June 27, 2016

BREXIT

Dear Investor:

The major event of the last quarter was the “Brexit”. As you know, the people of the United Kingdom, which consists of England, Scotland, Wales, and Northern Ireland, voted to leave the European Union. This brings 43 years of recent history to an end. On January 1, 1973, the United Kingdom joined the European Economic Community (EEC). This was essentially a free trade agreement between sovereign states. The EEC was replaced on November 1, 1993, with the Treaty on European Union (Maastricht Treaty). The European Union is a much stronger agreement with the individual states succeeding sovereignty to the European Union. Most of the states that have joined the EU have adopted the Euro. Others are waiting to do so. However, Denmark and the United Kingdom have an opt-out that allowed them to keep their own currencies. Thus, the UK is still using the British Pound for their financial transactions. This makes it much easier for them to go their own way as they do not have to put a new currency into circulation.

The referendum on this issue was humming along in the background for many months, but the market pretty much ignored it as no one thought it would actually happen. It was only in the last few weeks that it came forward as a big market moving issue. The polls started to show that the “leave” vote was quite strong and had some real chance of winning. In the end, the polls became too close to call. None the less, the market had assumed that the “remain” vote would prevail and moved up strongly on the day of the vote. The vote to leave was a big surprise to most, and markets around the world took a big hit. This is the first time that a member state has left the European Union. There are many implications to be considered.

Most sources I reviewed placed the UK economy as the 5th largest in the world at about $3 trillion GDP. They are a significant player. New trade agreements with the EU and other major partners will have to be negotiated over the next two years. While many have predicted the UK economy will be weaker, there’s no way to know at this point, as many of those predictions may have been designed to influence the vote. Recession fears are one reason the markets have reacted so negatively to this event. We know Europe has been weak since the Great Recession, they are way behind the US in their recovery. Many fear this disruption could cause a recession in the UK, Europe or both. Naturally, this would have a dampening effect on the rest of the world. This is the kind of uncertainty the market hates, and it’s not going away anytime soon. It’s going to take quite a while to see how all this plays out and what the actual impact turns out to be.

Currency turmoil is another kind of fallout. The Brexit changes the relationships between all the major currencies. The pound already took a big fall when the vote came out, but more broadly, this will

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likely also weaken the euro and strengthen the dollar. These had recently come into a more comfortable balance that was helping to reduce the headwinds to earnings in the US from the strong dollar. I expect that our multinational corporations will continue to have unfavorable currency adjustments to their earnings in the months ahead.

The Fed has also been thrown a curve ball by the vote to exit. It was only a month ago that the market was well primed and accepting of a possible rate hike in June or July. Then we were surprised by a very weak jobs report in May. Now with a potentially stronger dollar, worldwide recession fears, and a long period of uncertainty ahead, it's a real question if there will be any increase at all this year. Perhaps in the short run this may seem good, but it keeps us from getting closer to a true market where interest rates are set by supply and demand instead of central bank manipulation.

Meanwhile, the US economy has picked up in the second quarter and appears to be moving forward once again. Current estimates for Q2 are in the range of 2.6% annualized growth. While there are some very clear soft spots, most of the data has been good. The homebuilders' index has continued to improve. Builders are facing a scarcity of lots and labor in some locations. Housing starts have climbed to over 1.1 million. They were around 500,000 in 2009. Sales of existing homes rose to a nine year high in May. Consumer spending has also been strong. Retail sales are very good right now. Car sales are still high, but several articles have appeared talking about rising defaults in the subprime auto loan market. Total volume of US auto loans is in the range of $1 trillion. Subprime loans are about 20% of that or $200 billion. A default on some percentage of $200 billion is not going to start another crisis, particularly since there are still cars behind these loans that can be picked up and sold. What is does show us is that lenders have gotten very aggressive in this market. They realize that many people need their cars to get to work and will do almost anything to keep them on the road. This lowers their risk.

In conclusion, it seems very likely that we will have increased volatility this summer as everyone tries to digest this new scenario and figure how who the winners and losers are. This is going to take time, as we said earlier, no one has ever exited the EU. A lot of this just has to evolve, there's really no way to predict what it will look like in final form. Perhaps the EU may surprise everyone and try to find a way to keep them in, who knows. We are going to have to be patient. Right now the US economy is growing. Let's hope we are able to continue on that path. Please contact me anytime if you have questions on your portfolio.

Best Regards,

David E. Keim

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