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US ECONOMY: What Does "Brexit" Mean For The US and Global Economies?

You are undoubtedly familiar with the recent vote of Britain to leave the European Union (EU). Important why? What you may not be familiar with is the fact that Britain is the 5th largest economy in the world. Does that help explain it? Moreover, Britain (London specifically) is the undisputed financial capital of the European Union, dominating the trading of Euro currency securities. Quite simply, Britain is very important to the total European economy and the global financial markets. We need to remember that Britain exiting the EU is not an event that will occur tomorrow. It will take 1-2 years to complete with plenty of negotiations along the way. For the financial markets, this will be a point of uncertainty we'll need to live with ahead. In the meantime, let's examine some important facts.

30% of UK GDP is driven by trade. 15% of UK GDP is driven by trade with the EU specifically. As the UK breaks with the EU, future trade negotiations with EU members will now become an issue. Insurmountable? Far from it. Britain, along with Germany, are the two strongest economies in the EU. We assure you, British trade with the EU will not fall apart long term.

50% of UK direct investment comes from EU sources. This is in large part related to London's European financial sector dominance. Many global companies such as Caterpillar, EBAY and Ford have their foreign headquarters domiciled in London. The important questions ahead will be trading rules, taxation, etc. Until these are ironed out, future investment will most likely slow. This may be especially important in financial services. Already, some of the large Wall Street banks such as JP Morgan Chase and Goldman Sachs have made plans to relocate employees located in England primarily to Germany.

One-third of all foreigners of the UK living in the UK currently reside in London, which is another testimonial to the importance of London as a global financial center. Could London real estate prices be impacted by the Brexit? Quite possibly, although up until recently London has been one of the globe's hottest property markets. The potential "downsizing" of the London economy is a reality, the question being to what degree.

It's clear, there are a lot of uncertainties ahead, but Britain, Europe and the world will adjust. Will there be bumps along the way? You can count on it. What's possibly more important, though, are the nearer term fallout consequences. One of those important consequences revolves around global currency movements.

In the aftermath of the Brexit vote, the British pound witnessed one of its worst one day declines in recent memory. The Euro currency also reacted negatively. This is far from surprising. Britain could indeed face a slower economy ahead. Moreover, the Bank of England announced the very real possibility of cutting interest rates this summer. Neither of these issues are currency supportive. So just what does all of this mean for the US economy, if anything?

Of course the reciprocal of the Euro and Pound weakness is strength in the US Dollar. Dollar strength is a depressant for the foreign sourced earnings of US multinational companies. Important in that as of the second quarter of this year, S&P corporate earnings after they are reported will have declined for six consecutive quarters. Dollar strength is about the last thing the US corporate sector is hoping for right now.

Also in the aftermath of the Brexit vote, we witnessed almost immediate global Central Bank announcements of accommodation and monetary ease. As mentioned, the Bank of England intends to cut interest rates, China again devalued their currency, the European Central Bank announced it will expand the financial securities it will purchase with its ongoing $87 billion monthly quantitative easing program, and the Fed announced it would provide enhanced SWAP lines (think liquidity) to Euro financial institutions if needed. The only Central Bank not to take action in relation to Brexit has been Japan up to this point. To suggest global Central Bankers are "all in" in supporting global financial markets is an understatement.

As we contemplate fallout issues for the US economy from Brexit, where the Dollar heads going forward will be a primary question for the large US corporate sector. It's hard to imagine a weak Dollar amidst Euro uncertainty, continued negative interest rates and money printing from the Bank of Japan and European Central Banks, as

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well as ongoing Chinese currency devaluation. The key impact of the Brexit vote on the US economy and corporate sector is the ultimate impact on the trajectory of the Dollar relative to foreign currencies.

