Tamohara
INVESTMENT MANAGERS

<u>Brexit and Six Honest Serving Men</u> **June 2016**

The British have cast their vote on Britain's exit (Brexit) from the European Union (EU), sparking a sell-off in risk assets across the globe. A flurry of predictions and forecasts defining numerous outcomes and their repercussions on financial markets are being flooded by media. Fear seems to have gripped the financial markets - 'Risk-off', 'Crisis', and 'Meltdown' have suddenly seen a sharp rise in their usage in headlines and sales notes alike. Amidst this chaos, we draw upon the wisdom of Rudyard Kipling in identifying future course of action.

Six Honest Serving Men

Rudyard Kipling made famous a thinking framework in his "Just So Stories" (1902), in which a poem accompanying the tale of "The Elephant's Child" opens with:

I keep six honest serving-men
(They taught me all I knew);
Their names are What and Why and When
And How and Where and Who.
I send them over land and sea,
I send them east and west;
But after they have worked for me,
I give them all a rest.

We borrow four of Kipling's men in order to understand the current state of affair and their implications for the future (we rest Why and Where, for their work is widely covered).

<u>*What* just happened?</u>
Before we draw conclusions on the future impact of the event, it is important to understand what just transpired. On Friday, people voted in favor (albeit by a small margin) of the U.K. walking out of the European Union. This doesn't mean Britain has actually left the European Union – the vote is a reflection of the general opinion of the people - but it does mean that they will leave soon. The question is how soon?

<u>*When* will it transpire?</u>
The Brexit vote does not represent a formal notification to exit. Article 50 of the Treaty on European Union establishes the procedures for a member state to withdraw from the EU. It requires the member state to notify the EU of its withdrawal and obliges the EU to then try to negotiate a withdrawal agreement with that state. That notification could take place within days — for example, when EU member countries meet for a summit that is scheduled for June 28 to 29. Or British officials might wait a few months to pull the trigger. Once Britain notifies as per Article 50, it will have a two-year window (can be extended further) in which to negotiate a new treaty to replace the terms of EU membership. Britain and EU leaders would have to resolve issues like trade tariffs, migration, and the regulation of everything from cars to agriculture. Thus, the UK will exit the EU over a period of time, depending on how negotiations go.

<u>*Who* will it impact?</u>
While the answer to this question will only be known once the negotiations end, it could be safely assumed that the impact will be on companies that have cross-border operations between the UK and the rest of the EU. For instance, some of the EU members may impose tariffs on goods originating from the UK. These however could be partially offset for the UK companies due to the

GBP's depreciation against most currencies. Similarly, given some of the large EU member's exports to the UK, it could negotiate lower import tariffs on its products by allowing similar low tariffs on products coming in to the UK from other EU countries.

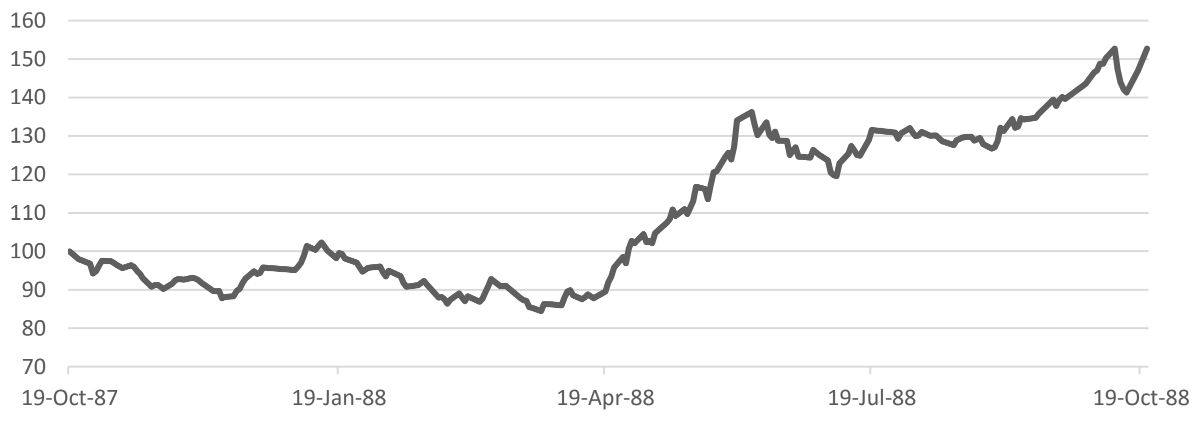
The vote therefore is not an end but the beginning of the exit process. Further, it is important to note that Norway has access to the single-market trade zone of the EU despite it not being a member of the union. Similarly, Greenland left the bloc's predecessor, the European Economic Community (EEC) in 1985 (although it was it was not a separate member state within the then European Communities, it was a territory within Denmark).

