Investment Perspective

KANAWHA
CAPITAL MANAGEMENT

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Global capital markets were jolted in late June by the outcome of a UK referendum on its European Union membership. Citizens voted 52% to 48% to leave the longstanding economic and political partnership. The *smart* money — meaning traders and London bookmakers — had been on the nation remaining in the EU. So stock, bond, and currency markets went haywire immediately after the unanticipated results were announced.

Some fear that this move could both threaten the region's fragile economy and mark a tipping point for the pan-European project. Although not formally established until 1993, the EU traces its origins back to the 1950s. Several initial "economic communities" were established soon after World War II to promote European integration and forestall the extreme nationalism that had devastated the continent.

With 28 member states now, the EU represents a large single market, facilitating the free movement of goods, services, capital, and people between them. Nineteen members also comprise a monetary union sharing a common currency, the euro. Britain has stayed outside that group, choosing instead to maintain control of its own monetary policy.

The British are leaving

Under the Lisbon Treaty, once the British government notifies the EU of its intention to withdraw, the parties have two years to negotiate the terms of the exit and the framework for their new relationship. This will likely be a drawn-out, tortuous process. The talks will need to address trade and investment issues as well as regulatory and security matters. So it is much too early to determine how consequential this decision will be for the UK or the broader region.

The Economist was less than sanguine, lamenting that the "outcome will be a Britain poorer, more isolated, less influential and more divided." Britain itself will bear the brunt of the initial financial and economic ripples. Within several days of the vote, the value of the pound had plummeted 11% against the dollar and 8% versus the euro. In early July, the currency hit a three-decade low in dollar terms.

Many prognosticators are now calling for a UK recession as waning confidence and heightened uncertainty prompt businesses and consumers to step back. The Bank of England has pointed to several key risks to the nation's financial stability, from high household indebtedness to a large current account deficit that must be funded by external capital flows. Meanwhile, a commercial real estate sector propelled by foreign investment could stress the banking sector if property prices subsequently fall.

It's not the economy, stupid

But at this point, the likelihood of UK financial weakness bleeding into a regional or worldwide contagion seems low. Actually, the political implications of *Brexit* are arguably more important than the economic ones. The decision further calls into question the sustainability of the EU model, particularly in light of the tension between many of the states since the global financial crisis. Only last year, attention was focused on the possibility of *Grexit,* a Greek withdrawal from the Eurozone.

It has been a mistake in the past to underestimate the commitment of European politicians and institutions to the EU project. However, Britain's withdrawal could be the first shot across the bow. Nationalist parties may figure prominently in French and German elections next year. So the debate will persist.

More broadly, Britain's pending divorce from the continent has some pundits sounding the death knell for globalization in general. Certainly, the British vote exemplifies what can happen when people feel like the "system" is letting them down. That mood has gained momentum in the West as individuals struggle to fully recover from the 2008-09 meltdown. For example, the United States has seen a surge in populist rhetoric and a backlash against political elites. The success of both Trump and Sanders — anti-establishment candidates from opposing parties — has been striking.

A flat world

Globalization denotes the interaction and integration among the people, companies, and governments of different nations. Driven by international trade and investment, the process has been greatly facilitated by technology innovations in recent decades. Although primarily financial and economic in scope, it has had important geopolitical dimensions as well.

A byproduct of globalization has been a more stable world order, at least in the West where the integration has been most pronounced. The incessant conflict between nation-states that characterized the 19th century and first half of the 20th has been extinguished — or at least shifted from swords to shouting.

With the fall of the Berlin Wall in 1989, hundreds of millions of new consumers were able to begin joining the world marketplace. The wall's collapse and subsequent dissolution of the Soviet bloc represents one of the most significant events since the defeat of the Axis powers in World War II. Countries that had previously been under the Soviet yoke are now members of NATO, the OECD, even the EU. Their societies have been integrated into the global economy and body politic.

Yet still bumpy

Obviously, not all segments of society have benefited from the inexorable forces of globalization. Sizable swaths of the population in the developed world have seen incomes stagnate and job prospects dim. So understandably, they do not necessarily favor the "free movement of goods, services, capital, and people." This phenomenon helps explain the anti-immigration fervor in both the U.S. and Europe as well as the push back against foreign trade. It also sheds light on the *Brexit* vote.

The McKinsey Global Institute just released a study that examined the income trends of households in 25 developed economies, including the United States. It found that over the 2005-2014 period, which straddled the *Great Recession,* 20-25% of households experienced *flat* or *falling* disposable income, adjusted for inflation. If transfer payments (social security, unemployment insurance, etc.) are excluded, 65-70% of households saw no income growth from 2005. In contrast, over the prior 12-year period (1993-2005), fewer than 2% of households failed to grow their income.

McKinsey points out that the deep recession and slow recovery from the 2008 financial crisis have been the chief barriers to income gains. But the authors also conclude that even if economic growth accelerates, certain demographic and labor-market factors will continue to hold back income growth. In the U.S., the *share* of national income paid to workers has been declining for decades. Secondly, wage growth has been unevenly distributed among different income levels. In other words, income for top earners has grown faster than that for others.

Long-term business trends help explain these disparities. With an increasingly global marketplace, more and more low-and medium-skilled work has shifted overseas. It has been supplanted by activities that are more capital- and knowledge-intensive. Technology and automation have not only altered the required skill mix, they have streamlined many processes, reducing the amount of labor required. Lastly, corporate America's preference for "temporary" workers has also impacted income levels.

More hope and change?

The structural forces unleashed by globalization have been in place for quite a while. But the financial crisis further dimmed the prospects of those on the losing side. So here we are in an election year with a lot of disaffected voters, clamoring for a change.

Whatever one's political leaning, part of the frustration no doubt reflects fatigue with the bickering in Washington and lack of progress on substantive issues. Well thought-out policy prescriptions are required to jump start the U.S. economy and achieve broader-based income growth. It is not as simple as erecting a giant wall or providing free college tuition for all, even though those statements make good sound bites.

And the solution is certainly not to batten down the hatches and recede from the world stage. But the rise of populist leaders in the West threatens a move toward more nationalist, isolationist, and protectionist policies. Such an environment would harm worldwide growth and be negative for stocks. Multiples would contract.

Keep emotions in check

The presidential and congressional elections in November will provide a clearer sense of the direction the United States might be headed. Meanwhile, Britain's transition out of the European Union will be slow going. Odds favor the country remaining strongly engaged with its current trading partners.

Europeans are wrestling with a geopolitical crisis, not a Lehman moment or systematic economic meltdown. It could certainly transform into a broad shock if trade contracts due to beggar-thy-neighbor policies or other protectionist measures. But absent major political shifts, that seems unlikely.

Most stock markets quickly recovered from their sharp *Brexit* sell-off despite losing a combined $2 trillion in value that fateful Friday. By the first week of July, both the Dow and S&P 500 had hit new all-time highs. Stocks' violent reaction to the news underscores the notion that investors must not blindly respond to seemingly ominous headlines. The initial hysteria over *Brexit* — talk of the breakup of the UK and disintegration of the EU, when details will not be known for years — was a textbook panic.

While it may be somewhat worrisome that stocks are back at their highs, it is worth noting that it had been over 400 days since the S&P 500 last hit a one-year high. Moreover, the recent recovery has been very broad-based, a healthy sign. But stocks are certainly not cheap and, in our view, will require more signs of a profit rebound to continue their momentum. Analysts currently forecast improving earnings, but time will tell.

— Christopher J. Singleton, CFA, Managing Director

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