

*“There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don’t know. But there are also unknown unknowns. These are things we don’t know we don’t know.”*

--Donald Rumsfeld

Here at the mid-point of 2016 it is worth noting the remarkable turn of events, both inside and outside of the financial world in which we, as professionals, occupy. The last six months have been “bookended” by great (more or less) market tumult: first with plummeting energy prices and confidence in Chinese markets in the first quarter calling into question the direction of US and Global economies, and second, by the stunning vote of British citizens to divorce themselves from the union they’ve shared with the 27 other members of the European Union for the last 40 years.



As we write, the major US equity indexes are up just under 5% from the depths of their tumble following last week’s British vote to exit the European Union (or “Brexit”), having made back substantially all of the decline. This illustrates the imprudence of rash decision making—even when faced with extraordinary, and unexpectedly negative data. Indeed, this market reaction to news of a “historic” development causes us to reflect on the volatility and recovery of markets just after the United States lost its AAA credit rating from Standard and Poor’s five years ago.

Our message has often been that not all headlines deserve absorption into an investor’s long-term strategy. In fact, most do not. On the other hand, the outcome of the “Brexit” vote is an important development which introduces more uncertainty into what have already been

unsettled markets. The tricky part is that this new data *must be incorporated into future strategic assumptions*. This one-time vote by Britain to “Brexit” the European Union was largely a political statement. It has political ramifications within both the UK and the EU, but is significantly intertwined with the economic wellbeing of both. So begins a journey into the “*unknown unknowns*”.

While the quote above is often attributed to Donald Rumsfeld, the concept of “known unknowns” goes back over 60 years to psychiatrists seeking to create a heuristic method of helping people better understand their relationship with themselves and others—or so says Wikipedia. However, it seems apt to us to apply it to “what happens next” following the Brexit vote and what ramifications it will have on the future of European and global markets. “Known unknowns” in the financial universe are generally modeled, using both an understanding of historic data and educated assumptions about future data points. In fact, “known unknowns” are generally the normative condition in finance. While forecasts (of economic metrics, markets, etc.) are rarely spot-on, they often do provide sound justification for modeling investment actions. *The issue with the Brexit vote, and therefore the longer term outcome, is that it is/was **POLITICAL** in nature, and the ensuing negotiations between the British government and the EU will be largely colored by political consideration—most notably on the EU side.*

Political moods across the developed and democratized world reflect voters’ contentment, discontent, optimism, or fear of existing and expected economic and social conditions. Since all four of these elements are *emotional responses*, it is *human emotion* that must somehow be quantified and incorporated into forecasting methodologies—a virtual impossibility given the seemingly illogical turns emotional responses can take. Thus, we enter into the sphere of *unknown unknowns* as we try to muster expectations for Europe’s future.

We maintain close contact with the asset managers in whom we’ve entrusted our clients’ assets, and with several other well respected thought leaders. After numerous conference calls, before and after the Brexit vote, and having digested several “white papers” on the subject, here is an “average” assessment of where things stand, in our view:

**The Known Knowns** (high degree of certainty): The Brexit vote most likely will result in a near-term recession for the UK (formerly one of Europe’s strongest economic components). London’s position as the major financial hub of Europe is placed in jeopardy given the UK’s withdrawal from the European Union. Most major banks across Europe and the globe established a major presence in London to play an integral part in London’s robust stock exchange. The financial sector accounted for 12% of UK economic output in 2014, employing over 700,000 people in London alone. We expect near term jostling among Paris, Frankfurt, Dublin, and other major financial nerve centers to attract this business, resulting in immediate job loss and job migration from the UK.

A somewhat mitigating factor in the near term will be the Bank of England’s interest rate reductions, and the likely continued liquidity provided by the BOE, as well as the Fed and the ECB (because a liquidity crisis is in no-one’s self-interest). Our reading of the consensus is that the ensuing recession will likely be short and shallow, but economic growth on the other side remains a question mark.

Lastly, we’ll report a consensus view that the economic ramifications within the UK *should not* throw the remaining EU, or global markets into recession, nor should it have much effect on

the US—beyond the negative effects of an increasingly stronger dollar. While Britain is a major economic player within Europe, the UK contributed just 2.36% to global GDP in 2014.

