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Tarheel Advisors Newsletter

Run for the Brexit!

Do you want the good news or the bad news first? Being an eternal pessimist, I always start with the bad news, so here it goes...

Once promising investment results for the end of the second quarter went down the drain as the United Kingdom held and passed a referendum to leave the European Union. The DOW dropped 600 points the day following the vote, and that was modest compared to the panicked selling overseas. This fire sale was exacerbated by the fact that most market and political pundits had set expectations that this referendum would fail. Market volatility and uncertainty is back, and in the short term investment results may suffer.

Now for the good news, and its really good in my mind - Democracy still works! Despite the immediate market losses, as I turn on my TV I've yet to see a single news story of London burning to the ground, or German foot soldiers storming British Parliament. We are seeing historical change in Europe, but thankfully it is coming from citizens staring down a ballot box instead of a bayonet.

While the markets are currently quite hectic, I suspect this story will mostly be a political one as we look back upon it in a few years. While there is certainly potential for economic fallout from Brexit, I personally consider this move to be a long-term positive for markets across the globe.

I've written about this subject several times at this point, but the fact of the matter is that the EU, and more specifically the Euro currency, was never built on a proper foundation. It is extremely difficult to foster a strong monetary union without also having a strong federal system aligning nations/states. The EU has tried to force a stronger federalized system over the past decade, and this loss of sovereignty was a core reason for Brits wanting to head for the exit.

Greece has been the prime example of the problems in the EU over the past several years. Their irresponsibility with their debt management has raised the specter of them being booted from the EU around this time every summer. Were a large country like Italy, France, or Spain to exit the EU via an economic collapse and debt crisis, then an economic panic would be a very appropriate response. However, the EU being forced into change via orderly elections may possibly be the best case scenario.

So, where do things go from here? This is the first country to ever leave the EU, so we'll be seeing a lot of precedent set over the coming months and years. From an economic standpoint, one of the biggest hurdles with the dissolution of the Euro will be in contract law. Many contracts in Europe have been based off the Euro, so as countries start to leave the union it could create some pretty wild fluctuations in currency valuations. Case in point, the British Pound dropped to 30 year lows after the Brexit vote.

We expect further political fall out over the next two years as the Brexit story starts to play out. It is plausible, but not highly likely for another half dozen or so countries to leave the union. While it is possible this leads to the entire dissolution of the EU, it is probably more likely that this actually leads the strengthening of the remaining EU partner countries under Germany's lead.

As investors, there is one very valuable lesson to take away from the Brexit story. For the most part, it is prudent to segregate your political views away from your investment views. I'm certain many investors in Europe who were against Brexit took the opportunity to liquidate their stock holdings after the vote, hence the broad sell off. However, after just a week most of the markets have recovered from the initial panic.

In just four short months US investors will be in a similar situation. At least 49% of people are going to wake up November 9th and be upset with the political outcome (given our choices it may be more...). No matter how upset or happy you are come November, try to remember that most likely it isn't a reason to make a drastic change in your investment philosophy and strategy. We've seen too many Republicans underperform their Democrat peers over the last 8 years due to political pessimism. Regardless of your emotional state, don't let politics steer your outlook for the next four years.

-Ryan Glover, CFP®

2016 Market Update

S&P 500	**+3.84%**
DOW	**+4.31%**
RUSS 2000	**-2.22%**
MSCI World	**-4.42%**
BONDS	**+5.31%**
GOLD	**+24.60%**

Mortgage Rates

15-Year	**2.75%**
30-Year	**3.53%**
5/1 ARM	**2.88%**

Did You Know?

* As of writing this article, the 10-Year US Treasury Bond is recording a record low yield of 1.366%

* For the quarter, Crude Oil prices gained over 26.1% to mark the best quarterly percentage gain since the second quarter of 2009. Year to date, prices are up 30.5%.

* The S&P 500 went 54 days without a 1% drop, The streak above ended once the S&P 500 dropped 3.6% on the day after the Brexit vote.

The Silver Lining

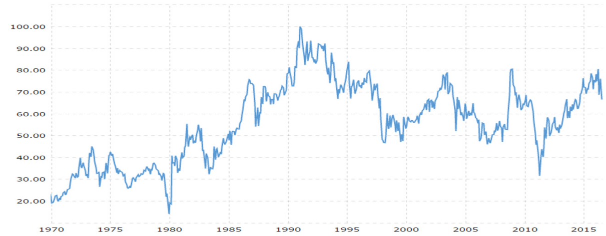
It's hard to find a more polarizing investment vehicle than precious metals. It seems that no one is neutral on the potential upside or downside of gold, silver, etc. You either love it, or you hate it. For my part, I think the best approach is somewhere in between, and the key to that stance is understanding what it is you're investing in and why your doing it.

