Executive summary

The surprising vote by citizens of the United Kingdom to leave the European Union (EU) is now in the rearview mirror. The initial negative reactions across most global equity markets have moderated and markets now appear to be digesting the evolving news and political positioning regarding Brexit. The decision to leave the EU now rests with the U.K. government, but they are unlikely to invoke Article 50 of the Lisbon Treaty notifying the EU council of their intention to leave the union, until new leadership is in place. New leadership will likely not be in place until October 2016 and once Article 50 is invoked, there will be up to two years of negotiations regarding terms of the U.K. exit. We believe global markets and economies are going to be impacted over time by this extended period of uncertainty. Growth prospects are somewhat muted and market volatility will be somewhat elevated given ongoing and changing news and events.

What are the possible outcomes now that the popular vote is in?

- **The United Kingdom stays in the EU on current terms.** The U.K. vote was non-binding, so the U.K. government is not obliged to act on the vote. Changing political leadership, perhaps new elections, could lead to a new referendum. For now, we view this as the least likely outcome, but it would be the most positive for global markets and economies.

- **A negotiated withdrawal from the EU.** Once U.K. political leadership is solidified, it can begin the exit process, including defining the type of relationship the nation prefers to have with the EU. The United Kingdom could seek to construct a relationship with agreements that reflect the concerns of its citizens. However, it appears it will be some time before such a solution could be reached. It is likely to be a couple of months or more before the United Kingdom invokes Article 50 to initiate withdrawal proceedings, and negotiations are scheduled to take up to two years and can be extended by a unanimous vote of the EU Council. At this time, we view this as the most likely outcome, but with some negative impacts for global economies and markets due to the cost of transition and interim uncertainty.

- **A destabilizing exit from the EU.** This would result if the United Kingdom starts the withdrawal process and, after two years of negotiations, no agreement is reached and there is no vote to extend negotiations. The United Kingdom would exit the EU with no trade agreements with its largest trading partner. Also, this scenario could involve further exit votes among other EU countries and a breakdown of the European experiment. We believe this outcome is improbable, but would be the most damaging to the global markets and economy. Much of the damage would be done late in the negotiation process or if we saw additional “leave” votes among other EU members.
Can the global economy continue to grow with this turmoil?

Generally, we expect this uncertainty to reduce potential growth across the global economy, but only slightly. The largest impact will be on the United Kingdom, which could slip into a recession within the next couple of quarters. There may also be a drag on EU economic activity, but we think it should avoid economic contraction and continue to experience modest growth. As each step of the political process around Brexit unfolds, there could be further positive or negative shocks to economic output, but most are likely to be more modest in nature. The exception is if we see a meaningful uptick in votes amongst EU countries to leave, which appears to be a low probability at this time.

The United States will likely see a fractional drag on economic output, but growth should remain relatively positive due to our solid fundamental underpinnings. Solid labor market growth, wage gains and stable investment trends point to solid, but slow, economic activity.

Global stock market impacts

- **United States**: The rise of uncertainty in both political and economic outcomes is likely to act as a drag on the U.S. stock market, potentially through a compression of the price earnings multiple for stocks. We have been looking toward earnings growth as the key driver of future equity market gains. With solid leading indicators of economic activity, plus low inflation, we think the fundamentals of the U.S. market still look good. Second quarter earnings and likely cautious statements and expectations by company managements in light of Brexit-related uncertainty could be near-term headwinds. However, more dovish global central bank policies could provide countervailing support. Investors are likely to seek companies with growing earnings and dividends in this environment of slow global growth. Valuations appear reasonable among these types of companies, leading us to favor the Technology, Healthcare and Consumer Discretionary sectors.

- **International equity markets**: Initial market reactions to the Brexit vote were quite negative, especially for companies relying on sales in the United Kingdom. Despite likely slower economic growth, the decline in the euro and British pound and additional monetary accommodation may reveal value opportunities across these markets, especially export-driven companies, which rely on the global economy to drive their earnings growth. Volatility across these markets is likely to be elevated for some time, following along with the shifting political situation.

Japan has also struggled recently, primarily due to safe-haven demand, which has strengthened the yen. The Bank of Japan (BOJ) is likely to engage in additional measures to weaken the yen, reflecting long-term plans to rekindle modest inflation and relieve government debt pressures on the economy. This should lead to some support for the Japanese stock market, especially if the government succeeds in enacting additional structural reform.