**The Known Unknowns** (expected, but uncertain outcomes/timelines): There exists a provision in the EU Charter for countries to voluntarily exit the European Union called “Article 50”. Article 50, once invoked, provides a specific framework for Britain’s separation from the EU covering trade, migration, travel and other cooperative issues. We also know that Article 50 provides a two-year window (from invocation) to conclude these negotiations. While David Cameron, in his resignation speech as the UK Prime Minister suggested that Article 50 would be invoked after his September 30 effective resignation date—we do not know when exactly negotiations will begin. Some in Europe are eager to press ahead as soon as possible (for political reasons), while some in England and elsewhere would prefer to delay.

The Brexit vote represents a crisis of confidence in the EU, no doubt. The outcome of the vote itself, however, partly owing to its unexpected result, has many pointing to the fact that the referendum on June 23<sup>rd</sup> was technically non-binding. Reports of “buyer’s remorse”, as well as Boris Johnson’s demurral at running for leadership (suggesting inter-party chaos) has some hoping for a second referendum to overturn the “Leave” vote. This, in the view of our asset managers, is unlikely—though expect the press to stir the pot.

So we know the basic framework for the Brexit, but do not yet know the time frame for its commencement. We know emotions run high in the UK itself, though the political make-up of Brexit negotiators will likely remain a mystery for several months (amazingly, there was no contingency plan in place!). Lastly, we know that we do not know the impact of the negotiation outcomes on either the UK or the EU (which is stating the obvious, as they have yet to begin). We can surmise that the outcome for the UK will be asymmetric (the EU takes roughly 45% of the UK’s exports, though less than 20% of EU exports go to the UK). But the *degree of pain* the UK faces remains unknown, and here we enter the black-box of politics and public opinion. It should be understood that the UK will clearly not be holding the cards once the negotiations start. The Europeans have a dual interest in making the separation of Britain quick, orderly, and as economically painless to them (the EU) as possible. The EU also has an interest in exacting more than a “pound of flesh” on the English—lest other resistive elements within Europe view a light penalty for the UK as an invitation to separate from the EU. In the years ahead, we expect periods of tempestuous negotiations, resulting in market volatility.

**The Unknown Unknowns:**

In our April Outlook we referenced HL Mencken’s notion that democracies deserve to get what they vote for “good and hard”. This being an election year in the US, and an unusual one at that, it’s a particularly ponderous notion. The anti-establishment has a “throw the bums out” temperament which infects voters across the developed world, as is evidenced by the Brexit vote. Note that voter turnout in Britain was high, at 72%--higher than the previous year’s general election according to the BBC.

The high voter turnout is indicative of a population impassioned by their opinions of the European Union. But this opinion is not just a British sentiment. The week following the Brexit vote, Italy’s euro-sceptic 5-Star party won the mayoral race in Rome. Recent polls show nearly half of *France* and a large swath of the *Netherlands* would vote to leave the EU, if given a similar referendum. Indeed, the Balkanization of Europe seems a more tangible possibility today than it did six years ago when we were writing about the PIGS (Portugal, Italy, Greece

and Spain). These elections will continue throughout Europe against the backdrop of the Brexit negotiations, which makes forecasting negotiation outcomes or economic ramifications so difficult—if not impossible.

**Our View:**

CCR Wealth Management has made the case for meaningful allocations to non-US, particularly developed markets based on favorable valuation comparisons, proactive monetary stimulus, and our confidence particularly in Europe’s continued recovery from the 2011 recession. Importantly, all these variables remain favorable and we expect central banks around the world to provide plenty of liquidity during this time. We’ve listened to non-US asset managers. In most cases they remain “bullish” and understandably seek “buying opportunities” amid this turbulence. Of course if you run a non-US equity portfolio—your job is to remain invested regardless of conditions.

However, we must weigh new information as it becomes available. In our view the visibility of continued European recovery is made more opaque by the prospects of the EU simultaneously battling to remain a cohesive entity. While we will remain engaged global investors, our model portfolios will reduce non-US allocations until such visibility improves. In truth, while most of the recent news pertaining to the Brexit vote has been negative, we do not know that all of the results will be in the long run. Interest rate hikes here in the US are likely off the table for the rest of the year (pending European developments), and there’s always the hope that such political drama might be the spark to ignite much needed reforms among the Euro-bureaucracy to assist the remarkable efforts made by the ECB.

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