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Brexit: A Black Swan arises in Europe

6/26/2016

Investopia: *"A black swan is an event or occurrence that deviates beyond what is normally expected of a situation and is extremely difficult to predict; the term was popularized by Nassim Nicholas Taleb, a finance professor, writer and former Wall Street trader. Black swan events are typically random and are unexpected."*

First off, clients should be aware that while I had no expectations of Brexit, all accounts on Friday posted either minimal losses or modest gains. We were not caught flat footed or leaning the wrong way at all going into Brexit. So there is really no reason to fear markets or events going forward. Rest easy, sleep well and enjoy the summer. Going forward we can be unemotional and thoughtful going forward to position portfolios for what I believe will be an extended down trending/bear equity market that will likely drop in the 35% to 50% range in the next two years. We will invest with these conditions in mind and not fight against an incoming tidal wave from foreign currencies but rather work in accordance with the wave.

"The penny has dropped" in Europe but they aren't laughing. To my eyes and experience, Brexit isn't really an entirely new phenomenon but a continuation of a course that we were already on. Brexit appears to be a final massive shove of Euro economies over the cliff into a full scale debt and credit crisis. What makes Brexit so incredibly foolish is the British government has no plans whatsoever going forward, there is huge void in their post-election planning. It's as if they didn't bother with anticipating the need for a plan since they didn't expect to win.

The effect of Brexit is similar to our own 9/11 attack in which the US economy and business cycle was already trending down before the attacks. Even though the Federal Reserve was in a much strong position than they are today, the Fed still couldn't postpone the 2002 recession. Now the Fed has a toolbox but no tools to forestall a recession.

I expect our holdings in Treasuries, gold, REITS, water utilities and inverse ETF's to move much higher this summer. The long drawn out 2-year trending sideways choppy US stock market should continue to break to the downside.

Furthermore, my expectation of the 10-year Treasury dropping to 1% yield is probably too conservative as 0.5% may be a better target. In other words, Brexit will accelerate the migration from the Euro and Sterling to the USD to a degree we've never seen before, thus pushing T-bond prices to continual series of all-time high prices. I'm sure many of you viewed my statement of the potential gains to be made in Treasury bonds with squinty eyed cynicism but now I have greater confidence it will happen. Accordingly, interest rate sensitive holdings which were purchased with the belief of impending recession such as REIT's and water utilities stocks should continue to do well since they trade with interest rates as opposed to the general stock market.

<u>Trading on Friday, June 24</u>

On Friday, Brexit day I sold off what I'm loath to do: Sell off winning or borderline profit holdings in commodities, Emerging Markets and PSA Public Storage. My early in the year call for a rotation into Emerging markets was obviously wrong as mentioned before and Brexit will only accelerate the future decline since a strong dollar is a wrecking ball to commodities and EM holdings.

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As the charts below will show US markets were already breaking down before Brexit, especially the NASDAQ.   Two weeks ago we added a modest position in the “PSQ” or Proshares Short QQQ which is an unleveraged inverse exchange traded ETF.   This was based on the Nasdaq Composite index was beginning to break below its 200 day moving average.

The NASDAQ proxy “QQQ” was already heading into a Bear market before Brexit as the declining top pattern was rolling over. Brexit pushed the QQQ below the important 200 day moving average.

Going forward

We do not have to do any major repositioning of assets as for the past two months we had been gradually shifting into Bear market and recession mode.

Brexit is a catalyst that will accelerate dramatic change in US, Europe and the balance of world capital markets. In a sense this is the first domino to fall and many more will fall going forward. In my opinion anyone who views Brexit in a positive light either for social, economic or markets point of view is severely underestimating the future impact.

What we like to own going forward

- Mid to long dated U.S. Treasuries (they're going up much higher in price as yields drop much lower).
- Municipal Bonds (especially high yield munis)
- REITS and water utilities (they trade more with interest rates than the stock market bond proxies)
- Inverse Exchange Traded Funds (we own the unlevered Inverse funds as we expect to own them for an extended time. Levered Inverse funds are prone to time/price decay)
- Cash: It may pay 0% for now but better than a loss.

What to sell or avoid

- Worldwide common stocks including Emerging markets and especially banks.
- Convertible bonds, Corporate or taxable High Yield bonds (credit crisis is sure to follow)
- Index funds (You can easily lose 40% peak to trough)
- Commodities (Commodities need a weak dollar to do well, we have exactly the opposite).

Based on how the Euro banks are trading, something very big and negative is going on

This is where I believe Ground Zero is in the current Brexit/Euro crisis, it's the banks again. Look at those charts, large Euro banks falling 20% in a single day and I have no idea how the ECB can solve this problem. It's very likely that we're going to see a European banking crisis soon with a cluster of banks becoming insolvent simultaneously.

The problem facing the ECB is that in an effort to save the European economies they've adopted a massive QE policy and 0% interest rate policy. This is an environment where banks cannot make money so in an effort to save the Euro economies they'll end up killing the banks.

All of these banks are of the "too big to fail" size and I would expect them to all be nationalized which would require another massive round of QE which will more weight to the sinking Euro and propel the Gold and the USD higher.

DB [NYSE]

Deutsche Bank AG

Financial | Foreign Regional Banks | Germany

BCS [NYSE]

Barclays PLC

Financial | Foreign Money Center Banks | United Kingdom

CS [NYSE]

Credit Suisse Group AG

Financial | Foreign Money Center Banks | Switzerland

SAN [NYSE]

Banco Santander, S.A.

Financial | Foreign Money Center Banks | Spain

Brad Pappas

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Long all securities mentioned except the Euro banks.