Typically, an investor does not actually purchase physical amounts of gold or silver bullion as an investment. Bars or mass amounts of coins are awkward to keep on hand and are relatively illiquid for one-off sales. In the investment world, positions in precious metals are usually either taken via an exchange –traded fund (ETF) or by making a first derivative play by buying one or multiple mining stocks in the sector. The most common of these choices is the SPDR Gold Shares ETF (GLD), which has been around since 2004 and trades in real-time like any normal stock. On its website, SPDR describes the ETF as "*fractional, undivided beneficial ownership interests in the Trust, the sole assets of which are gold bullion, and, from time to time, cash. SPDR Gold Shares are intended to lower a large number of the barriers preventing investors from using gold as an asset allocation and trading tool. These barriers have included the logistics of buying, storing and insuring gold.* " So, what you actually own is much like a stock certificate of old that entitles you to a share of the over 31.5 million ounces of gold denominated in 400oz bars in a London vault of HSBC Bank. At the current spot prices, this is worth around $42 billion — That's a lot of gold!

As mentioned above, the advantages of holding an ETF are mainly the liquidity. You can buy or sell at anytime you want or need to. For this benefit, you pay the custodian an internal management fee (.40% for GLD), which is pretty low compared to how much it would cost you to rent a safety deposit box or buy a home safe large enough to accommodate your own stash of gold bars. On the downside, an investment in gold or any precious metal provides no current income, and in the case of the ETF mentioned above, doesn't really provide any Armageddon insurance that sometimes is the rationale for owning precious metals. It's not like you could easily go to London and carve off a small piece of a few bars on hand to equal your ownership after all.

So, all that being said, what place does gold, silver, or other precious metals have in a portfolio? We are firm believers in diversification, and precious metals as well as other alternative investments fill a crucial part of that strategy. One of the main benefits is the low overall correlation to both equity and bond markets. In fact, the historic correlation between the two asset classes is virtually zero making the precious metals performance relatively random when compared to the S&P 500. Sometimes this is good, and sometimes it's bad, but in the long-term, it's a nice piece of the puzzle .

Case in point this year. Through June 30th, Gold is up 24.6% and Silver is up 32.5% YTD; including almost 10% alone since the Brexit announcement. Considering that stock markets around the world have been rather lackluster, this type of upside may be just what's needed to prop up portfolios until things turn around.



A couple other quick notes on gold and silver. Historically, the ratio of the price of gold to the price of silver has averaged around 50:1. As you can see from the chart above, it has wildly fluctuated above and below that average in the last 40 years, but inevitably the prices seem to equalize around that benchmark. This would indicate that all things being equal, silver would offer a better short-term prospect since the ratio is currently around 70:1. Also, I mentioned the mining companies themselves earlier in the article. A lot of investors get enamored with one particular company, or even a handful of companies that they may have read something about online or heard from a buddy. Typically, we would recommend that you avoid exposure to these type of investments as it is a highly leveraged and speculative way to gain exposure to precious metals that does not provide the same type of diversification as the pure commodities. Any individual miner is subject to a lot of specific risk with respect to their own mines' production, geographical risks as many of the top mines are located in countries that have volatile governmental structures, and of course, the business leverage to the spot price of the precious metal. Let's say it costs Company XYZ $1,000 an ounce to pull gold out of the ground at their mine because of the labor and machinery, which are relatively fixed costs. If gold can then be sold at the current spot price of $1,300/oz, that is a nice profit margin. However, just think about what a 11.5% correction in the spot price does to this figure. If gold falls to $1,150/oz, which is just giving back half of its gains in the first 6 months of the year, the profit margin for Company XYZ drops 50% from $300/oz to $150/oz. Yes, this can magnify gains on the upside, but the downside risk of exposure to mining stocks offsets the potential reward in our opinion.

In conclusion, precious metals definitely have a place in most portfolios, but we would recommend you maintain that exposure in the 5-10% range depending on your risk tolerance, income needs, and the current investment environment. With political uncertainty abounding these days with the Brexit and the imminent US presidential election this Fall, this could be the true silver lining for portfolio returns.

-Walter Hinson, CFP®

<u>Our Advisors</u>

Walter Hinson, CFP® (919) 439-0383

walter_hinson@tarheeladvisors.com

Ryan Glover, CFP® (336) 510-7255

ryan_glover@tarheeladvisors.com