Secondly, and equally important, is how the US Fed will react going forward. We all know that 2016 has been a year of false starts for the Fed in terms of finally normalizing interest rates. After raising interest rates last December for the first time since 2008 by a very small 0.25%, the 10% stock market correction in January of this year scared the Fed from going any further at the time. In May, the Fed again came out of the fear bunker and suggested a June rate hike. A very poor payroll report one week later put a definitive end to that suggestion. In the aftermath of Brexit with global uncertainty rising, the Fed is now firmly on hold. The chances of any interest rate hikes prior to the election are next to nothing and by the end of the year, slim at best.

The risk the Fed is running by forestalling further rate hikes, and this is the same risk being run by Central Banks globally, is that they will have no "ammunition" (lowering interest rates) should a global slowdown bordering on recession unfold. We're not near recession in the US, in fact we expect a perceptually pleasing GDP number for the second quarter that could approach the mid-2% level. However, the realities of a slowing global economy and slowing S&P corporate earnings are clear and present.

As we have mentioned many a time, we exist in a globally interconnected world. The Brexit decision is yet another marker of the character and interdependence of the global economy in which we find ourselves.

US INTEREST RATES – Beyond Interest Rates

Despite the waffling of the Fed in 2016 regarding further interest rate hikes, Brexit likely clinches the fact that there will be no rate hikes prior to the US election, at the very least. We'll most likely see England cut interest rates soon and we would not be surprised at all to see Europe and/or Japan descend further into negative interest rate territory. The past 8 years have been one incredible journey for Central Banks. From tens of trillions in quantitative easing (printing money) to interest rates in developed economies hitting zero, and below zero in the case of Europe and Japan, what may have seemed unthinkable half a decade back is now reality. As of the end of June, just shy of $12 trillion in global government bonds carried a negative yield. Meaning? A current investor now has a 100% guarantee of losing money over the maturity of these bonds.

Moreover, the money printing and lower interest rate prescription of Central Bankers for returning the global economy to historic rates of economic growth has been weak at best, over the current cycle. Central Bank actions have definitively raised asset prices (think stocks and real estate), but have done little to spark global job growth, business investment, etc.

Are the Central Banks solely to blame for the relatively moribund global economy at present? The answer is "no." In fact, it's plainly obvious that politicians globally have avoided more than a number of hard choices in both fiscal policy and economic reform, both in the US and globally. Central Banks can influence monetary policy (money printing and interest rates), but have zero influence on government fiscal spending or economic policy reform. The fact is that politicians globally have relied virtually 100% on Central Bank actions to "fix" the slow moving global economy. The recent Brexit vote is suggesting the world's voting populous is moving beyond interest rates as being a key issue to their wellbeing. Way beyond.

Although the Brexit vote will clearly have economic ramifications, social issues likewise played a key role in the voting outcome. As you may know, controversial immigration issues in broad Europe have been front and center for some time now. Had Britain stayed in the EU, the EU would have dictated immigration policy to the country. This key political issue that had been left unaddressed throughout Europe has absolutely nothing to do with money printing or negative interest rates. Britain essentially voted to be able to make their own decisions. Since the politicians were not going to address this sensitive issue, British voters finally took it into their own hands. The more Europe avoids structural reform, the more internal pressure we will see for individual countries to leave the EU and the Euro currency ahead. Of course the reaction to the Brexit vote was ever more accommodation by the European Central Bank. For now, the Euro politicians are missing the key issues completely.

If we dissect the voting outcome in Britain, we see that the "leave" vote dominated the middle and lower class responses. Wealth inequality has not just been an issue

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in the US, but rather globally. Britain simply chose to express this issue at the voting booth. Again, money printing and negative interest rates have gotten financial asset prices up, but apparently the middle and lower classes in Britain have not felt they have benefitted in terms of real economic improvement. They are now moving beyond interest rates.

