John Dessauer Investments, Inc.

www.johndessauerinvestments.com

John Dessauer's market review and update as of Wednesday August 24, 2016

The past few days I have been in London, Brexit country, relaxing and seeing the world from a slightly different perspective. I found one article in the *Financial Times* to be particularly enlightening about the Brexit issue. Britain's new Prime Minister, Theresa May, says the country is not ready to start the process of leaving the European Union. It may be two or three years before the process begins. An article by Richard Thaler exposes the underlying mistake in calling for the referendum in the first place. My conclusion is that an eventual reversal is possible. The bottom line is that financial markets are correct to be ignoring the Brexit vote.

The original charter creating the European Union (EU) did not anticipate that a member might choose to leave. It also did not provide for a member that broke the rules, but could not pay its debts. The latter is known as the Grexit mess. The financial crisis triggered by Greece has subsided. Greek banks are open and operating with new capital. The possibility of a Grexit has been eclipsed by the referendum vote in Britain known as Brexit.

In 2009 the EU adopted the now famous Article 50 of the Lisbon Treaty. However, once again they missed the mark. Instead of providing clear rules for a country that decided to leave the EU, it provides for a long process of negotiation. Article 50 calls for two years of negotiation with a possible extension, but says nothing about what happens if the parties are unable to reach an agreement. The popular presumption is that there would be separation and that the departing country would be out, treated under the rules of the World Trade Organization. However, that presumption is questionable because of the tangled web that the years of EU membership have created between Britain and the EU single market. For example, there are all sorts of rules and regulations with respect to banks and other financial organizations that exist independent from the EU charter, but which assume continued membership in the EU.

Britain's new Prime Minister Theresa May says the government is not prepared to start negotiations. It may take a year or more for the government to complete the necessary preparations. Add on the two years allowed for negotiations and the uncertainty caused by the Brexit vote could linger for three or more years. The only certainty is an unusual agreement among economists that if Britain leaves the EU it will be bad for Britain and bad for the EU.

Richard Thaler concludes: "Furthermore given the ambiguity of Article 50, voters had no way of knowing what outcomes would come from a vote to Remain or Leave…… But the referendum was held, so the question is what to do now. Certainly a majority of just four points in a nonbinding referendum should not be considered a mandate to hastily invoke Article 50. The vote was more like a straw poll of voter sentiments about a range of issues than a considered evaluation of the costs and benefits of membership in the single market.

Since voters were given a choice that was impossible to evaluate sensibly, they should be given the opportunity to change their mind if the facts change-either a vote of parliament or a second referendum. In short, Brexit should not mean an immediate Brexit."

The first logical conclusion is that the former Prime Minister, David Cameron, made a huge mistake calling the referendum. As so often happens in politics, his successor is the one stuck with the extremely difficult task of dealing with the Brexit vote aftermath. The Bank of England has already taken steps to provide economic stimulus. Data on Britain's labor market are encouraging. Job creation has not declined. Britain continues to create new jobs at a robust pace. If the economy remains stable, then a year or so from now the pro Leave enthusiasm may have waned, opening the door for a reversal through parliament or a second referendum. At least for now, and for the next year or more, Britain, the EU and the global economy have dodged the Brexit bullet.

So far there continues to be strong foreign demand for U.S. treasuries. But, because of an unexpected twist, that could change when the Federal Reserve raises interest rates.

While the yield on ten year U.S. treasury bonds is a scant 1.5%, that is more appealing than a guaranteed loss (because of negative interest rates) on German or Japanese bonds held to redemption. However, there is a growing problem. Capital Economics, a consulting firm, warns: "A sharp increase in the cost of hedging has diminished the appeal of Treasuries to many foreign investors, especially those whose funds are denominated in yen and euros."

In 2014 a Japanese investor could buy a ten year U.S. Treasury, hedge the currency and enjoy an annualized yield of 2.5%. Today that same transaction would provide a yield of zero because of increased hedging costs. Why have hedging cost increased?

John Higgins of Capital Economics explains: “First, three-month U.S. dollar Libor has risen, mainly due to upcoming changes in money market fund rules rather than any underlying financial problems or expectations of tighter Fed policy.”

Libor means London Interbank Offered Rates. In the aftermath of the 2008 financial crisis there were instances where Money Market funds were threatened. U.S. regulators have imposed new rules on what Money Market funds can and cannot buy. This is increasing demand for the allowed securities. The stronger demand is what has pushed up Libor, raising hedging cost for foreign buyers of U.S. Treasury securities. I think it is a safe bet to say that the Washington based bureaucrats who wrote the new Money Market rules and regulations had not a clue about Libor, the cost of hedging and the possible effect their new rules might have on demand for U.S. Treasury securities. However, I will also bet that the members of the Federal Reserve board are aware of Libor and hedging costs. That, after all, is part of their realm. They also understand that if they raise interest rates faster than the market expects, the costs of hedging will increase. New Money Market rules and regulations plus hedging costs are another reason the Federal Reserve will procced with caution on the extent and timing of future interest rate increases.

The stock market has been calm, trading in a narrow range, waiting for third quarter earnings. In a little more than a month we will start seeing third quarter results. If sales and earnings have been growing this quarter, then a case can be made for higher stock prices by year end. Meanwhile, patience is the best strategy.

I will have the next market review and update for you one week from today on Wednesday August 31, 2016.

All the best,

John Dessauer