John Dessauer Investments, Inc.

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John Dessauer's market review and update as of Wednesday June 8, 2016

Disappointing May jobs numbers suggest the U.S. economy is not as strong as Federal Reserve board members and many economists had hoped. Odds now are that interest rates will stay where they are at least until there is more data on the economy. Meanwhile, the Brexit vote is just days away. A British exit from the EU would present a challenge for the U.S. as well as for the global economy. PIMCO, a U.S. based bond managing firm, thinks the British will vote to leave the EU. Morgan Stanley thinks they will vote to stay in the European Union (EU). I think Morgan Stanley will be the winner of that debate. The vote is on Thursday June 23, 2016.

There is widespread agreement among politicians and economists that the British economy would suffer if voters elect to leave the EU. Even those who support the "exit" admit there would be an economic cost. They argue that the economic pain would be short lived and worth it because in the long run Britain would be better off.

Britain joined the EU on January 1, 1973. In the early 1970s the British economy was a basket case. Unemployment and inflation were high. The talk among investors and economists was not if, but when, would the British economy collapse. I remember listening to a talk by Hans Baer, senior partner in the Julius Baer Bank of Switzerland. I think it was in 1974. Hans argued that Britain was a crisis that would never happen. He believed the British people and their government would find solutions to the challenges, and that the economy would eventually recover. Hans came out right much sooner than even he expected. The British discovered oil in the North Sea. Oil profits provided the boost needed to pull the British economy out of recession. Of course, being part of the EU was also a major factor in the British economic recovery. The British benefited from membership in the EU because their oil revenue could be used in trade throughout the EU without barriers or red tape from customs duties and regulations. Looking back over the last 43 years it is clear that the British have benefited tremendously from membership in the EU. The obvious question is: after more than four decades of economic benefit, why are so many British voters so anxious to divorce their economy from the EU? The main reason is immigration. Membership in the EU means that people can move freely from one country to another in search of jobs, tax benefits or for any other reason. There is fear that the flood of refugees from Syria and the Middle East into Europe will eventually mean an unwanted flood of immigrants into Britain. The “leave the EU” proponents argue that Britain will suffer irreparable economic and cultural damage unless immigration is brought under control.

In a joint statement on June first, senior members of the “Out” campaign had this to say: “Migration brings many benefits to Britain - culturally, socially and economically. We want Britain to continue to benefit from migration. But, if we are to welcome more people to Britain then the public must be reassured that we have control over who comes here. Our membership of the EU means we don’t have control.”

The problem with this argument is that Britain actually has a large measure of control over who comes and who does not. Figures released at the end of May put net migration at 330,000 in 2015. Of those, 184,000 or 56% came from the EU. Britain had full control over the remaining 44% or 146,000. And voters are just as upset over the 146,000 as they are about the 184,000 from the EU. Leaving the EU would not completely solve Britain’s migration issue. This is why I think Morgan Stanley will be proven right on June 23. The polls currently show 44% in favor of staying in the EU and 41% wanting out. But they also show 19% either undecided or not willing to say. Based on these polls, the vote could go either way. Hans Baer is no longer available, but if he were, I believe he would bet on the British voters being sensitive to their economic history and current welfare by voting to stay in the EU.

If I am wrong and the vote is to leave the EU, there likely will be a political and economic crisis in Britain that would be felt in Europe, emerging markets and the United States. The British government is very clear in wanting to stay in the EU. A vote to leave would be a national vote of no confidence that would mean political uncertainty. The uncertainty would impact financial markets and trade agreements, leading to a fall in the British stock market and the British pound. Morgan Stanley thinks the euro would also fall because a vote to leave the EU by the British would raise serious questions about other members. The idea of Greece leaving the EU would gain credibility. Others might also be worried about immigration and seriously consider leaving. A fall in the pound would lift British inflation above target, forcing higher interest rates and depressing economic activity. A recession in Britain following a vote to leave would be highly likely. A fall in the pound and euro would mean a strong U.S. dollar. As we have painfully learned, a strong dollar hurts U.S. reported corporate profits and U.S. exporters. Because of the weak May jobs report and poor first quarter growth rate, the U.S. could be threatened with a slide back toward recession if the British vote to leave the EU. A strong dollar would also be bad news for emerging markets and commodities. Finally, a British exit from the EU would be bad news for major banks, including U.S. banks. They would have to relocate their banking operations from London to another European capital like Brussels or Frankfurt. There would be losses on British real estate and major relocation costs. The banks would survive of course, but during the relocation process operations would suffer. Even a temporary slowdown in international banking operations would be bad news for the global economy.

The bottom line is that the U.S. and global economies have a lot at stake in the British June 23 referendum. With a vote to stay in the EU there would be a post referendum British recovery in investment, stronger economic growth, a lift in confidence and in the pound. The U.S. would breathe a sigh of relief. Federal Reserve board members would resume their debate about raising interest rates. And the world would be back to waiting for data on U.S. second quarter growth.

Our best investment strategy is to hold on to our portfolios of quality stocks and wait patiently for the results of Britain's June 23 referendum vote.

I will have the next market review and update for you one week from today on Wednesday June 15, 2016.

All the best,

John Dessauer