Rudyard Kipling was one of the most popular writers in the United Kingdom in the late 19th and early 20th centuries. Accordingly, today’s quote from him seems appropriate given the U.K.’s vote to secede from the European Union (EU) accompanied by the trouncing of the world’s equity markets Friday morning. That market action brought about instant comments from Wall Street’s gurus about the winners and losers from said vote, as well as instant opinions as to what it all means. I find such a “rush to inform” to be disingenuous and advised folks to sit back and take a breath (a deep breath). Indeed, I think it was futile to instantly speculate on the ensuing economic damage. My advice to the media last Friday was to do nothing. Better to take a breath, sit back, and analyze the facts over the weekend. Above all, I stated, do not panic. Maybe it’s because I am old, or the fact that I have seen this type of action before, but this kind of news generally only has a short-term impact on the markets. As Warren Buffet states, “The most common cause of low prices is pessimism – sometimes pervasive, sometimes specific to a company or industry. We want to do business in such an environment, not because we like pessimism, but because we like the prices it produces. It’s optimism that is the enemy of the rational buyer.”

Obviously, it was “optimism” about a “remain” vote that rallied the equity markets into last Thursday’s closing bell. Subsequently, I also told inquirers that my mantra of some 50 years has been, “never on a Friday,” meaning equity markets rarely bottom on a Friday. They tend to give participants over the weekend to brood about their losses, leaving them in “sell mode” early the next week . . . aka Turning Tuesday.

So it is now Sunday and I have had a few days to read the news and think about the state of the state. Here are some random gleanings, in no particular order:

1. The U.K. will face a very long period of uncertainty, which is a negative for its economy.
2. The U.K. is a net exporter of services and a net importer of goods from the EU. Fifty percent of the U.K.’s exports go to the EU, while only 10% of the EU’s exports go to the U.K. (trade barriers?)
3. In the coming months there will be a significant decline of business with the U.K.
4. In the U.K., the sectors that should feel the most negative impact are: auto, energy, telecom, electronics, retail, financial services (including insurance), and the metals industries.
5. It is in the best interest of the EU, and the U.K., to get a new code of trade as soon as possible.
6. The Brexit vote is indicative of some longer-term trends of anti-politics and anti-politicians.
7. Bond yields are not going to go up.
8. Intervention is coming to stabilize the various markets.
9. Who’s next to leave the EU? The Podemos in Spain get a lift, the far right in France as well, the Five Star crowd in Italy, the Dutch are likely to vote to leave, and the list goes on.
10. Germany takes a “hit,” with roughly a fifth of German cars sold to the U.K.
11. The British pound probably trades to parity with the euro.
12. London real estate (commercial and residential) takes a “hit.”
13. Expect more monetary easing around the world (BOJ, PBOC, BOE, etc.)
14. Investors will overweight low beta and defensive stocks going forward.
15. The Brexit is more negative for Europe than it is for the U.K.
16. The real risk to the EU breakup is Italy.
17. Does this end globalization?
18. Expect the exit process to begin this fall, but it will take years to complete.
19. Our “no FOMC rate hike until December” seems more likely.
20. The U.S. dollar should strengthen (the British pound traded to a 31-year low against the U.S. dollar).
21. The big winners will be the lawyers.
22. Boris Johnson is likely to replace David Cameron.
23. It will not be easy to determine if it is to be a “hard” or “soft” economic landing for the U.K.

Importantly, investors should contemplate that the Brexit vote was indeed a referendum and is therefore not binding for the British government. The British parliament can take that vote and say, “Thank you very much, but we are staying in the EU.” They can also say, “We think the referendum is a mistake and we will take another referendum in six months.” In fact, according to the BBC, “A petition calling for a second referendum on [the] U.K.’s membership of the EU has gained more than two million signatures following the vote to leave” (BBC). Surprisingly, there is also a chance the Brexit vote may actually bring the rest of the EU closer together. Hence, I will say it again, “Take a Breath” (Take a Breath) and exhale for clearer thoughts this week!

Structurally, there is Article 50 in the Lisbon Treaty that states the EU will negotiate with the withdrawing country over a two-year period. Prime Minister Cameron could have invoked Article 50 immediately, but he did not. I take that as somewhat of a positive sign that a deal may still be able to be worked out. Obviously the worlds’ markets were caught wrong-footed, but we have seen that action before. In the fall of 1978, when the anti-Shah forces rioted in Iran, the D-J Industrials quickly lost ~14%. Again in the fall of 1979, when there was a massive flight from the U.S. dollar, the Industrials lost a quick ~11.3%. More recently we experienced the “Flash Crash” of May 2010 and “Flash Crash II” in August of last year, yet the world did not come to an end. This is not a “Lehman Moment,” nor is it a Bear Sterns déjà vu, both of which left the global financial system on the brink of collapse.

Speaking to the equity markets, Friday’s Flop finally broke the S&P 500 (SPX/2037.41) below its 2040 – 2050 support zone, bringing into view the May 19, 2016 intraday low of 2025.91 and the 200-day
moving average at 2020.80. It also broke the SPX below its 20-month moving average that we wrote about last Monday. Of note, however, is that while not massively oversold, like it was on June 13th, the NYSE McClellan Oscillator has again become oversold. As well, my proprietary algorithm is still green (green is good) and it has not flipped to red like it did right before Christmas in 2015, which caused me to admit defeat on the “Rip your face off rally.” Given this set of metrics, I think the odds of some kind of “low” occurring this week are pretty decent. Hence, investors should make out their “shopping lists.” While many “bulge bracket” research firms rushed to publish lists of companies with high exposure to the U.K., I think a better strategy is to look for U.S. companies that derive 90% or more of their revenues domestically. A few on my “shopping list,” which are favorably rated by our fundamental analysts and screen positive on my algorithm, include: UnitedHealth Group (UNH/$137.29/Strong Buy), Mid-America Apartments (MAA/$101.11/Outperform), Unum Group (UNM/$32.06/Outperform), and Laboratory Corp of America (LH/$129.62/Outperform).

The call for this week: The Brexit vote is not a “Lehman Moment!” As the always clear-headed Jim Paulsen (Wells Capital) states, “It’s not like the U.K. is going to remove itself from the world economy and not trade with anyone. Once the emotion of this event fades, investors may get back to the fundamentals, which at least in the U.S. are looking better.” And the fundamental fact is that American companies generate ~70% of their revenues in the U.S. So again, “Investors should contemplate that the Brexit vote was indeed a referendum and is therefore not binding for the British government. The British parliament can take that vote and say, ‘Thank you very much, but we are staying in the EU.’ They can also say, ‘We think the referendum is a mistake and we will take another referendum in six months.’ In fact, according to the BBC, ‘A petition calling for a second referendum on [the] U.K.’s membership of the EU has gained more than two million signatures following the vote to leave.’ Hence I will say it again, ‘Take a Breath’ and exhale for clearer thoughts this week!”

P.S. – the SPX gapped down over 3% Friday morning. According to the must-have Bespoke organization, “Of the 17 times the S&P futures or SPY gapped down 3%, the best results were from the open to four days later, up 14 times average 6.5% (see chart on the following page).” This morning, as expected, there is a downside follow through (SPX down 16 points). Get ready to buy em’ . . .
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Source: Bespoke Investment Group.

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