John Dessauer Investments, Inc.

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John Dessauer's market review and update as of Wednesday July 6, 2016

I am in Europe and the talk everywhere is about the UK voting to leave the European Union (EU). I expected to hear concerns about other countries wanting to leave the EU and worries about long term economic damage to the UK. However, to my surprise, the biggest concern is the steep decline in the British pound.

The Swiss worry that there will be fewer British tourists because Switzerland, which is already expensive, now costs 10%-15% more for a visitor using British pounds. In the International New York Times there was an article about realtors back home in Florida suffering because British buyers of Florida condos were reconsidering.

From the international news it seems the pound is also the initial concern for the Bank of England. Like our Federal Reserve, the number one priority for British central bankers is the British economy. They do not want to see the pound in freefall; that would force them to defend the pound by raising interest rates. Higher interest rates would hurt housing and credit, offsetting any benefit to British exporters. The Bank of England would much rather be in a position to cut interest rates to help the economy, if necessary.

The political turmoil in the UK is amplifying the uncertainty. Boris Johnson, a major proponent of leaving the EU, and a former mayor of London, said he is not running for Prime Minister and will not lead exit negotiations. Voters are feeling betrayed and worried that they were misled by the pro-exit politicians.

But the pessimists may, in the long run, be surprised. There are well informed people who see a bright future for the UK after leaving the EU.

“The bottom line is that investors should ignore scare stories about what would happen if Brexit wins. Great Britain runs consistent trade deficits with the rest of Europe. Regardless of what foreign leaders say before the vote, if the British vote to leave, the rest of the EU is going to chase them to the ends of the earth. No way will they allow one of their biggest export markets to become more distant. They will beg the UK to sign a free trade deal. In addition, and this is actually great economic news, it would free the US and UK to sign a free trade deal that the EU is now holding up. Any market volatility would be short-lived and any swing to the downside would be a buying opportunity. Brexit is not a reason to sell. In fact, freedom is a good thing.”

This was obviously written before the vote. But it has turned out to be spot-on as far as far as market volatility is concerned. It was written by Brian Wesbury, an American and chief economist for First Trust Portfolios, L.P.

The popular media are still painting a picture of British vulnerability, as if Britain needs access to the EU single market more than the other way around. The fact that Britain has been running consistent trade deficits with the rest of the EU is an eye-opener. Now we know the EU needs access to the British market just as much as Britain needs access to the EU. Another eye-opener is that the EU has been stalling on allowing the US and UK to sign a free trade agreement. US media have focused on the possible damage to the US economy from the Brexit vote. They have completely missed the free trade opportunity. The US economy will benefit from the Brexit vote if a free trade agreement with the UK becomes the reality.

There is another aspect of the EU that the media have ignored. Here is what Matt Ridley, a British Journalist who sits in the House of Lords has to say: “The EU is also against free trade. It says it isn’t, but its actions speak louder. The EU has an external tariff that deters African farmers from exporting their produce to us, helping to perpetuate poverty there, while raising prices in Europe. The EU confiscated Britain’s right to sign trade agreements-though we were the nation that pioneered the idea of unilateral free trade in the 1840s. All trade agreements that the EU has signed are smaller, as measured by the trading partners’ GDP, than agreements made by Chile, Singapore or Switzerland. Those the EU has signed usually exclude services, Britain’s strongest sector, and are more about regulations to suit companies than the dismantling of barriers.

Even worse than in Westminster or Washington, the corridors of Brussels are crawling with lobbyists for big companies, big banks and big environmental pressure groups seeking rules that work as barriers to entry for smaller firms and newer ideas.”

Matt Ridley completely destroys the American idea of the EU as a free trade promoting organization. Instead we see the reality: a collection of unelected elitists, using power to promote the status quo, unconcerned about slow growth and high unemployment. The EU has been slower than the US to recover from the 2008 financial crisis and recession. Without the benefit of a relatively strong German economy the EU might be still struggling to avoid a new recession. Clearly, the EU needs to change. The Brexit vote may force change that otherwise would have been fiercely resisted.

The bottom line is that Britain is in a much stronger negotiating position than the popular media portrays.

A strong British economy with a stable currency is in the EU’s best interests. EU politicians who are now talking tough about the Brexit vote are on the wrong side of economic reality. A weak British economy could tip the EU back into recession, especially if a weak economy was coupled with a sinking British pound.

I expect Brian Wesbury to be right. Tough talk from Brussels will soon be replaced by quiet negotiations with a goal of preserving the current free trade between the two.

Closer to home the BEA (Bureau of Economic Analysis) has, once again, revised its calculations on the US economy’s first quarter performance. The stock market has been soft because investors thought they had good reason to worry that the US might be at risk of sliding back into recession. Those fears were eased a bit when the BEA said, sorry, we didn’t get it quite right - the US economy grew at a 0.8% not a 0.5% rate in the opening quarter. Now the BEA says it has better information and the rate of growth in the first quarter really was a more respectable 1.1%. That makes the Atlanta Federal Reserve’s current estimate of 2.6% growth in the second quarter look realistic. The BEA also revised the first quarter rate of growth for corporate profits to 2.2%. (The BEA’s corporate profits report is a broad measure of profits from corporations, public and private, that file US tax returns.) That is the best quarterly profits growth rate since the third quarter of 2014. No wonder stocks have almost fully recovered from the post Brexit plunge. The outlook for the US economy and US corporate profits is improving. That is positive for our portfolios.

I will have the next market review and update for you one week from today on Wednesday July 13, 2016.

All the best,

John Dessauer