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Navigating Brexit-Sparked Market Volatility

"When you least expect it, expect it." I seem to remember that line from a 1970s sitcom. Perhaps it was an older brother promising revenge on a younger sibling? In any case, as it turns out, those cautionary words aptly describe the results of the Brexit referendum—and the market at large. Even in the days leading up to the United Kingdom's historic vote, Wall Street gave an exit vote less than a 25-percent chance of succeeding! And recall that Prime Minister David Cameron, who resigned in the aftermath of the vote, actually called for the referendum. Talk about a misread of your constituents! Therefore, it's no surprise that the shocked markets reacted the way they did.

Reaction was swift and severe when the British people decided to end their country's 43-year membership in the European Union (EU). London's blue chip index, the Financial Times Stock Exchange 100, lost 4.4% of its value in one day. The British pound sterling was down 14% against the Japanese yen and 10% against the U.S. dollar. Additionally, Germany's DAX market lost more than 7%. And, in the United States, the S&P 500 plummeted 600 points.

Those commenting on Brexit also had extreme reactions. Alan Greenspan called the markets' reaction the "worst period I can recall since I've been in public service" and predicted additional volatility in the weeks and months ahead. Other commenters were almost cavalier as stocks fell globally, noting the world will survive and the "British people will still eat fish and chips this weekend." In my view, these emotional comments stem from the very root of the "leave" camp's victory. In both cases, the emotion of fear sparked irrational decisions. Remember that the leave campaign appealed to citizens' fears that they had lost control of their country—seemingly stopping short at regaining control and not offering specific plans for the future.

This illustration of how fear can influence our decisions should provide a lesson for investors. Reason, not emotion, should rule in times of stress. An email I received from Dimensional Fund Advisors provides the rational reassurance I would offer all investors: "Dimensional Fund Advisors has nearly 35 years of experience managing portfolios, including during periods of uncertainty and heightened volatility. We monitor market events—including their impact on trading and trade settlement—very closely and consider the implications of new information as it comes to light. We are paying close attention to market mechanisms and they appear to be functioning well. Our investment philosophy and process have withstood many trying times and we remain committed."

One other interesting point to note is that the VIX Index, which is a gauge of market fear, hovered between 24 and 25 on Friday, June 24. Interestingly, that level, which was measured the day after the Brexit victory shocked the world, was well below other points that we've experienced during the past year. Specifically, the VIX soared to above 50 in August 2015 and registered above 24 for several days in both January and February 2016. So much for Alan Greenspan's analysis that Brexit thrust the markets into unprecedented territory! I also note that the S&P 500 has made a healthy recovery since the new year began with such a decline.

I reiterate what I have said so often—fearful (or greedy!) investors often abandon their diversified investment strategy at exactly the wrong time. The market rewards patience and reason. We'll see more volatility in the coming weeks and months as new leadership in the UK negotiates an exit from the EU. As always, maintaining proper diversification and a long-term market view will be your best strategy.

I'll conclude with a few assumed certainties and possible repercussions that, in the midst of all this market confusion, warrant watching:

1. **The prospect of another interest rate hike by the U.S. Federal Reserve has decreased dramatically.** At the Fed's most recent June policy-setting session, the official written statement did not even reference the upcoming UK vote! However, in a later press conference, Federal Reserve Board Chair Janet Yellen admitted that the *potential* negative impacts of an exit influenced the members of the Federal Open Market Committee (FOMC) not to raise rates. The Fed chief said this about the then yet-to-be-cast Brexit vote, "It is a decision that could have consequences for economic and financial conditions in global financial markets. If it does so, it could have consequences in turn for the U.S. economic outlook that would be a factor in deciding on the appropriate path of policy." The ultimate exit vote will likely strengthen the U.S. dollar

and weaken the Euro and Pound Sterling. Interest rates in the EU and UK will probably drop.

2. **The UK vote reflects increasing populist sentiments.** On opposite ends of the political spectrum, the U.S. presidential campaigns of Bernie Sanders and Donald Trump embody the same anti-establishment message as Britain's leave campaign. Across the globe, decades of pushing for greater globalization seemingly have been met with a strong populist wave. Importantly in the UK, post-vote politics now divide older and younger voters. "You've had your day and now you are ruining our future," declared one young EU loyalist.
3. **The world's central banks will not stand idly by.** The Fed was quick to offer reassurance: "The Federal Reserve is prepared to provide dollar liquidity through its existing swap lines with central banks, as necessary, to address pressures in global funding markets, which could have adverse implications for the U.S. economy," the Fed said in a written statement issued before Friday's opening bell on Wall Street. Also, the Group of Seven nations, or G7, commented, "We recognize that excessive volatility and disorderly movements in exchange rates can have adverse implications for economic and financial stability." The group also made the following statement: "G7 central banks have taken steps to ensure adequate liquidity and to support the functioning of markets. We stand ready to use the established liquidity instruments to that end."

The bottom line is that while we will closely monitor events in Britain and around the world, the future will likely be better than Friday's market portends. The vote to leave the EU does not change the fundamental outlook for U.S. equities. Nor does it change the fundamental outlook for international equities. Yes, many continue to look for low and slow growth in the years ahead, but dips caused by events like the Brexit also present opportunities to buy. By resisting the fear that often prompts selling and by staying fully invested, investors can ensure that they don't lock in losses due to the Brexit aftermath. Pushing fear aside and re-committing to your diversified investment plan will leave you well positioned for the future.

Stay Diversified, Stay the Course!

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