Is this behavior and sense of disenfranchisement unique to Britain? Far from it, just take a look at the current US Presidential election cycle. Is Trump's popularity due to the fact that he is a masterful politician with incredible economic philosophies and ideas? Or is Trump a symbol of meaningfully growing disappointment in the political "status quo," somewhat akin to what we just saw in Britain? Rising stock and real estate prices in the current US economic cycle have been accompanied by one of the weakest jobs and wage recoveries post-recession on record. Business spending in the current cycle has been weaker than any expansion cycle in close to a half century. For the first time in decades, inflation adjusted household income in the US has fallen over the last 8 years, now resting at levels last seen in the mid-1990's. Are these the real issues of importance to the US populace, and not whether the Fed will raise interest rates by a quarter point before the end of the year? Of course they are. Trump's popularity suggests exactly this. In the face of little to no economic reform in the US, US voters are moving beyond interest rates.

Although this discussion may sound a bit philosophical, voting outcomes impact real economies. Politicians globally have avoided the hard choices and any sense of reform (pension issues, government debt/spending, etc.) in the current cycle, deferring to the Central Banks to work their money printing and interest rate magic. We see global politicians and Central Banks simply repeating the same behavior and expecting a different outcome, but now the global ballot box is starting to bite back.

Although we're sure the financial community will continue hanging on every word of the global Central Bankers for a time, one of the key behavioral issues we look for ahead is a breakdown in belief that Central Bankers can "right" the global economic ship all alone. The Brexit vote is a crack in this belief system. Globally, we need to recognize that we are moving beyond interest rates as key economic and social policy drivers.

US STOCK MARKET – All-Time New Highs!!

The results are in we recently hit all-time new highs! Although this is true of both the S&P 500 and Dow Jones Industrial Average, the headline to focus on here is the new high we hit during the current cycle for stock buybacks by US companies. Without question, stock buybacks by the corporate sector have been a key underpinning of the bull market in US stocks since 2009, but we've gone to new heights for stock buybacks in the current cycle as of the first quarter of this year. For now, stock buybacks are a key issue as corporate earnings have declined for five straight quarters. When earnings are reported for the second quarter of this year, the number will change from five to six straight down earnings quarters.

Remember, when we refer to earnings, we're talking about Dollars. However, Wall Street is very much fixated on "earnings per share," as opposed to absolute Dollar earnings, when looking at individual companies. In fact, we've seen many an instance when a corporation's earnings are down meaningfully in a quarter, but it's earnings per share are up. How can this happen? Stock buybacks that shrink the number of shares outstanding for the company.

Stock buybacks are nothing new, we've seen them in every cycle for decades. Corporations simply have a matter of choice. They can use their cash to expand their business, or they can buy back shares in an attempt to improve their earnings per share. Let's look at some facts. These are all numbers as of the close of the first quarter of 2016:

- In the first quarter ended March 2016, US corporations spent $166 billion on stock buybacks. This is an increase of 15% year over year and a 16% increase quarter over quarter. It's also a new quarterly high for the current stock market and economic cycle.
- 41 companies spent over $1 billion buying back stock in the first quarter.
- Looking at the trailing 12 months ended as of the first quarter of 2016, US companies spent $603 billion buying back their shares. Over this

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same period, actual corporate earnings declined close to 7%.

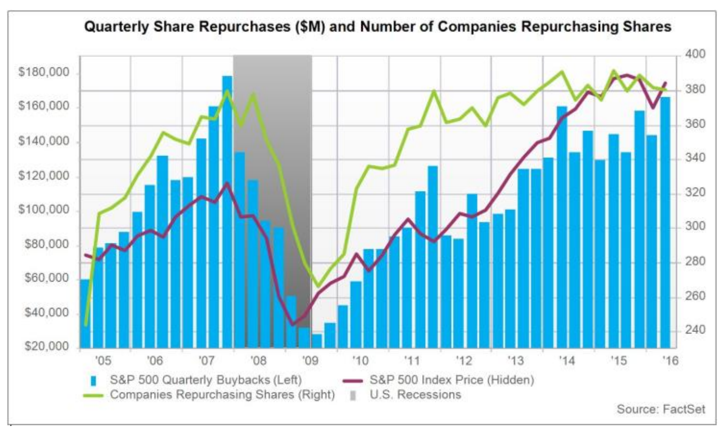
- Share buybacks for the 12-month period ended March 2016 accounted for 73% of corporate net income and 60% of free cash flow. The slump in earnings drove the percentage of net income devoted to this from 48% to 73% in the same period. The greater the earnings decline, the more resources devoted to stock buybacks for now. Clearly the primary business of US corporations as of late has been share repurchases, dedicating the bulk of their earnings and cash flow to this activity.
- 146 companies spent more on share buybacks than they earned for the twelve months ended 3/31/16.

