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Economic and Market Outlook

June 24, 2016

(After Brexit—Special Report)

The Unthinkable--Revisited

Investment strategists worldwide were wrong. The nearly universal opinion about Brexit (the British exit from the European Union [EU]) was that the vote would be to remain. When the vote turned out to be to leave, all markets worldwide were stunned.

However, the Brexit vote's direct effect on the United States is limited because trade with Europe and the United Kingdom (UK) combined is just a little over 2.5% of our Gross Domestic Product (GDP).

The indirect effect, of course, is clearly one related to an increase in uncertainty and volatility. But domestic demand by U.S. Consumers (i.e., 70% of GDP) will not be greatly impacted.

It is also highly probable that the Federal Reserve will delay to year-end, or even 2017, what had appeared to be a likely increase this July.

The UK will now serve as a real-life experiment in what happens when a developed nation turns inward (i.e., shuns globalization).

Those who believe the UK will be better off out of the EU will now find out. The process of divorce will be long and messy as Britain works on new trade agreements as well as on a multitude of new relationships.

Most economists expect a sharp drop in UK economic activity—perhaps even a recession in 2017-18. If a recession does develop, it will harm the very voters who voted for exit the most (i.e., blue-collar voters in middle England).

The major fear is contagion, with the UK itself potentially losing Scotland and, perhaps, Northern Ireland as well, plus the strong probability that the EU will see a number of member exits.

It is now hoped that the UK and all 28 members of the EU will, in fact, succeed in new trade talks concerning the free flow of goods, services, workers, and capital, as well as succeed in resolving the many problems that built-up resentment—in particular, the free movement of residents of one country to another (i.e., immigration policies).

From our perspective, it is hard to be hopeful for them, as we expect prosperity to slowly leak out of both the UK and the EU over the next two years.

Historically, there have been many shocks to our markets since World War II. As Sam Stovall, of Standard and Poor's, said Friday, June 24, 2016, "What you find is that the market goes down 6% to 8% in a one-week period and then takes about two weeks to get back to breakeven."

The U.S. market fell about 3.5% on Friday, so some additional decline can be expected in the next several days.

It needs to be remembered that, while Brexit is a "Crisis Event," in the same category as those we laid out in our September 30, 2001, report entitled, "The Unthinkable Happened," many of the events were far more directly and indirectly a problem for us, yet all but 3 of the 18 stock-market disruptions that took place with these events was clearly recovering or even more than offset within two months (Pearl Harbor/Pres. Nixon Resigns/USSR Invades Afghanistan took longer). (See Table attached.)

We repeat—many of the events were dramatically worse than the implications of Brexit.

The data presented in the attached Table offer illustrations of the value of staying the course—simply put, the market recovered in short order.

After this week's fireworks, the Dow Jones average finished down less than 1.6%, despite the 610-point, or about 3.5%, loss on Friday.

From our perspective, the key to Brexit's long-term effect will be if any material damage shows up among the major sectors of our GDP. If it does, we will, as we always have, move to protect portfolios (i.e., protect principal).

Following this Special Report is our regular quarterly Economic and Market Outlook report, which the Brexit vote does not change.

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Table—Event Crisis
(Source: Forbes.com)

<u>Event</u>	<u>Date</u>	<u>Dow Jones Average Decline</u>	<u>2 Months Later</u>
1. German Invasion of France	May 9, 1940	-17.1%	+8.4%
2. Pearl Harbor	December 7, 1941	-6.5%	-2.9%
3. Start of Korean War	June 23, 1950	-12.0%	+15.3%
4. Eisenhower Heart Attack	September 23, 1955	-6.5%	+6.6%
5. Launch of Sputnik	October 3, 1957	-9.9%	+6.7%
6. Cuban Missile Crisis	August 23, 1962	-9.4%	+21.3%
7. JFK Assassinated	November 21, 1963	-2.9%	+12.4%
8. Oil Embargo	October 18, 1973	-17.9%	+10.2%
9. President Nixon Resigns	August 9, 1974	-15.5%	-5.7%
10. USSR Invades Afghanistan	December 24, 1979	-2.2%	-4.0%
11. Hunt Brothers Corner Silver	February 13, 1980	-15.9%	+16.2%
12. 1987 Crash	October 19, 1987	-34.2%	+11.4%
13. Gulf War Ultimatum	December 24, 1990	-4.3%	+19.8%
14. Russian Coup	August 16, 1991	-2.4%	+1.6%
15. World Trade Center Bombing	February 26, 1993	-2.8%	+8.4%
16. Asian Financial Crisis	October 7, 1997	-12.4%	+10.5%
17. Long Term Capital Failure	August 18, 1998	-11.3%	+24.7%
18. World Trade Center/Pentagon Attack	September 11, 2001	-14.3%	+19.4%
Average for 18 Events		-10.97%	+10.05%