Volume 69

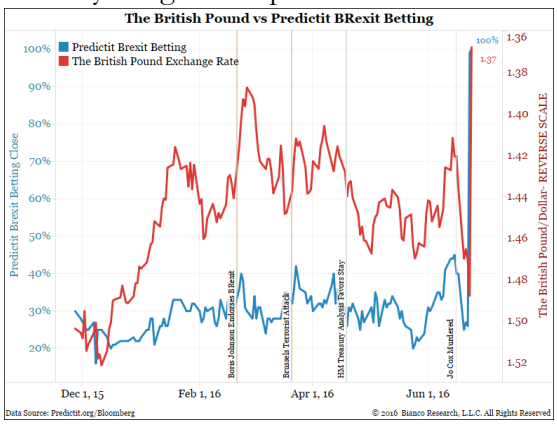
THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

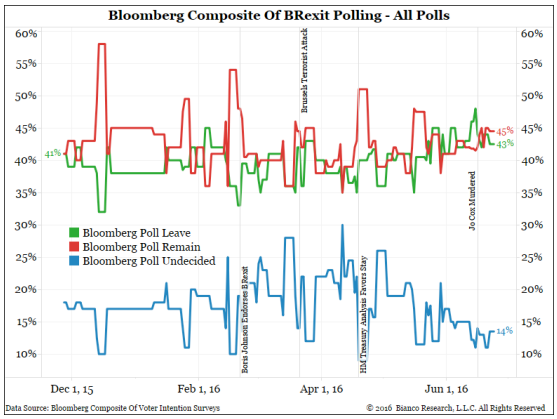
July 2016

We have noted on many occasions within the confines of these reports that capital markets thrive on certainty and struggle mightily when confronted with uncertainty, because investors know how to properly price securities when they understand the perceived risks and potential rewards associated with any given market environment, but tend to price in the perceived worst case scenario when confronted with market environments that are fraught with uncertainty.

This is why markets rallied very strongly into the "Brexit" vote once the betting platforms and British pound started reflecting a virtual certainty of a decision to remain within the European Union, and why the global capital markets lost a massive $2.6 trillion of value in only one trading day, once this perceived certainty was shattered. This is sum is greater than is the size of the entire Canadian economy.



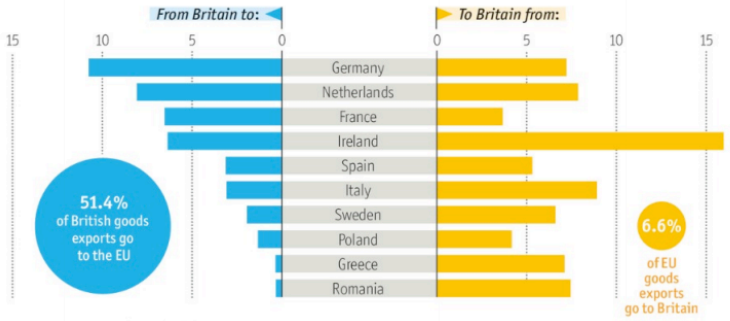
How could the "smart money" have gotten everything so wrong? Many have offered explanations, almost none of which we find very satisfying. One of the most common is that the torrential rains that hit the London area (which has a very pro-EU leaning) on the day of the referendum held down voting numbers.



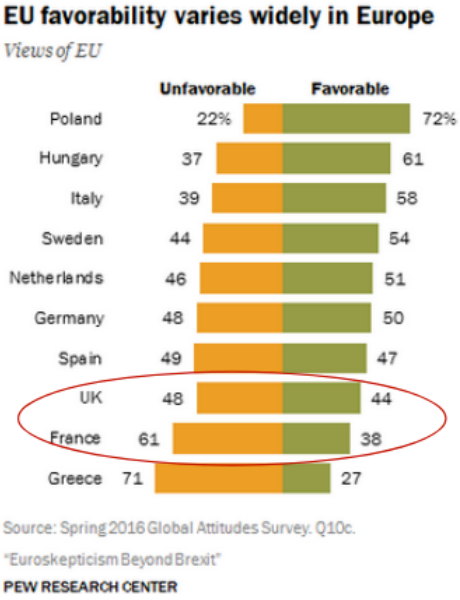
Instead, we attribute the referendum's shocking results to a perhaps less obvious fact, which is that Boris Johnson, Nigel Farage and the rest of the pro-"leave" faction did a remarkably effective job of convincing the voting public that the dire warnings coming out of the International Monetary Fund (IMF), the World Bank, and virtually anyone who has ever successfully passed an economics class were simply fear-mongering being perpetrated by the existing establishment in order to protect their own power and greedy self-interests.

