MV CAPITAL MANAGEMENT

Weekly Market Flash

And Then There Were 27

June 24, 2016

It was almost three years ago to the day. On July 1, 2013, Croatia became the 28th country to join the European Union. “Joyous Croatia Joins Europe Amid a Crisis” ran the *New York Times* headline of that day. The article noted that the accession of the Balkan republic represented a “rare moment of satisfaction” for an EU beset by stagnant economic growth and a chronic financial crisis. Today there is little in the way of satisfaction or joy in Brussels, as Europeans digest the reality that their club is set to shrink in numbers for the first time since representatives from France, West Germany, Italy, Belgium, the Netherlands and Luxembourg met in a sumptuous room in the French foreign ministry in April 1951 to sign the Treaty of Paris. The British have spoken, and they plan to go it alone.

Of Polls and Pain Trades

Longstanding readers of our weekly commentary will be familiar with our general view on event-driven trades, which is easily boiled down to two simple words of advice: do nothing. The Brexit vote is a compelling case in point for this view. One week ago, poll numbers were showing a slight momentum trend towards “Leave,” risk asset markets were pulling back and volatility was up. Then, a new batch of polls over last weekend suggested that momentum was shifting back towards “Remain,” perhaps in the wake of the brutal shooting of Labor parliamentarian and strong Remain supporter Jo Cox. The momentum shifts in both cases were fairly tempered, with most poll-of-polls composites showing a likely outcome within statistical margins of error either way.

Of course, that did not stop the punters from placing their bets. As the week progressed those bets – now skewed heavily towards a “Remain” outcome, looked more and more like a sure thing. As markets closed for trading on Thursday, the odds as reflected in financial betting markets were over 95 percent for Remain (despite the fact that actual polls still showed nothing remotely that convincing). Global equities closed sharply higher, as did the pound sterling. Then the results came out. There will be pain trades aplenty today, and hopefully a useful reminder about the non-existence of free lunches. Sometimes “do nothing” really is the most prudent course of action.

What Next?

There is still much that is unknown about the economic impact of Brexit; first and foremost, what specific kind of relationship the UK will have with the Continent going forward. Will Britain be part of a free trade area framework similar to what Norway has with the EU now? Or will there be some kind of customs arrangement for certain goods and/or services, similar to Turkey’s current arrangement? Or something altogether different? There would appear to be plenty of free-lunch thinking among Leave supporters who imagine they can somehow benefit from favorable trade with the EU while restricting the free movement of people (anti-immigration being perhaps the strongest motivating sentiment behind Brexit). Much was promised by the Leave campaign of a highly questionable nature.

That thinking is likely to be disabused by EU negotiators not inclined to be overly accommodating, lest Britain’s example set the stage for further referenda (chatter about France and a “Frexit” lit up the Twitterverse almost instantaneously following last night’s outcome). Article 50 of the Treaty of Lisbon sets forth (very briefly) the terms of disengagement from the union; at this point, all that is clear is that the time frame for leaving is two years. We don’t even know who Britain’s point person in the negotiations will be, as current prime minister David Cameron intends to step down in October. All of which is to say – we would caution against getting too deep into any one particular scenario ahead of even knowing opening gambits on the key issue of ongoing coexistence.

The View from the Corridor

Meanwhile, even today’s frothy market of pain trades and a spike in the VIX volatility index may not drive the S&P 500 below the floor of the corridor where it has been stuck for more than twenty months. So far, at least, the pullback in stocks is relatively contained while bond yields and currencies have also settled down from the more frenetic activity levels seen earlier in Europe, before US markets opened. There is essentially no doubt that central banks the world over are prepared to flood the markets with as much liquidity as they think necessary to stave off a collapse in asset prices (Fed funds futures markets, however improbably, even allow for a 10 percent chance that the FOMC's next move will be a rate cut). The policy floor is firmly in place. Meanwhile, the next several months may prove even tougher for stocks on the upside, if uncertainty in Europe sets the stage for another strong run by the US dollar. We were just starting to see more corporate management teams gently guide sales and earnings up in expectation of more forgiving currency conditions. Stiffer currency headwinds imply more resistance at the valuation ceiling.

These conditions may change, of course, and we will be closely following the nuts and bolts of how Brexit plays out in the coming weeks. For now, though, we are comfortable with where our portfolios are positioned. We maintained a somewhat more defensive than usual position even as asset markets rallied strongly in March and April, with underweight positions in small caps and non-US stocks while favoring higher quality, dividend-paying large caps. We continue to maintain a modest cash buffer to augment a fixed income allocation of mostly high quality short and intermediate durations. That persistent corridor serves as a useful metaphor in our opinion: neither is it time to go into a super-defensive crouch, nor to let the bulls run rampant. Stay in, but stay cautious.

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