How will the markets behave?

We've said this in the past (How Bad Is It; February 2016): Volatility is a characteristic of the market – the opportunist could use it to his advantage while the fearful could turn the advantage into a loss by selling at the bottom. In the short term, prices are a barometer of sentiments while in the long term fundamentals catch up. While sentiment may remain coordinated across the oceans, fundamentals aren't. Clearly, there is little impact on the earnings of most Indian corporates from the Brexit. Thus, while in the short term prices may fall, eventually, they will trace earnings. In the following section, we look at movements of the S&P BSE Sensex (rebased to 100 in each case) over a period of 1 year after some major (non-recessionary[1]) global events (source: Wikipedia and Forbes):

1. **Black Monday (1987)**

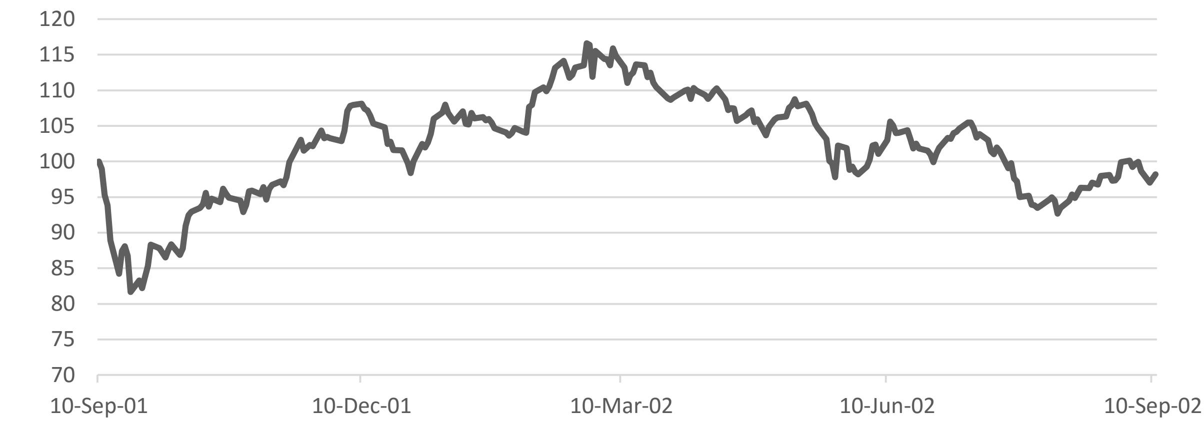
On Thursday, October 15, 1987, Iran hit the American-owned (and Liberian-flagged) supertanker, the Sungari, with a Silkworm missile off Kuwait's main Mina Al Ahmadi oil port. The next morning, Iran hit another ship, the U.S.-flagged MV Sea Isle City, with another Silkworm missile. On Friday, October 16, when all the markets in London were unexpectedly closed due to the Great Storm of 1987, the DJIA fell 108.35 points (4.6%) to close at 2,246.74 on record volume. Then-Treasury Secretary James Baker stated concerns about the falling prices. The crash began in Far Eastern markets the morning of October 19. Later that morning, two U.S. warships shelled an Iranian oil platform in the Persian Gulf in response to Iran's Silkworm missile attack on the Sea Isle City.



2. **9/11 Attacks**

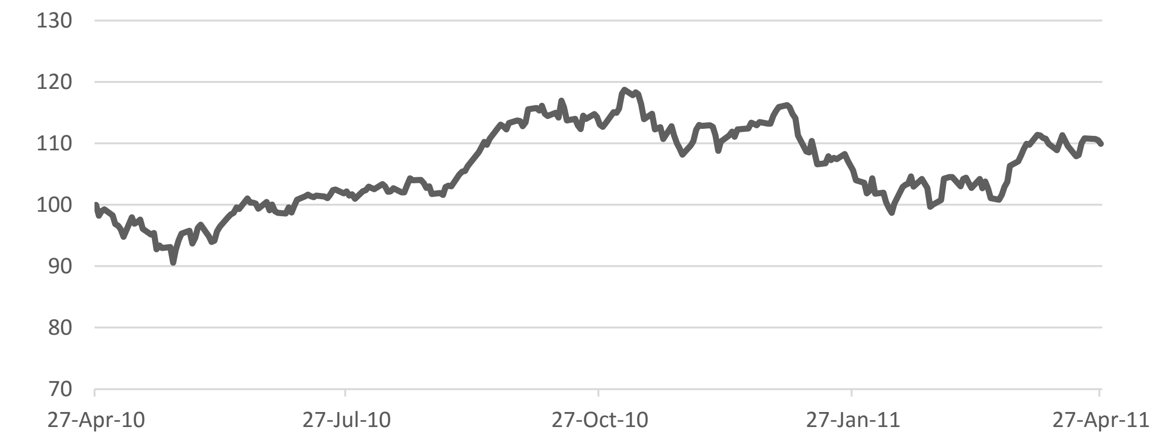
The September 11 attacks (also referred to as 9/11) were a series of four coordinated terrorist attacks by the Islamic terrorist group Al-Qaeda on the United States on the morning of Tuesday, September 11, 2001. The attacks consisted of suicide attacks used to target symbolic U.S. landmarks.

