STONE
INVESTMENT GROUP LIMITED

Sleep well.

June 24, 2016

Brexit: If You Leave Me Now - What Do I Do Without You?

The initial results of the referendum have shocked markets worldwide - an obvious understatement. However, UK's detachment from the EU is not instant. David Cameron's departure and succession will be the most immediate near-term source of economic volatility. These events signal that the UK is setting down a path of painful policy discussions and revised trade arrangements that impact future generations as well as keep markets in a higher state of volatility. These voting results continue to support our belief that mainstream voters in capital market-biased economies seek change. We believe this is a result of an extended slow growth environment post the 2008/2009 global financial crisis.

At Stone Asset Management Limited ("SAM"), we believe that such a nationalist view from the UK will only reinforce other campaign efforts for change and we could be upon a pendulum shift from globalization back to nationalization and trade barrier management. We expect contagion within the EU as change becomes a stronger view among voters, and we now have concerns for a change in the White House. These potential changes would suggest that gold has room to thrive as fears permeate, but longer term, the US economy has just been thrust into the top spot and thus the USD will be attributed safety status. Global GDP is poised to suffer and remain in the doldrums until uncertainties can be smoothed out. Our expectation is that the Fed's hands have been bound preventing them from additional rate increases.

For some time, SAM as a firm has maintained a defensive posture regarding the events that are unfolding. Over the last six months we have closely monitored Canadian mutual fund money flows and as we saw more passive behaviour by investors, it reinforced our defensive posture and the belief that the capital markets were preparing for event-driven catalysts to create change. While the Brexit results do come as a surprise, our portfolios are optimally positioned to seek out long-term investment opportunities amid the historic market chaos that is about to ensue. We believe that maintaining/reinforcing a tilt toward the US economy is both prudent and opportunistic and that being disciplined on price will serve well as markets struggle to find their way to stability. Undoubtedly, the Fed will hold in perpetuity on rates given the added sucker punch to asset values this morning. At SAM we believe that a rate hike ought to do us good because it will be the ultimate combination of events to spur a global reset. Yellen will use Brexit as an excuse to defer a rate increase indefinitely.

Canada, with its view to becoming a post nation and an aggressive supporter of globalization will need to reconsider its policies and prepare to consider revised trade arrangements with the UK, the EU and Asia, and will continue to be highly sensitive to the US as a trading partner. Bargaining power for trade agreements is at risk should this tidal wave of change away from post nation and globalization continue to build momentum and win the White House.

In conclusion, SAM believes we need to be aware that a global reset is materializing. This means sticking to our investment discipline, protecting capital, taking the opportunity to purchase businesses at the right price and providing our clients with a portfolio of businesses that have resilient cashflows and the ability to have their share prices reflect their growth. It is our belief that wealth is created by Growth Over Time® and in this market volatility we are being provided an opportunity to buy long-term growth at a cheap price.

For further insight into the implications of Brexit results, please see the attached commentary from Rathbone Unit Trust Management, sub-advisors to the Stone & Co. Global Growth Fund and Stone & Co. EuroPlus Divided Growth Fund.

It's Friday, and the Saint Jean Baptiste Day holiday in Quebec. We suggest you manage your day and then enjoy your weekend. As always, we thank you for entrusting your investments with Stone.

Sincerely,

Stone Asset Management Limited

T 416 364 9188 T 800 336 9528 F 416 364 8456 E INFO@STONECO.COM
36 TORONTO STREET, SUITE 710 TORONTO, ON M5C 2C5 STONECO.COM

Investment*Update*

24 June 2016

Gone, but not forgotten

The UK has voted to leave the European Union, which will trigger two years or more of negotiations once Westminster formally notifies Brussels of its intention to secede. However, the referendum result is advisory rather than mandatory and there are significant constitutional issues that must be resolved before such notice can be given. As a result, UK and EU politics will have a significant impact on financial markets in the short to medium term.

More questions than answers
UK voters have spoken and, contrary to the guidance of most of the political class, have voted to leave the European Union. This should now trigger a formal exit process, but given the constitutional challenges, lack of precedent and relatively close result, this will not be straightforward. The government may choose to delay formal notification until the Conservative party leadership situation is resolved and until its policy ducks are in a row. There is even a chance that the UK could remain in the EU – the referendum is not legally binding and Parliament must vote to repeal the 1972 European Communities Act. Also, despite their rhetoric in the run up to the vote, European leaders may well explore new ways to keep the UK in the EU. Either way, following initial disruption to financial markets, there will be a period of reflection as all parties come to terms with the result.