Despite these assurances from the "leave camp" the two days following the referendum produced a greater than $3 trillion loss in global capital markets, which represents the worst two-day loss in history.

It also left both the Liberal and Tory Parties in absolute disarray, and left Prime Minister David Cameron with little choice but to resign. It also cost Britain its AAA credit rating, it caused 12 of Britain's banks to be downgraded for credit quality, and catalyzed the British pound to collapse to a 31-year low. That is not even to mention that Britain seems headed for a deep recession when and if it does ultimately withdraw from the EU. Indeed, Britain entered the "Brexit" referendum as the fifth largest economy in the world. As a consequence of the outcome, it just ceded that position to France, primarily as a result of the collapse in the value of its currency.

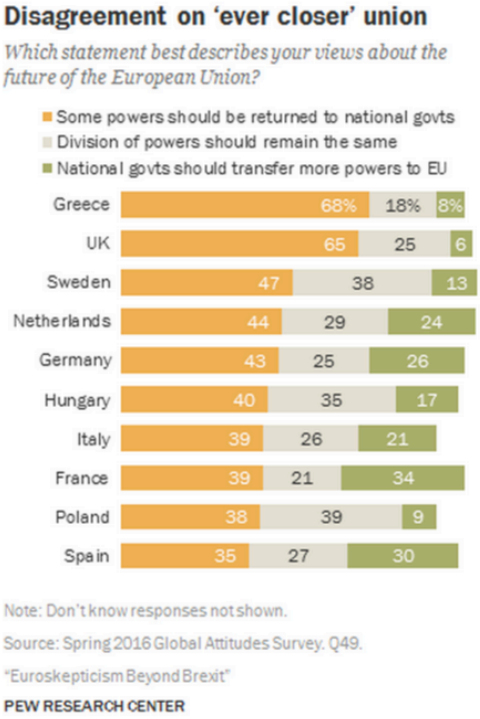


Tied to the hip. Exports of goods between Britain and the EU, 2014, % of national totals. Source: Economist.com



Obviously, the British population was misled by the "leave" camp, which is why there is already a petition with more than 4 million signatures on it asking for a second referendum. By law, this means that Parliament must discuss the issue. However, on June 27th, Prime Minister David Cameron pronounced in Parliament that, while he still thinks that "Brexit" is a terrible idea, the outcome of the referendum should be passed into law.

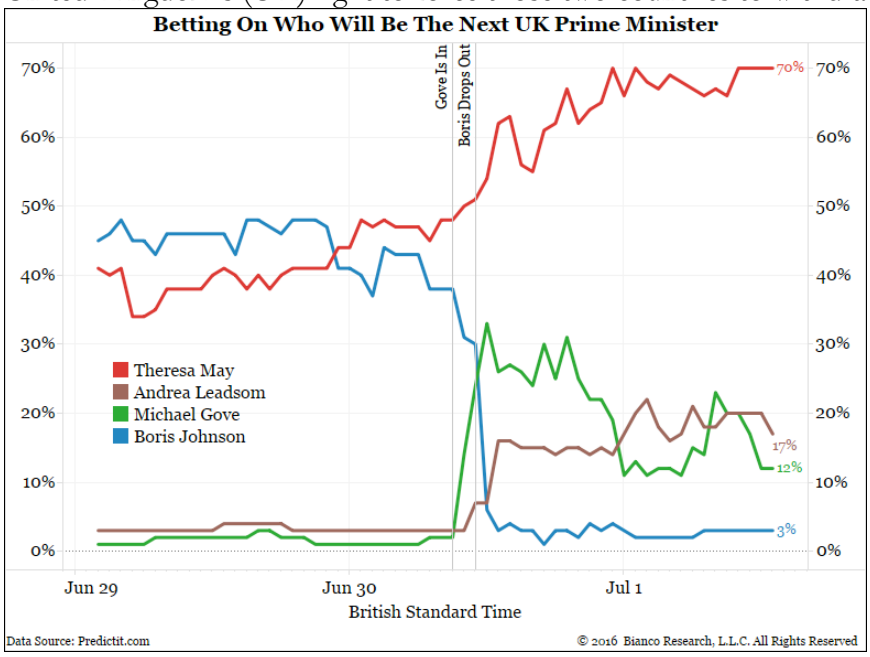
Importantly, he also said that he would not invoke Article 50 of the Lisbon Treaty (which starts the withdrawal process), and that he would leave that step for the new Prime Minister, who is not likely to come to power until September at the earliest. Technically, the new Prime Minister could elect to never even invoke Article 50, as the referendum is not legally binding.



