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Not All Earnings are BREXIT driven

The BREXIT debate has ended and U.K. voters opted by a narrow margin to leave the European Union. Now the process of negotiating a separation begins, which officially will happen sometime over the next two years. But realistically, the implications for global trade will take a lot longer than that to be determined. While it is tempting to speculate on what the global economic changes will be, there is a wide range of potential outcomes making accurate predictions very challenging. The one impact that is relatively certain is a sharp drop in the British Pound and shift in capital flows. We have added a list of currency related effects in a table on page 4. In the meantime, we continue to focus on current earnings trends driving relative stock returns.

Last quarter we postulated that the forces driving downward revisions related to oil prices, foreign exchange drag, and waning capital investment were abating and that

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Total Return	2Q16	1 Year
Russell 1000	2.5%	2.9%
Russell 1000 Growth	0.6%	3.0%
Russell 1000 Value	4.6%	2.9%
Russell 1000 Cons Disc	-1.2%	1.9%
Russell 1000 Cons Stap	4.7%	17.5%
Russell 1000 Energy	11.2%	-6.7%
Russell 1000 Financial	2.6%	-2.7%
Russell 1000 HealthCare	6.2%	-3.6%
Russell 1000 Industrial	1.4%	5.7%
Russell 1000 Info Tech	-2.3%	3.6%
Russell 1000 Materials	4.0%	-1.2%
Russell 1000 Telecom	7.3%	23.4%
Russell 1000 Utilities	7.0%	31.5%

Total Return	2Q16	1 Year
Russell 2000	3.8%	-6.7%
Russell 2000 Growth	3.2%	-10.7%
Russell 2000 Value	4.3%	-2.6%
Russell 2000 Cons Disc	-1.7%	-13.9%
Russell 2000 Cons Stap	9.0%	10.5%
Russell 2000 Energy	7.2%	-38.9%
Russell 2000 Financial	4.0%	1.9%
Russell 2000 HealthCare	4.7%	-21.1%
Russell 2000 Industrial	2.8%	-6.7%
Russell 2000 Info Tech	2.7%	-3.0%
Russell 2000 Materials	12.6%	-4.6%
Russell 2000 Telecom	11.5%	17.9%
Russell 2000 Utilities	10.8%	30.7%

Total Return*	2Q16	1 Year
S&P 500	2.5%	4.0%
MSCI AC World	1.2%	-3.2%
MSCI AC World Ex U.S.	-0.1%	-9.2%
MSCI World (Developed)	1.3%	-2.7%
MSCI Emerging	0.7%	-7.7%
MSCI Dev. Europe	1.2%	-5.8%
MSCI Pacific Ex Japan	2.6%	-5.0%
MSCI Japan	-7.8%	-23.7%
MSCI China	0.1%	-23.3%
USD/EURO	-2.5%	-1.2%
USD/U.K. £	-7.4%	-15.3%
USD/MSCI EM FX	0.0%	-4.2%

* in local currency, net of tax withholding

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An Increasingly Correlated World by Chris Zogg, CFA
Missing Quarterly Expectations - The Rising Penalty by Rick Villars, CFA

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earnings expectations may be stabilizing. In fact, earnings have stabilized in Energy and dollar related industries, allowing expectations to flatten as seen in the green and blue lines in exhibit #1. But according to a recent SSGA survey an earnings slowdown is still the top U.S. investor concern. With the BREXIT related U.S. dollar strength and weakness in oil prices, these drivers may once again prove troublesome if they persist. Yet, there is some positive earnings momentum building in other areas.

Exhibit #2 shows rising expectations for both 2016 and 2017 for the Consumer Staples sector. Clearly, the last year has been a bit unusual for a sector that is known for its stable earnings stream. After a -12% drop in 2016 earnings expectations from the beginning of last year, the outlook began to rise in March. A deeper look shows the strongest rise in expectations for the Food Products industry, depicted in exhibit #3. Within this group sentiment for the large packaged food manufacturers had become quite negative with demand for fresh foods growing, an FX headwind for foreign sales, and slowing volumes in key emerging markets. But during the quarter, FX headwinds abated, emerging markets stabilized, and companies took product innovation up a notch. They are responding more agilely with ingredient reformulations of legacy products to be more natural and healthy. This is arresting their decline in market share and in some cases leading to firmer pricing. While product refresh progress has been made, there is still much room for continued improvement. Several of the big players in the industry reported positive surprises followed by a much more constructive tone in their conference calls. Additionally, while commodity costs are often over-shadowed by packaging and marketing expense in this industry, the lower input costs shown in exhibit #4 could also be providing a bit of a tailwind.

