to reporting to you again in three months.

Sincerely,

FELIPE

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