To emphasize, Britain is still a member of the European Union (EU), and is likely to remain as a member for at least another two years. Indeed, once Britain invokes Article 50, it starts a two-year process of negotiation regarding their exit, and despite their vehement protestations, there is nothing that the remainder of the EU can do to force Britain to accelerate the process.

While we believe that one must assume that a "Brexit" will ultimately take place, there are a number of reasons why it is far from being a foregone conclusion.

For example, based upon the Scotland Act of 1998, the Scottish Parliament must agree to any measure that eliminates the application of EU laws in Scotland. Since Scotland (and Northern Ireland) voted overwhelmingly to stay as a part of the EU, it should be no surprise that factions in both countries are attempting to put in place constitutional challenges to the United Kingdom's (UK) right to force those two countries to withdraw from the EU. Of note, if "Brexit" does take place, it is highly likely that Scotland will hold another referendum about remaining as part of the UK, and it is fully expected that it would be successful this time. This would effectively end the 300-year-old history of the "United" Kingdom.



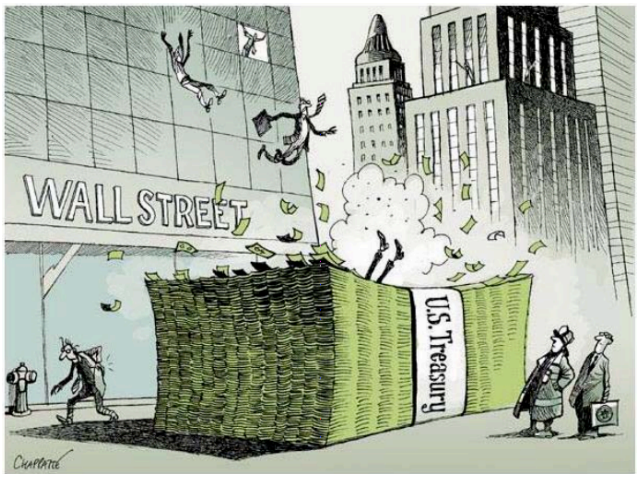
In addition, the law firm Mishcon de Reya has just filed a lawsuit that would require the British government to get Parliamentary approval before it can invoke Article 50, and it is estimated that 75% of Parliament's 650 members favor remaining in the EU.

Further, Theresa May, who is an overwhelming favorite to be elected as the new Prime Minister in September or October, has stated that, while she would plan on invoking Article 50 (despite being a strong opponent of "Brexit"), she would not do so until 2017 at the earliest. There is a lot that can happen between now and then.

Of interesting note, since 2001, France, Ireland, and The Netherlands have all held referendums on European-related issues which were ultimately just ignored by politicians. The same is true of a 1992 referendum in Denmark. There is certainly historic precedent for Britain to do the same.

However, despite these and other obstacles to the actual implementation of "Brexit", we believe that, at this point, it is only prudent to assume that it will go through as planned. However, that outcome is nowhere near as dangerous as it would have been a week or two ago, when the markets fully reflected everyone's confidence that "Brexit" would be defeated. In other words, so much of the post-"Brexit" losses just retraced the powerful rally that preceded the referendum based upon overwhelming confidence that Britain would stay in the EU. Now, almost everyone expects for "Brexit" to take place, which means that much of its associated risks are already reflected in prices. If, for some reason, "Brexit" does not take place, it would likely be an even more powerful bullish influence than the "Brexit" vote was a bearish influence.

This is a political crisis, not a financial crisis, and we do not view it as a 2007-style systemic risk. Indeed, on many levels, "Brexit" is just part of a broader phenomenon that includes Donald Trump, Bernie Sanders, "Occupy Wall Street" and the "Tea Party Movement".



