



June 24, 2016

Opportunity amid Rising Uncertainty

Dear Clients and Friends,

As many of you have likely seen, global stock markets are reacting to a voter referendum that Britain will exit the European Union (EU), the so-called Brexit vote. FBB Capital Partners has been following this situation, as well as other geo-political events as we look to protect clients on the downside, while also watching for upside opportunities. Here are our thoughts on what's happening with the Brexit vote, and how FBB is responding to the new uncertainty.

What happened?

This morning, the United Kingdom voted 52% to 48% to leave the EU, rattling global capital markets that expected the UK to remain in the EU. In pre-market trading, the S&P500 index is down nearly 4% and oil is off 5%.

How should investors view this volatility? We are framing today's move by looking at market action over the past week as investors placed bets on the potential outcome of the Brexit vote. Our view is that the S&P500 rose 2% between June 15 and June 23, on the belief that the UK would remain in EU.

Therefore it is not surprising that this morning investors are wiping out that 2% rally and taking the market down another 2%, potentially on fears the European instability could spread and possibly depress earnings for U.S. companies.

Making sense of today's move

While today may be an emotional day for investors with TVs and trading screens showing lots of red, we prefer to look at facts and data which suggest today's market is ~1-2% oversold. Here's the math. On one hand we have the U.S. market down 2% from the pre-Brexit (mid-June levels), described above. On the other hand, we know that U.S. blue chip companies in the S&P500 generate about 3% of their revenue from the UK, according to a financial data provider called FactSet.

Using these data points, today's move implies that large U.S. companies will lose 2/3 of their UK business, just because the UK is leaving Europe. We view this as an over-reaction, because even if the UK enters a recession, we believe British demand for imports (from the U.S) is unlikely to fall by 2/3.

What's next? Upside and downside scenarios

Where could we be wrong? Although we view today's market move as an over-reaction, there are economic outcomes that could be better or worse than our current analysis. In a downside case, we could see a meaningful UK recession following the Brexit vote, as well as rising uncertainty as other EU members, such as France, voice interest in voting to leave the EU.

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A splintering European Union could slow global growth and fuel rising demand for safe currencies, such as the Dollar. A stronger greenback would likely depress U.S. exports, global commodity prices and U.S. Treasury rates, while delaying a Fed Funds rate hike for months. In this scenario, we could see U.S. equities fall back to early 2016 levels, when many of these factors were in play.

However, there is another scenario in which markets recover from today's decline and follow a historical pattern of financial responses to geo-political events. Using data compiled by our friends at Northern Trust, equity markets on average fall by 4% over an 8-day period following unexpected global turmoil, but then fully recover in 37 days.

We also take a longer view of factors driving the market, which support an upside scenario. We believe that over the long term, corporate profits drive stocks. Our sense is today's Brexit vote may weigh on near term corporate profits, however we believe earnings will continue to grow as we exit 2016 and into 2017, likely driving stocks higher.

How is FBB positioning amid the new uncertainty?

FBB continues to look for opportunities to position client portfolios as we enter a period of rising uncertainty. We believe EU stocks will likely decline more than U.S. investments following the Brexit vote and heading into today's Brexit results, FBB has kept a low exposure to European equities, despite nominally lower valuations compared to the U.S. EU stocks typically make up more than 20% of global equity indices, however FBB clients generally have a much lower exposure.

What's more, FBB has taken advantage of the market volatility over the past year by moving up the quality spectrum into stocks with cleaner balance sheets and less operational risk. We believe these moves will help add ballast to client portfolios during times of elevated volatility.

As we look beyond today's Brexit vote, we see both uncertainty and opportunity. We continue to look for investments where near-term volatility or sentiment changes may obscure a high quality business trading at a discounted valuation. We believe the current market moves may open up additional opportunities for FBB clients.

Sincerely yours,

FBB Capital Partners' Investment Committee