The other area where earnings are bouncing off of a trough is the Consumer Discretionary sector as seen in exhibit #5 on page 3. The themes driving this upward momentum are familiar. Consumers are increasingly preferring experiences over things and are ever more likely to do their shopping

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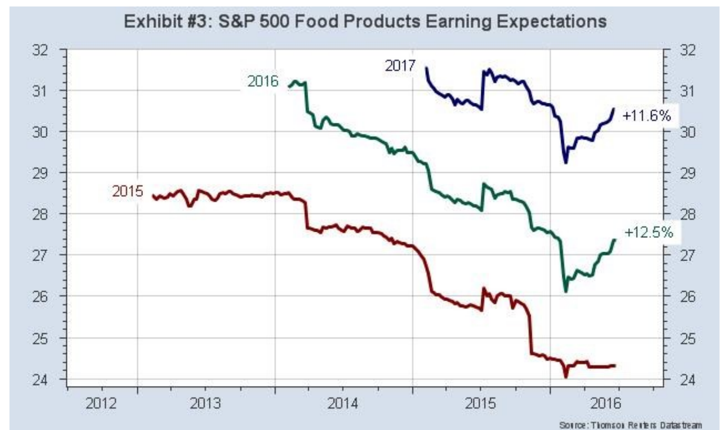

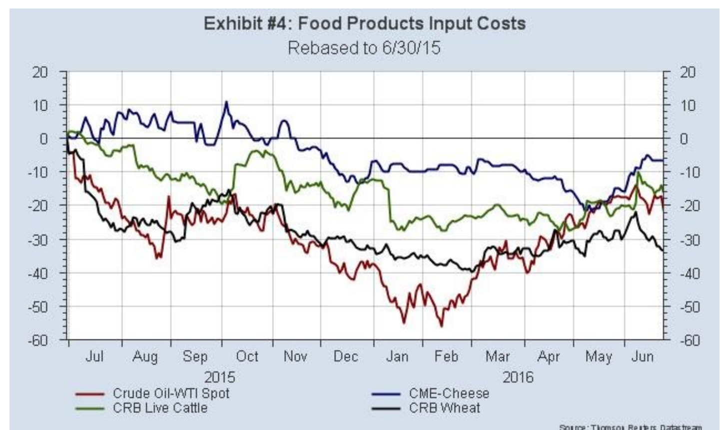

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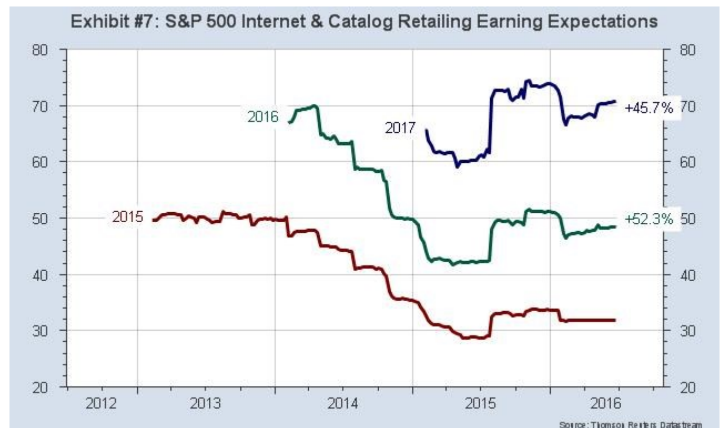
online instead of in the store. Exhibit #6 shows a bottoming of expectations for Hotel, Restaurant, and Leisure companies. Much of 2015 expectations trended sideways, but then slipped at the end of the year. The slide continued in the first quarter, but reversed in the second which is attributed to the recovery in consumer confidence and other indicators of firmer demand. The other area of strengthening earnings momentum is online retailing, which has been a standout growth engine for the sector. Exhibit #7 shows rising earnings expectations for this industry on top of an outlook that is already quite optimistic (+52.3% for 2016). The success of Amazon is a major driver of these expectations, but other online retailers are also participating.