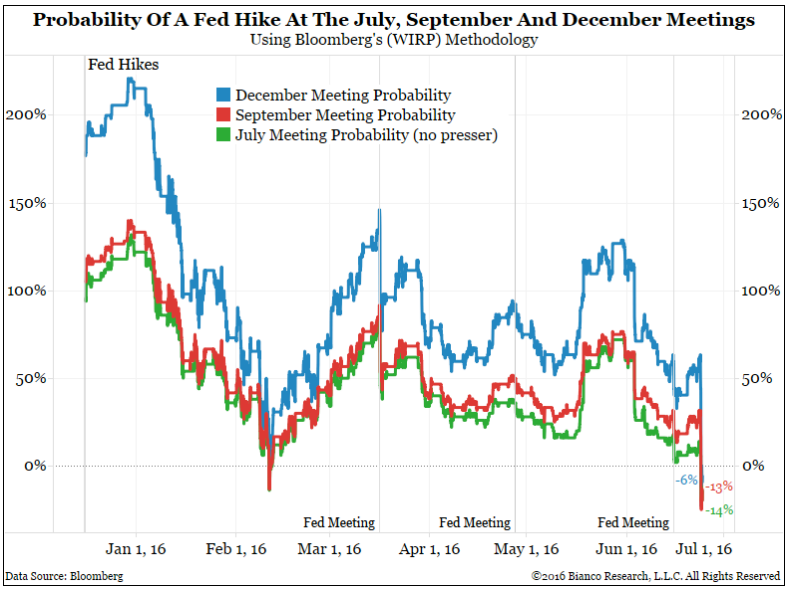
We view each of these as manifestations of a backlash from the global financial crisis, the broad perception that the wealthy were bailed out at the expense of the less fortunate, and the fact that those most responsible for the crisis were never held accountable for their actions. There is a resulting distrust of the status quo and the nebulous "establishment".

It is this perspective and the growing trends towards nationalism, isolationism, protectionism, populism and xenophobia that have so many European leaders worried that a "Brexit" could catalyze a chain reaction with France, Finland, The Netherlands, Greece, and Italy each of which want their own EU referendum that could ultimately undo 70 years of European integration.

Indeed, an Ipsos MORI poll taken in nine EU countries showed that 45% wanted a referendum on EU membership and that 33% would vote to leave the EU. This poll was actually taken a full three months before the "Brexit" vote.

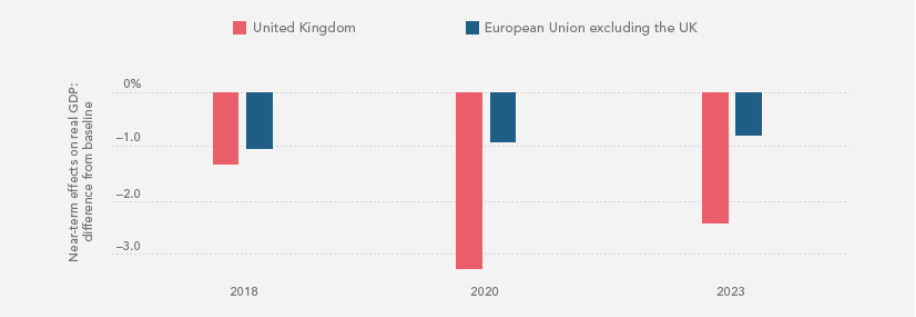
Like the election indecision in the 2000 Presidential vote, even a political crisis can roil markets with the uncertainty that they create. However, unlike in 2000, this political crisis carries with it some rather draconian economic risks.

The British Treasury estimates that the "Brexit" will cause the loss of 500,000 British jobs, a 10% decline in British home prices and a decline in the size of the British economy of 3.5% (a deep recession). Estimates are that it will shave approximately 1% off of the remaining EU economy and between 0.25% and 0.5% off of the economy of the United States.



Given the low economic growth rates that prevailed prior to the "Brexit" vote (the World Bank just cut its global growth forecast from 2.9% to 2.4%), the "Brexit"-related headwinds pose a risk of pushing the global economy perilously close to recessionary levels.

This is one of the reasons why the Fed Funds Futures contracts are showing a greater likelihood of a Fed rate cut in 2016 than a rate increase this year. Similarly, Bank of England Governor Mark Carney just announced that economic conditions in Britain are already deteriorating and that further monetary stimulus is likely over the summer. British Chancellor Osborne has also just announced a proposal to cut corporate taxes to 15% in a bid to keep companies from pulling out of the U.K as a result of the "Brexit" vote.