[1] Most recessions are formed on the back of excesses. We haven't seen any such excesses in the recent past.



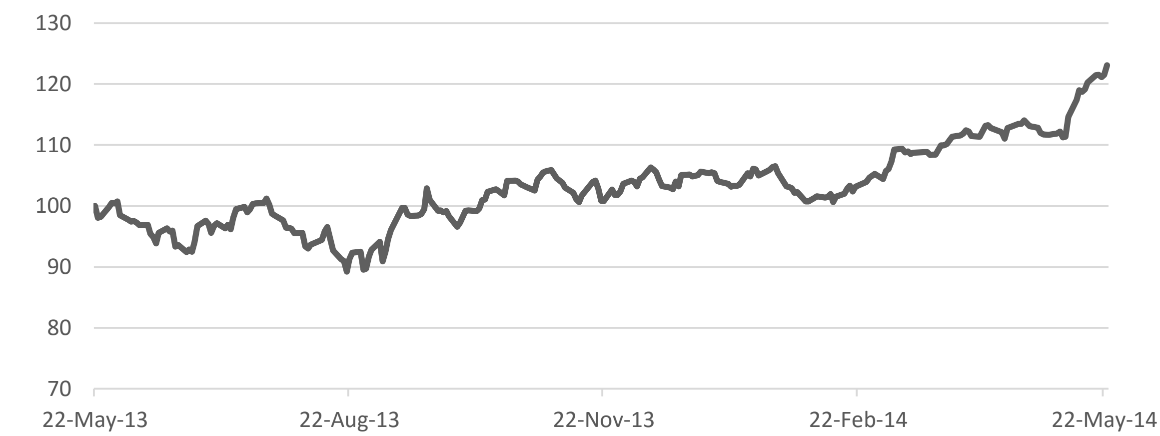
3. European Debt Crisis

Standard & Poor's downgrades Greece's sovereign credit rating to junk four days after the activation of a €45-billion EU–IMF bailout, triggering the decline of stock markets worldwide and of the Euro's value, and furthering a European sovereign debt crisis.



4. Taper Tantrum

On May 22, 2013, the Federal Reserve announced that it would begin tapering back its roughly $70 billion a month in bond and mortgage backed securities program. The news made risk assets the ugly duckling of financial markets.



5. Chinese Black Monday

On Monday, August 24 2015, world stock markets were down substantially, wiping out all gains made in 2015, with interlinked drops in commodities such as oil, which hit a six-year price low, copper, and most of Asian currencies, but the Japanese Yen, losing value against the United States Dollar. The 8 percent drop in China on August 24 was termed "Black Monday" by the Chinese state media.

Source of all charts: bseindia.com, Tamohara

Same Old, Same Old ….

As can been seen from the five instances above, in most cases, the Sensex was higher or close to the point where it was before the sell-off started, in less than a year. This is not to say that the markets will recover from here on in a year, but to drive the point that while sell-offs seem to be coordinated in the short term, eventually fundamentals take over – our boring rhetoric.

Thus, rather than mulling over global sentiments and the direction of markets, investors would be better off in using any corrections to their advantage. The theory of finance says that asset values are determined by discounting their future cash flows to their present value. Thus, ideally prices changes should mirror changes in the value of the cash flow. However, we have seen that quite often, asset prices rise and fall (often disproportionately) without any regard for cash flows. Some may consider this as a change in the discount rate, akin to the change in P/E that investors accord at different stages of the market. Students of behavioural finance would agree that changes in the P/E (or valuation parameters in general) are a reflection of changing investor psychology rather than changing fundamentals.

Short term price fluctuations, therefore, are a reflection of investor sentiment and not the underlying business. As an ex-colleague succinctly put it: P/E stands not for 'Price to Earnings' but for 'Perception to Earnings'. Investors would be better off if their portfolio allocations were built upon estimates of sustainable earnings rather than driven by perceptions.

Until next month,

Team Tamohara

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