Brexit, Grexit, Exit, Exit, Exit

In a few days we shall get the results from the UK on whether it stays in the EU. Emotionally a large part of its citizenry wants to leave, but pocketbook considerations may make them think it might be better to stay in the EU. Commerce and markets dislike uncertainty and there will be less uncertainty if there is no change and the country remains attached to the continent. The heart wants to leave, but the brain says it might be better not to do so. If the UK is truly a nation of shopkeepers, it will calculate the pros and cons of membership and will vote to stay in the EU. We shall soon find out.

There is a more profound question, however, that needs to be addressed. What brought the UK and Greece, the two extremes of what used to be called Western Europe, to contemplate exit? An exit from what? The two situations are completely different. Compared to other countries, the UK is highly prosperous with a decent growth rate and low unemployment. It is not weighed down by the strictures attached to the Euro. Greece is in the opposite situation. It has negative growth and suffers from high unemployment. It is burdened by the rules attached to the Euro and no longer has the flexibility to use its currency to correct economic imbalances.

Is there a common thread here? Do both countries symbolize a more widespread theme, an underlying current of dissatisfaction that one senses in many parts of the developed world?

Spanish voters will shortly go to the polls to again try to form a stable government. The outlook is not encouraging. Hungary and Poland, which have done relatively well economically in the last few years, have recently adopted nationalistic policies that run counter to EU political principles. Austria, a couple of weeks ago, very nearly elected a president that strongly espoused immigration policies that are not in keeping with EU consensus thinking. France, Italy and Germany have seen a significant increase in alternative political parties that are questioning the status quo.

There is a general unease, a swelling anger that seeks an exit from conditions as they are today. There is a mood of frustration, of unnamed anxiety that crosses geographic boundaries and pervades society as a whole.

The United States is not exempt from this generalized sense of underlying tension, this search for an exit from something not well defined. It is too facile to simply trace this unease to economic factors and blame income inequality for our problems. Undoubtedly the financial collapse of 2008/2009 and the attendant recession have played significant roles in souring the mood of the population at large. But this does not adequately explain the unexpected surge in popularity of extremist trends in both US political parties. There is something more deep-rooted at play. There is a sense that we have lost our way - that we are no longer in control of our destiny, and that we have lost a trust that binds us together.

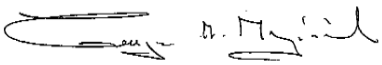
This search for an exit from existing conditions is also manifest in the financial markets. The Fed is trying to exit from its current stance of extremely low interest-rates but finds the road very difficult. Monetary authorities fully recognize that there are limits to the effectiveness of monetary policy and that there is a need for fiscal initiatives to stimulate economic activity. But effective

governmental initiatives are lacking. There is a pervasive sense of stasis that has set in as politicians ineffectively try to deal with the twin problems of ballooning budget deficits and increasing social expenditures.

It is necessary to recognize that the economic and financial landscape has changed. There are no useful historical precedents to help us find our way. We are skating on the thin ice of aggressive monetary policy and hope that this will continue to support us. We must, however, be aware of the dangers. Market valuations are stretched. There are increasing signs of speculative behavior. The risks are not insubstantial. There are no easy solutions that will relieve our stress over how best to position ourselves in this environment fraught with fat-tail risks.

Does the notion of risk-free still exist when there is more than $10 trillion invested in negative interest rates? How attractive is it to invest in 10 year Bunds at a negative interest-rate? Quantitative easing may provide temporary support for the economy, but it creates artificial pricing of assets. How long can this go on? Where is the exit?

We obviously do not have the answers. We can only try to invest in a disciplined manner in companies that we believe are credit-worthy and will pay us back at maturity regardless of which way macroeconomic or political winds blow. We do not make directional bets on economic or interest-rate forecasts that are increasingly fragile. We must be prudent investors aware of the risks that surround us. We remain focused on generating attractive risk-adjusted returns without ever forgetting the necessity of preserving capital, both in nominal and real terms, over the longer-term.



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