Why is this important and what does it mean to our investment outlook ahead? As we have stated many a time, corporations have choices in how they use their cash. They can buy other companies, they can invest in themselves with direct business investment (property, plant and equipment, inventory, etc.), they can increase their dividends paid to shareholders, and they can buy back their stock. A standout data point in the current cycle has been lack of business investment. In fact, it's the weakest in terms of growth rate we have seen in half a century. There is an old saying in the markets that "if a company will not invest in itself, why should you?" In investing in themselves, companies act to grow employment, increase purchases from suppliers, etc. Business spending contributes to an overall increase in economic activity. Stock buybacks do none of what we've listed. Stock buybacks are driven by the primary goal of increasing a company's stock price.

Nobody is faulting US corporations for acting in their own self-interest with their own cash. The last time we checked, there are no non-profits in the S&P 500. The fact that over the last twelve months corporations have spent six times the amount of cash on stock buybacks as they deployed in business spending says a lot about the outlook from the Board Rooms of Corporate America. Why have they done this?

Real earnings are falling and stock buybacks are an attempt to keep "earnings per share" growing for as long as possible. In other words, companies want their stock prices to keep rising. The second reason has to be that businesses are uncertain as to outlook ahead. Like investors, when was the last time corporate management teams witnessed "emergency" zero percent interest rates for 8 straight years? Never. When is the last time they witnessed the Fed printing $3.5 trillion in an attempt to reinvigorate the economy? Never. When was the last time in their careers have they seen the lowest GDP growth rates in a half century? Never. The anomalistic lack of business spending in the current cycle speaks volumes about what corporate management teams really believe. We've been through a lot of these issues before in prior newsletters, but think they bear repeating given their importance to where we find ourselves today.

Having said all of this, there is one other important issue regarding stock buybacks. The huge increase in the first quarter of this year compels us to highlight this behavioral issue. First, have a look at the next chart.



Although a little bit busy, the blue bars in the chart represent the Dollar level of US corporate stock buybacks. The red line represents the S&P 500. Finally, the green line is the number of companies buying back stock in any period.

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As you can clearly see, the last time we saw quarterly stock buybacks as high as we saw in the first quarter of this year was the second quarter of 2007 – exactly at the last very meaningful stock market cycle high. Here's the funny (and ironic) thing about stock buybacks, they are always the hottest and heaviest at the end of a long stock market cycle as opposed to the beginning. It is ironic that at the top of a cycle companies are paying peak stock price to buy back shares. As you will also see above, at the stock market lows of early 2009, the cheapest prices for stocks seen in years, buybacks were nowhere to be found. Is this the ultimate definition of buy high and sell low, something thought to be the plight of unsophisticated and emotional individual investors? Something like that.

Although the cycle "rhythm" of buybacks seems totally illogical, the logic is found in the self-interest of corporate management teams trying to keep their stock prices high for as long as possible, and by default their stock options at high price levels. This is especially true when real Dollar-based earnings start to deteriorate, which is exactly what we are seeing now. After all, the cash to fund stock buybacks belongs to shareholders, not management, right?

So the message is that although stock buybacks have been a key underpinning of US equities in this cycle, we need to beware of extremes. Extremes in stock buybacks relative to real business investment is a loud message. It's a loud message about corporate earnings outlook and the age of the financial market and economic cycle. It's a very good bet that somewhere ahead as buyback activity starts to decline noticeably, we'll be looking at the peak of the current cycle. We're simply not there yet.