UK's Historic Decision and its Expected Fallout

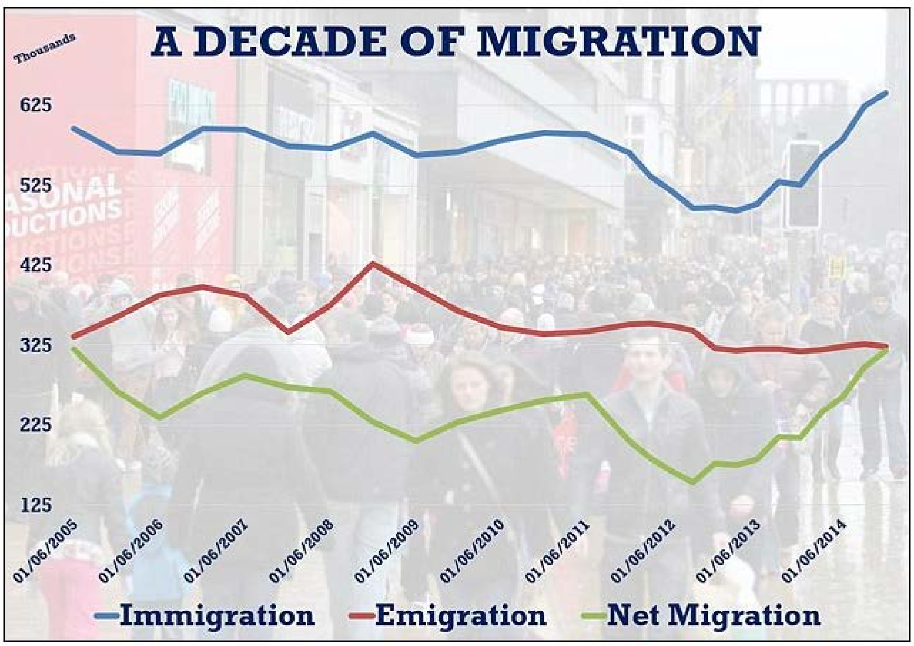
Not surprisingly, we've decided to dedicate this month's white paper to the recent Brexit vote. We will tackle this topic by addressing both the positive and negative outcomes for the Eurozone and UK, as well as what might be the future path in terms of UK/EU negotiations and finally the investment implications as they apply to Lynx's investment roadmap.

Let's start with the good news as we see it. To begin, money needs a home and in times of turbulence that home tends to reside in lower-risk asset classes and geographies. Today these asset classes are relatively stable dividend paying stocks (e.g. utility companies), gold bullion (a historic safe haven asset) and U.S. Treasury bonds, while the favored geography is, without question, the United States and to some extent Asia. Another interesting dynamic is the perpetually falling Treasury rates; as low as rates are, demand for Treasuries continues unabated. Consequently, the low rates coupled with the dovish sentiment at the Fed, and central banks globally and the now unprecedented negative rate environment, have provided the backdrop for today's U.S equity popularity. Despite what is considered to be a fairly and in some cases richly valued U.S. stock market by historical standards, the recent upheaval and lack of clarity overseas continues to drive both domestic and international allocators to invest here. Given that it could take at least two years for the UK and EU to work through their new relationship, we believe the likelihood that today's U.S. demand subsides is low. We also expect that for those investors willing to take on more risk for a higher relative return, demand for riskier investments such as spread products like high yield bonds and contingent convertible bonds (CoCos) (chart 1) should remain in vogue.

Chart 1 - BofA Merrill Lynch US High Yield Option-Adjusted Spread

Now let's address the bad news. Until the vote we felt that Europe was on a path of slow and steady recovery. Today we believe there is a clear divide between "pre Brexit" and "post Brexit" and in the post Brexit era our prediction is for a stagnant European recovery over a longer period of time that will likely include heightened volatility and instability. The UK, very obviously, will deal with the majority of the uncertainty as it maneuvers through the appointment of new a Prime Minister, possible elections and then the EU negotiations. While all this is occurring, UK's current residents are left with many unanswered questions about what the future may hold for their families, their homes, their jobs and their country. For an example, as of two years ago, the number of French ex-patriots living in London was so large the city was tagged France's "sixth biggest city" (chart 2 provides UK migration trends). In response to this uncertainty, the country will slow, productivity will fall and overall GDP will come down. Though the weakened currency makes UK exports more attractive, its trade deficit will likely widen as much of what it sells abroad is financial services to the EU. Tourism will likely help as the value of the sterling provides incentive to international travelers, but all told it will not be enough. Neither UK residents nor the international community will be comfortable investing in the UK until clarity and then a sense of normalcy returns. Furthermore, the potential for Scotland to pursue a referendum in order to allow the country to take over its own interests, stay attached to Europe and self-govern, provides a further negative catalyst.

Chart 2 - UK Migration



A three year boom in net migration has been fuelled by a steady fall in the number of people leaving the country and a huge increase in those arriving

Now, we'll briefly discuss what may occur during these UK/EU negotiations based on history. To date there are two leading countries considered quasi EU members, Canada and Norway, each with its own semi-detached relationship. In the case of Norway, for a similar price as paid by a full member EU state, they've retained access to EU's internal market, which allows them to trade goods with EU states tariff-free, while labor is allowed to flow freely, but the agreement does not allow them a vote over the EU rules with which they are obliged to comply. The Canada model, or Canada-EU Comprehensive Economic Trade Agreement (CETA), (which has yet to be officially approved), eliminates 98% of the tariffs between Canada and the EU without the obligations that Norway faces, but only part of the services sector is covered by CETA. Though both models present issues from a UK perspective, the largest in our opinion is with the Canada model, which would likely not give UK financial services the EU market access it has now. It would be hard for London-based banks to regain the rights for their services in the EU, while the potential for those banks headquartered in London to relocate becomes a real concern. Approximately 80% of UK GDP is comprised of service related businesses, while of that, 10% is the financial sector specifically. Therefore, it is quite clear that the UK/EU negotiators have their work cut out for them, the outcome of which remains very much opaque.

Which leads us to the concluding paragraph about Lynx's investment expectations and the direction in which we will allocate capital. To begin, in terms of geography, we remain focused on the U.S. markets and as well continue to look for compelling opportunities in Asia and the emerging markets, all of which are less impacted by Brexit. We find spread products attractive within the U.S., namely high yield bonds and financial sector preferred stocks, which are currently yielding 6%. U.S. banks are in the best shape they've been, in terms of the balance sheet, in decades and as their earnings remain low given the rate environment, their common equity isn't nearly as compelling as an investment in their preferred stock. While U.S. banks are in solid financial shape, which in turn makes their preferred stocks a good buy, as we've discussed, UK/European banks are in a precarious position today. Does this mean we're avoiding preferreds and CoCos in this region? Actually no, as long as an investor can stomach the volatility, we believe through an active approach, a manager can take advantage of the volatility and should be able to provide investors with an attractive relative return. Another area of interest is the commodity market. Now that oil prices have stabilized and interest rates are low, the demand for oil and other commodities has stabilized as well and should increase over time. We believe that the foreseeable low rate scenario is likely to fuel stability in the oil market. The MLP sector which has been trading under distress and consequently at high yields is likely to benefit from this stability. Lastly, we remain interested and informed about the situation in Europe and look forward to potentially taking advantage of any opportunities that present themselves in the wake of the Brexit vote and the ongoing highly volatile environment.

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