Brexit and global monetary policy

The rise in uncertainty appears to have put global central bankers in a more cautious mood.

- **Federal Reserve (Fed)**: We now believe a rate increase is unlikely until the December Federal Open Market Committee meeting. By this meeting, we will be past the U.S. presidential election, we should have new leadership in the United Kingdom, additional clarity on the next step to Brexit and U.S. labor markets and inflation data should improve. There are very slight odds for an increase at the September meeting, but we believe this would require key economic data to perform well above expectations. In 2017, barring a significant uptick in political uncertainty, we believe the Fed is likely to raise rates two or perhaps three more times.
Brexit: A Long-term Spectre of Uncertainty – continued

- **Central banks**: The European Central Bank (ECB), the BOJ and the Bank of England are all likely to increase monetary accommodation this year to support their economies and to counter recent market volatility. The Bank of England is likely to cut rates due to much lower expectations for economic activity. The ECB and BOJ are both expected to expand quantitative easing programs and the ECB may explore additional negative interest rate policies.

**What are we watching?**

In our view, uncertainty will be a part of our investment landscape for a couple of years, with the Brexit debate and terms haunting consumers, companies and investors. This uncertainty will likely be experienced as a drag on economic output, as well as temporary spikes in market volatility and investor risk aversion. Political decisions and negotiation news will be primary drivers of this volatility. We will be watching a few key political events to evaluate likely outcomes, as well as market and economic impacts.

- **The replacement of David Cameron as U.K. Prime Minister and related key political positions**. Prime Minister Cameron has refused to initiate EU withdrawal and is leaving this act to his successor. A new Prime Minister is the first step toward the Brexit event. The new leadership will determine the appropriate negotiating position of the government with the EU, as well as internal U.K. constituencies, such as Scotland and Northern Ireland.

- **The political position of EU ministers, as well as Jean-Claude Juncker, President of the European Commission**. Public statements made will establish their bargaining position and help us understand the degree of difficulty for negotiations. For now, they have indicated free migration is a key component of any EU trade arrangement, which is an important issue for the United Kingdom.

- **The standing of populist or Eurosceptic parties across Europe, including the National Front in France**. In particular, stress has been seen in Italy, Spain, Portugal and Greece. The relative popularity of such parties could lead to additional votes on “leaving” the EU and would increase uncertainty and risks.

**Investment strategy during periods of uncertainty**

Heightened market volatility and an uncertain political environment often lead investors to raise cash or shift to lower risk portfolios. In our view, this may not be appropriate and may damage portfolio performance relative to long-term goals and needs. Interest rates are historically low around the world and cash is typically paying U.S. investors zero or near zero income. Around the world, the volume of negative yielding government debt surged to more than $11 trillion at the end of June, compounding the difficulty for investors to find positive yields to meet their goals. Higher risk asset classes are likely to become a component in attempting to generate long-term returns. As of the end of June, nearly two-thirds of S&P 500 stocks offered a dividend yield in excess of the current yield for the 10-year U.S. Treasury.

We believe investors should maintain well diversified portfolios across global stocks, bonds, real estate and commodities to help combat market volatility and to remain on track for long-term goals. Returns are likely to be modest, given low interest rates and fair to full equity valuations. However, we believe portfolio diversification across a mix of growth and income investments is preferable to help potentially weather the long-term nature of this uncertainty while continuing to earn some return over cash in the near term.

If you have any questions about your investment strategy through these tumultuous times, please reach out to your Wealth Management Advisor.
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Diversification and asset allocation do not guarantee returns or protect against losses.

**Past performance is no guarantee of future results.** The S&P 500 Index consists of 500 widely traded stocks that are considered to represent the performance of the U.S. stock market in general.

**International investing** involves special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards and other risks associated with future political and economic developments. Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. **Equity securities** are subject to stock market fluctuations that occur in response to economic and business developments. Investments in **fixed income securities** are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. Investment in fixed income securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. There are special risks associated with an investment in **commodities**, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors. Investments in **real estate securities** can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates and risks related to renting properties (such as rental defaults).

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