# THERE WILL ALWAYS BE AN ENGLAND

July 2016

The classic song "There will always be an England" sung by Vera Lynn was popular during World War Two and helped lift the spirits of the English people as they were besieged by the hardships of war. Britain's decision to leave the European Union recently cannot in any way be compared to the trials of war but it may have a lasting impact on England and its place in the world economy. Indeed some have predicted that the England of the future might be very different if Scotland decides to seek independence and join the European Union and Northern Ireland chooses to unite with the Republic of Ireland. How this all will evolve is merely conjecture at this point and the short term dramatic market reaction after the "Brexit" vote will give way to a more rational assessment by investors in time.

The possible negative consequences of the Brexit are troubling as the nationalistic sentiments behind the vote to leave are present in other nations and the exit of more countries from the European Union would risk economic upheaval. Many are concerned that with much of Europe experiencing negative interest rates due to the actions of the European Central Bank that there would be little more that could be done by the Bank in the event of a significant recession in Europe. In a larger context some analysts fear that the Brexit vote is an indicator of worldwide voter dissatisfaction with governments, immigration policies, central banks, economic alliances and other institutions perceived by some as responsible for the inequality in jobs, incomes and prosperity. These sentiments are not confined to Europe as evidenced by the current political environment in the U.S.

In our world of 24 hour political and financial news coverage the need to dramatize and analyze is ever present. We need to know immediately what the consequences of any important event will be even if many of those providing the analysis were the same ones who failed to predict the event in the first place. In fairness to the financial media there are guest experts who honestly answer "I don't know" when asked about the consequences of something like the Brexit vote but, more importantly, they follow it with "... here's what I do know."

The late investment management pioneer David L. Babson advocated that investors focus on what was predictable rather than unpredictable. We really don't know what the long term consequences of the Brexit vote will be and many of the perceived negative effects may prove short lived. Consumers, workers and successful companies are quite resilient and after what may be a difficult period of adjustment the adaptable elements should continue to thrive.

The initial shock of the Brexit vote to the global stock markets was tempered as the second quarter came to a close and the S&P 500 has provided a positive total return of 3.84% year to date. Foreign developed markets lagged the S&P 500, as represented by the iShares MSCI EAFE Exchange Traded Fund, which declined by 2.98% year to date. Emerging markets fared better as the iShares MSCI Emerging Markets ETF has gained 7.58% year to date.

In addition to the Brexit vote, markets have endured a number of challenges in 2016 including the collapse in crude oil, global fears of recession (which have been rekindled by Brexit) and concern about Fed rate hikes among other worries. The turmoil in the equity markets has kept bond yields low as the 10 year Treasury note now yields roughly 1.40 %, a record low, down from approximately 1.80% on March 31, 2016. It seems unlikely that the Fed will raise rates this summer given the current international concerns.

This "lower for longer" interest rate outlook has resulted in over half of the stocks in the S&P 500 having a dividend yield higher than that of the 10 year Treasury Note according to Ned Davis Research. With the stocks of many top quality companies with growing dividends selling at yields over 100 basis points (one percent) or more above that of the Treasury Note, there do appear to be long term opportunities in select stocks. Investors must bear the volatility and uncertainty of events such as the Brexit crisis to take advantage of these opportunities.

One sector particularly impacted by the crisis and the Fed's restraint has been the financial services companies. For the past few years major U.S. banks have continued to strengthen their balance sheets and raise their dividends yet many of these stocks are down this year. We believe top quality companies such as J.P. Morgan Chase and Wells Fargo, with dividend yields over 3.0%, represent good values, among many others, in spite of the international challenges and unfavorable interest rate environment.

The S&P 500 seems fairly valued at an estimated forward P/E ratio of about 17X expected earnings for 2016. A stronger dollar versus other currencies as a result of the Brexit vote may temper overseas' earnings for multinational companies but we still expect the second half of 2016 to be better than the first. Bond yields seem to be stuck at these low levels as the Fed will be very careful about rate increases this year but eventually we expect rates to gradually rise. We continue to believe there are opportunities in both foreign emerging and developed markets. We are unsure about the consequences of the Brexit vote but we firmly believe that sound, well managed companies will adapt and, yes, that there will always be an England.

Have a wonderful summer and we appreciate your confidence in Knox & Downing Advisors.

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