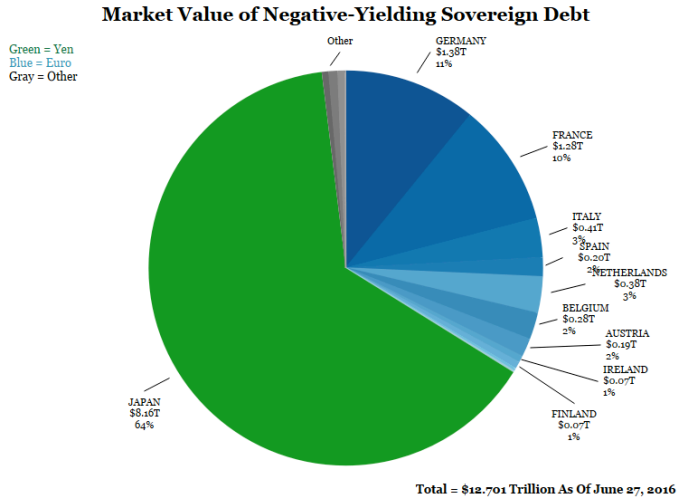
From our perspective, all of this comes down to two big questions. The first regards the severity of a risk of contagion (that other countries will follow Britain's lead). The second regards the impact on the global capital markets and whether or not changes need to be made to portfolio allocations in light of the "Brexit" referendum.

In regard to the risk of contagion, the fact that in the Spanish election, which was held almost immediately after the "Brexit" referendum, the conservative Partido Popular party gained seats against the far-left Podemos and Ciudadanos parties suggests that "Brexit" may have at least temporarily scared voters away from further anti-establishment moves. In addition, according to the latest poll from the European Commission, 37% of all EU citizens currently have a positive view of the EU versus only 23% with a negative view (38% are neutral), which suggests that the contagion risks are not as high as have been feared.

Even in the UK itself, the 52% to 48% split for "Brexit" was due almost entirely to voters above the age of 55, whose lives and job prospects will be least impacted by leaving the European Union. Of voters under 24, 75% voted to stay in the EU and, of those between 25 and 49, 56% voted to remain as part of the Union.

In regards to portfolio adjustments the first reaction is probably to get very defensive, and to stay away from the affected markets by shifting to the relative safety of the United States. We agree that foreign allocations should be reduced, but not eliminated, as Europe is already trading at a valuation discount of between 20% and 25% versus the U.S. In addition, the weaker pound and euro should greatly benefit exporting companies by making their exports more competitive overseas. This should be especially beneficial to British companies (and their stocks), as they make only 22% of their revenues from their home market. This largely accounts for the fact that, after experiencing severe losses in the days immediately following the "Brexit" vote, the British blue-chip FTSE Index rebounded to set a new 2016 high by the end of June.

In stark contrast, the stronger dollar is likely to be a stiff headwind in the face of domestic blue-chip earnings, as will the relatively protectionist agendas of both Trump and Clinton. Indeed, S&P 500 companies derive approximately half of their revenues from exports and foreign operations, which means that the expected slowing of the global economy and the stronger dollar are likely to significantly impact domestic blue-chip earnings. While the S&P's direct exposure to Britain is only a modest 4%, its direct exposure to continental Europe is a very substantial 17%, which is notably concerning.



Japan also faces currency-related challenges, as its economy depends overwhelmingly on its ability to export. Despite all of the economic headwinds faced by Japan, and the fact that almost two-thirds of the world's negative yielding debt is originated in that country, the value of the yen keeps climbing higher and higher, and this trend is exacerbating Japanese deflation and hurting Japanese corporate profits.

In contrast, the world's emerging markets may actually benefit from the "Brexit" vote and all of the turmoil and economic slowing that should come about as a result, as these markets tend to be very influenced by the level of interest rates, and these European issues should keep interest rates lower for longer than almost anyone would have expected just a few weeks ago.

In many regards, current conditions are largely unprecedented, which certainly complicates any attempts to anticipate future market leadership. However, if one ignores most of the political issues and just concentrates on the prospects for interest rates, currencies, and global economic growth, one can craft a reasonable market hypothesis.

This process suggests that one emphasize large capitalization exporting companies out of Europe and Britain and smaller-capitalization companies out of the U.S., which tend to cater to a domestic consumer base. Similarly, one should reduce one's exposure to smaller capitalization foreign companies and large-capitalization domestic exporting companies.

It also suggests that one should emphasize defensive consumer staple stocks over more economically sensitive (cyclical) stocks. Despite the fact that they are already quite over-valued on a normalized basis, it also argues for either high-yielding stocks or companies growing their dividends. This would include real estate investment trusts (REITS) and even utilities. An exception would likely be banks and other financial companies in light of our expectations for rates remaining near historic lows for an extended period of time and the fact that there is a banking crisis emerging in Italy, which may create the next challenge to the sustainability of the EU (because Italy wants to use public funds to bail them out in violation of EU law that requires stock and bondholders rather than taxpayers to foot the bill for any bailout). Despite all of these aforementioned issues, we continue to prefer equities, REITs and even high yield bonds over virtually any other asset class over the longer term.