**Letter to Clients**
**June/July 2016**

## Whither England?[1]

*"Bring me my Spear: O clouds unfold!*
*Bring me my Chariot of fire!"*

William Blake

The British vote to leave the European Union has created concerns both real and imaginary about the short- and long-term implications of Brexit. While it will take some time to understand the exact nature and extent of any fallout, we believe that what is called for in the immediate aftermath is a good long deep breath. There is no doubt that there is a huge amount of uncertainty in Europe and the UK (as well as the US) about the meaning of Brexit. To be sure, uncertainty has its own consequences, which can be seen in the gyrations of currency and stock markets in the wake of the vote. But while the future of Britain as we know it is in doubt (will Scotland remain part of the UK? how will the movement of goods and people between the UK and Europe work? who will lead the UK after the departure of Cameron?), we have reason to believe that the impacts on the US economy and most American companies will be relatively muted.

When markets move sharply, as they have in the UK and Europe in particular, there are often aftereffects that sometimes become more important than the initial shock to the market. The key question is how policymakers (both economic and political) respond after the initial shock.

Walter Bagheot, in his book Lombard Street, provided advice to policymakers about how to avoid making bad situations worse. He noted that "In wild periods of alarm, one failure makes many, and the best way to prevent the derivative failures is to arrest the primary failure which causes them." Crises such as the crash of 1987 and the failure of Long Term Capital Management in 1998 created chaos in the short run. If you were around for them, you probably remember that they were quite nerve-wracking. But they did not have a long-lasting effect on markets, largely because there was adequate credit available to avoid follow-on problems. We have reason to believe—as supported by the positive results of the US bank stress tests released last week and by the response of central banks to this and other recent events—that sufficient credit exists within the system today.

But let's look beyond the markets' response to the "real" economy. Firms operating in the UK, especially those that did not adequately prepare for the UK's departure from the EU, face increased uncertainty today. The EU generates massive amounts of regulations that govern the way firms operate and are expected to operate over the next few years. As of

[1] With apologies to the late Leon Trotsky

last Friday, all that appears to be up in the air for the UK. In response to this uncertainty, firms rationally may either delay hiring or move operations elsewhere and defer equipment purchases and investment decisions until some of the uncertainty is reduced.

The resulting drop in economic activity is likely to have an impact on the UK as well as on its most significant trading partners. However, while the US is one of the UK's largest trading partners, the UK is only the seventh largest importer of goods produced by the US. Consequently, the UK has accounted for only about 3% of US trade this year, compared to the approximately 30% of our total trade for which Canada and Mexico are collectively responsible. It is worth noting as well that US exports are only 13.5% of GDP, so that exports to the UK are an almost vanishingly small 0.4% of US GDP. But what about second order effects and the possibility of recessionary contagion? The GDP of the UK is about $3 trillion, a bit less than 4% of world GDP. Even a sizable drop in UK GDP would, we believe, have but a modest effect on world GDP or the outlook for GDP next year (you can do the math).

The UK exit from the EU will, however, require action from a second set of policymakers—the political officials who will negotiate the trade arrangements between the UK and the rest of the world. Germany is a major exporter to the UK and both countries would suffer if for some reason there were a sizeable reduction in trade. While the immediate impulse of EU officials might be to punish the UK in order to deter countries like France or the Netherlands from following suit, we believe that, over time, rational self-interest on the part of the EU's power base will likely dictate a more accommodating stance.

There are obviously numerous open questions surrounding Brexit and the implications for the UK, the EU and countries with economic ties to each, including the US. As the picture resolves into clarity over time, we will adapt our portfolio as might be required. But we at Marshfield do not view this event as one that fundamentally changes the long-term value propositions of our portfolio companies. Companies like Moody's and Goldman Sachs which, judging from the market reaction in the aftermath of the vote stand in the crosshairs of concern, represent global utilities whose services will continue to be needed even if economic activity is dampened for a while. One of the virtues of buying companies such as these with a large margin of safety is their ability to withstand such buffeting by the market. And one of the virtues of buying what we believe to be resilient businesses rather than stocks to be traded is that what you are buying is the long-term prospect that the business, managed intelligently, will make money over time. Despite some possible hiccups in the near term, we have continued faith that our companies should do just that. And, as always, we will be cheerfully scrutinizing whatever volatility-wrought carnage there is for opportunities to buy other good companies at fire sale prices.

**Marshfield Associates**