

The Vote Heard Around the World

Most of you know by now that the United Kingdom's decision to leave the European Union (EU) will be an event that goes down in the history books and studied by our children for years to come. I commend you if this is breaking news to you. It probably means you were on vacation somewhere with the will power to detach yourself from technology. And for that I'm envious of you! The day following the vote was equally as historic in many financial markets, and not in a positive way. Here is a little recap of some of the history that was made throughout the trading day on Friday:

- S&P 500's largest opening gap down since 1987
- EU banking index down 14.5% - largest single day decline on record
- Gold increased 5% - biggest single day increase since the fall of Lehman Brothers
- Spanish stock market down 12.35% - largest decline since 1987
- Italian stock market down 12.5% - largest decline since 1997
- GBP/USD down 12% intraday (closed down 6%) - largest intraday decline on record

Some of the moves seen in markets and individual stocks around the world were utterly mind blowing. During the day on Friday, there were times when I had to pinch myself to make sure it wasn't just a bad dream reliving the fall of 2008. This is not 2008; it is 2016 and the world is not melting down.

Honestly, no one knows how the United Kingdom's departure from the EU will play out in financial markets. If Friday was any indication, we are most likely in for more volatility over the course of the next several days and weeks. Markets do not like uncertainty and that was the main byproduct of last week's events. The severe and swift negative reaction in financial markets around the world was not a result of the actual vote to leave the EU. Rather, the negative reaction exhibits what the vote represents.

The vote to leave was more indicative of a country's desire to distance itself from globalization and regain its sense of nationality. The citizens of the U.K. no longer had a desire to be European, but rather to be British again. The decision to gain one's country back and be more independent is understandable, but sure does complicate things. For starters, trade agreements will need to be renegotiated between the United Kingdom and the rest of the world. This could certainly cause a disruption within the British economy, but I fail to see how it causes the global economy to spiral out of control as some people have suggested. The U.K. is the fifth largest economy, but it makes up only 4% of global GDP. At the end of the day, it's significant specifically to the U.K. if they fall into a recession, but not really to the overall global economy. The secondary and tertiary effects of the U.K.'s decision are what need to be monitored closely in the months to come.

At the very least, the U.K.'s vote to leave calls into question the ability for the EU to remain together and for the future of the Euro as a currency. Now that Britain has left, it is much easier and much more likely that other countries will also vote to leave.

And the potential for the EU to dissolve one day is the biggest risk of all. It is this uncertainty that could cause individuals and corporations to take a step back and reevaluate future investments. Unfortunately, the current U.S. economy and world economy for that matter can't afford a pause in consumption and investment.

The real question most of you are probably wondering is how the recent events directly affect the U.S. markets. We've already seen a 75 point decline (3.5% drop) in the S&P 500 on Friday alone. I suspect a bit more downside in the U.S. markets can be expected over the next few weeks. The magnitude of a potential decline is anyone's guess, but as you'll recall from my past columns, we are starting this decline at a very overvalued level. It doesn't matter if you measure valuation using earnings, revenues or cash flows, as all of these measures say the same thing - the markets are expensive. A 3.5% single day decline and 4.5% off an all-time high is not going to cause this market to go from expensive to cheap overnight. As I've said many times before, we need one of two things to happen before we put a significant amount of our clients' cash to work. Corporate earnings need to accelerate and grow again or prices need to decline so that valuations can justify the fundamentals. It looks like the latter might be the most probable outcome in the near future.

Over the past few months, the S&P 500 has managed to increase a little over 17% off of the lows set in February. Part of the reason for the S&P 500 to come within a stone's throw of making a new all-time high was the expectation for earnings to rebound in the second half of this year. Well, all it took was a vote in one country to put the earnings revival into question. Over the next month, it will be interesting to hear what companies have to say regarding their earnings outlook. If executives reiterate uncertainty concerning the recent global events and are hesitant to give future guidance, you can bet that analysts will begin to bring down their future earnings estimates. Another reason for the recent second half optimism was the decline in the U.S. dollar. Again, with uncertainty looming throughout the EU and the Euro currency, the value of the Euro and other currencies are likely to decline against the U.S. dollar. This will lead to our currency appreciating back toward the levels we witnessed in the back half of last year and beginning of this year. This will ultimately reverse the currency tailwind we just recently experienced. The negative effects of a stronger dollar on international revenues and earnings will once again be highlighted and likely to be a headwind for future earnings estimates.

However, there is a very real chance that financial markets around the world do not experience much of a decline and instead head back toward record highs. Coordinated central bank policy has the ability to reverse the recent negative price action. This has managed to do the trick for the past 8 years, so let's hope central banks haven't lost their touch. If global central banks can get together to come up with a plan to stem the decline within the financial markets, we may very well be on our way to making an all-time high in the S&P 500 in the not so distant future.

So how does Tandem, as an investment manager, react to all of this news? The short answer is - we don't. There is no reason to panic and liquidate all of our clients' holdings. We've been net sellers for nearly two years now and already sit on a significant amount of cash. On the flip side, there is also no reason to run out and put all of our clients' cash to work tomorrow. As you will recall from last month's column, the numbers within our quantitative model will dictate when we put cash to work. We weren't really getting any "buy" signals a month ago when the S&P 500 was practically at the same place where it closed on Friday, and nothing much has really changed on the corporate earnings front since then. Therefore, it is very likely that we need to see more downside in the markets before companies become attractive again.

My best guess is that we stay within the trading range that has been carved out over the past two years - 1810 and 2130 on the S&P 500. With all of the uncertainty looming within the EU and the upcoming U.S. elections, we are likely to trade down to the

lower end of the range at some point. It's not time to panic. Rather, it's a good time to be patient and leg into positions as opportunities arise. It's also a great time to book your trip to London or book a Scottish golf trip, because it just got 10% cheaper overnight!

--Billy Little, CFA

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." ~ Ralph Waldo Emerson

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