Summer 2016

It'd be a bit daft, of course, to not start this quarter's *Folio* by addressing the not-so-cleverly-named "Brexit," Britain's recent decision to leave the European Union. After all, the passing of the referendum gobsmacked many experts.

And understandably so. Unlike others in the Union, Britain had taken a bolder route to economic recovery (austerity and reduction of government spending) and been outperforming every European country in economic and employment growth-and is the only EU member to reduce government spending as a percentage of GDP to pre-crisis levels.

Voters' motivations for passing the referendum, however, were far more complicated than simple economics. Social issues like immigration and welfare reform played a major role. Whether or not the Brits' choice was sound is not up to us to determine, and a moot question at this point. Our focus is on the immediate and long-term impact. The morning after the decision, markets around the world were adversely affected, though they've bounced back some since. This surprised exactly nobody. The only thing universally agreed upon by investors is uncertainty makes them nervous.

And there's plenty more uncertainty to come. Britain's road out is a long one. First, an election to replace Prime Minister Cameron, a staunch supporter of staying in the EU, which won't be held until October at the earliest. Then the filing of "Article 50," the provision in the EU charter that starts the exit process. The Article sets a two-year timetable to renegotiate all trade agreements, worldwide. And we haven't even mentioned the possibility of the country's reversing its decision, through a second referendum, among several other options, due to "Bregret." (From here out, we'll spare you the Briddiculousness of these freshly coined words.) The point is, there are a lot of things to work through still, and a lot of time for things to change.

If Britain does leave, however, their companies will continue to sell goods and services, and consumers will continue to buy their goods. There are many examples, but let's use Unilever PLC as one. The company sells over $59 billion (USD) worth of consumer products, including brand names like Dove, SlimFast, Vaseline, Lipton, and Ben & Jerry's, around the globe. Only 25% of that, however, is sold into the European markets. Elementary math tells us that means 75% of their products are sold to the rest of the world. This won't change, though new contracts and trade agreements will have to be worked out. Britain is the fifth largest economy in the world, at just over $3 trillion. They are too big and too important to be ignored. Jeremy Siegel, Professor of Finance at the Wharton School, may have summed it up best: "The Brexit vote is a revolt against centralization as much as globalization. Voters said I am willing to trade with my neighbors, but I want to control my borders and my destiny. This is not an economic disaster."

That said, Britain's decision to leave the EU is a big deal, and the events that follow need to be monitored closely. We're on it. But equally important, and imminent, issues are being lost in the headlines. The second quarter earnings season, for example, is shaping up to be another disappointing affair. According to FactSet, S&P 500 companies are expected to report a 5.2% decline in earnings from the second quarter of 2016. This would mark the first time since the height of the financial crisis that the index has endured five straight quarters of profit contraction. The energy sector remains the main culprit of the S&P 500's profit contraction, with an expected 77% year-over-year drop. However, excluding energy, S&P 500 companies are still expected to report a 1.7% slide in earnings.

But even that fairly alarming fact comes with a glimmer of good news. Starting with the third quarter of this year, analysts are revising their earnings estimates. Low unemployment, continued (but slow) jobs growth, and low energy prices take time to make an impact on economies. As we mentioned earlier this year, the tentacles of low energy prices reach far. They stimulate consumer goods demand and economic expansion through cheaper goods, manufacturing costs, and transportation (to get the goods where they need to get). Current analysts projections are for the S&P 500 and the S&P TSX indices to grow earnings by 9% and 14%, respectively, next year. Additionally, the stabilizing of oil prices gives rise to better earnings prospects for the energy sector (the biggest drag) as companies adjust. Most energy companies can be profitable at the current rate of $45 to $50 per barrel.

Like Great Britain's decision to (probably) leave the EU, the reality of earnings declines isn't great news, but comes with opportunity. It's now easier to meet, or exceed, expectations. The problem with good times (a clause you rarely hear, we're guessing) is they bring with them the ever-increasing expectation to outperform the latest report. We're entering a period of pessimistic expectations. To our minds, overly pessimistic. To whit, many folks are saying the markets are overvalued by historic measures. Not true. In fact, current earnings are at the upper end of "normal", about 18 times earnings. And interest rates are low, with no sign of changing, so it's easy to argue the markets, on a relative basis, are cheap. If the earnings increases analysts are predicting come true, the markets (even with historically low interest and inflation) will drop right into the long-term average valuation of about 15 times earnings.

Some of the headline-grabbing and lesser-reported economic issues of the day are cause for concern. Not panic. The remainder of 2016 promises plenty to be excited about. To paraphrase one of Britain's favorite sons, Winston Churchill, there's opportunity in every difficulty.

We will continue to be vigilant in our stewardship of your trust and hard earned investments.

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