Prior to the BREXIT vote there were emerging signs of an economic inflection point. Our friends at Strategas Research Partners highlighted real U.S. consumer spending growth at 4%, bottoming commodity prices, rising manufacturing activity as indicated by the purchasing managers' index, a more dovish FED, better housing data, rising corporate confidence, and U.S. dollar stability to name a few. Some of this economic momentum will be muted by the uncertainty created by trade negotiations yet to come between the U.K. and their trading partners. The falling U.K. pound and the Euro relative to the U.S. dollar is the most visible economic drag, making U.S. exports less competitive and reinstating a negative translation effect of foreign earnings. The other immediate reversal is apt to be in corporate confidence. While business confidence was beginning to look like it could lead to an uptick in investment, the newly uncertain global business climate is almost certain to put many foreign investment projects on hold and may even lead to hesitation for decisions to expand domestically in the U.S..

We believe the U.S. may be uniquely positioned to weather the storm. The consumer is still in a healthy position and employment is not apt to be hurt directly by BREXIT. A stronger U.S. dollar will mean goods are cheaper for U.S. consumers, which could support a retail revival. Lower interest rates will help support already rising housing activity



that is largely a function of pent-up demand. Below the surface, which is dominated by headlines of global turmoil, there are still some positive dynamics at work. All is not

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well in the global economy, but investors focused solely on what might go wrong may miss the big picture.

Market drivers, as indicated by factor returns, have been mixed throughout the quarter. During April and May companies with high earnings growth led the pack, while June saw a return to investor preference for high dividend paying, large cap companies. For the full quarter growth stocks outpaced their value oriented peers.

What begin as a fairly straight forward market dynamic that was beginning to see a better growth story emerging, ended in a cloud of uncertainty induced by the BREXIT vote. While we cannot claim to have predicted it, we always felt the market was underestimating the possibility that it could happen. Thus we are not overly surprised by the dramatic knee jerk reaction. The magnitude of the surprise and the vacuum of uncertainty feeds a tendency for investors to pull the trigger first and figure out the fundamentals later. No doubt about it, BREXIT will have a significant impact on trade and capital flows that will play out over many years. The last week has seen a flurry of hyper activity in the investment industry to figure out what the potential impacts are and the likelihood of them happening. As always, the media has a tendency to pick up the most sensational stories so those pundits predicting the most extreme consequences are getting more air time than professionals taking a more balanced, measured approach to analysis. Despite the short-term swings in sentiment of the past week, understanding BREXIT ramifications is going to be a marathon rather than a sprint.

Likely Implications of a BREXIT related slide in the U.K. Pound and capital flows

On the U.K.	On the U.S.A.
◊ U.K. exports will be more competitively priced, giving U.K. exporters a boost.	♦ Money will flow into the U.S. dollar due to its safe haven status making our goods less competitive in global trade.
◊ Inflationary pressure due to a higher cost of imported goods.	♦ Imports from the U.K. will be less expensive for U.S. consumers
◊ Reduction of incoming foreign investment capital due to the uncertain outlook for trade companies have already put planned U.K. investment on hold.	♦ Currency translation effect will reduce the U.S. dollar realization of foreign sales.
◊ A U.K. recession is almost assured as capital dries up. A European Union recession is a possibility.	♦ Recession in the U.K. and possibly the broader European Union will be a drag on U.S. exports. About 4% of U.S. exports go to the U.K. so a contained recession is not a huge impact, but if it spreads to all of Europe that would effect 23% of U.S. exports.
◊ U.K. banks get a significant portion of their funding from foreign wholesale sources. This funding will dry up or get much more expensive, leading to; • Reduced lending • Squeezed net interest margin	♦ U.S. banks with large U.K. or European operations will see a drag on earnings from currency translation, incur costs of reforming capital structures, and ultimately may have to segregate capital.
◊ The U.K. current account deficit was -7% at the end of 2015, meaning they are dependent on foreign capital flows. An end to those flows will require a significant readjustment in how many things are financed.	

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