It should be remembered that until it secedes, the UK is a member of the EU and will continue to benefit from the single market – while there will be uncertainty, the full economic impact of this vote will not be felt for some time. In the meantime, political uncertainties, particularly now that David Cameron has indicated that he will resign as prime minister, will continue to impact on financial markets.

Leaving the EU
As we have said, the lasting economic implications will not be known for many years. Of the many questions, most pertinent, perhaps, is will the UK be able to negotiate continued access to the free-trade area? Further out, what will happen to the EU without the UK? Will it integrate further, dismantling the remaining barriers to trade and investment? This could mean the UK losing much of its considerable market share of European trade. Or will the entire EU project stall?

Economic integration – particularly the removal of barriers to trade – should lead to considerable improvements in productivity over the long term. If ‘Brexit’ requires the UK to forsake access to the European Single Market, it is imperative that it works hard to enact new trade deals and sign new agreements of economic integration with faster growing economies than the EU. With an ageing workforce, productivity will be the key driver of economic growth in Western economies in the 21st century. Those economies able to capture the greatest gains in productivity are likely to generate better returns on investment, attract higher portfolio allocations and experience stronger foreign exchange rates.

The impact on the EU
Certainly, if Brexit is something of a lynchpin moment for the EU, it is wrong to assume that the UK is in any way more immune to the economic and market consequences. Trade and financial links will remain strong, many for at least another decade. Investors must be mindful here when assigning risk premia to UK investments going forward. Market-based measures of the likelihood of eurozone disintegration did not flinch in the run-up to the referendum. This seemed at odds with the swelling tide of populist, anti-EU politics on the continent. We expect markets to start factoring in this chance of contagion now that the UK has voted to leave, which will raise borrowing costs throughout the region and curtail GDP growth via tighter financial conditions.

That said, for the majority of EU members, the case for leaving is far weaker than the UK’s. This is due to even higher levels of intra-regional trade, weak banking systems dependent on the buttresses erected by the ECB and the council of finance ministers, and the fact that most are just too small to stand a better chance of negotiating trade deals alone. Surveys suggest that the majority of citizens may want their own referendum, but that only a minority want to leave. While the act of holding referenda could lower economic confidence throughout the region, the UK has shown that the effect on growth

Rathbones
Look forward

prior to the decision might not be very significant. The Netherlands and Sweden are arguably most likely to hold their own referenda, due to higher than average non-EU trade and prominent anti-EU/anti-immigration voices.

UK economic uncertainty

Turning back to domestic matters, we believe that uncertainty will pervade financial markets and weigh on economic growth for at least two years. Uncertainty alone is enough to delay spending, hiring and investing. And with the chancellor's new fiscal rules, this will dictate another round of budgetary austerity in order to make up the shortfall in tax receipts from that delayed spending, hiring and investing (although the fiscal rules might be suspended if a new chancellor is appointed). While HM Treasury's estimate of the short-term impact of Brexit (GDP 3.6% to 6% lower than would have otherwise been the case over two years) suffers from some rather extreme assumptions and uses some economic sensitivities notably out of line with the general consensus among academics, we believe growth will be 1-2% lower over the next two years largely from uncertainty alone. Numerous independent forecasters share this view. Investors should be mindful of sectors most correlated with GDP growth, such as certain cohorts within banking, insurance and consumer goods.

Trade and investment

Although we believe that GDP growth will suffer in the first few years, we have never agreed with the hyperbole from the 'remain' campaign that trade and investment will collapse. Although we know from survey data that access to the single market is an important factor contributing to the UK's attractiveness as an investment destination, it is far from the only reason. The UK ranks as one of the easiest places to do business in Europe (taking into account red tape, tax regimes, etc.), while it also excels as a centre of agglomeration – an economics term to sum up the benefits gained when companies locate near each other. Moreover, the threat of Brexit did not seem to have a deleterious effect on investment over the last 18 months. Investment intentions surveys did not soften as much as expected, while data compiled by EY show that 2015 was another record year for inward foreign direct investment. Britain even attracted more manufacturing projects than Germany for a second year in a row, despite the threat of tariffs on international trade if the UK leaves the free-trade area.

Moving on to trade, the UK will retain access to the single market until negotiations conclude. Even if the UK must in the end give up its access, goods exports to the EU would be subject to tariffs equivalent to just 3.3% of their value on a weighted average basis. Given that the business models of most UK exporters are not predicated on being the lowest cost producer, and that sterling has already depreciated by 12%[1] since its November peak (thereby already more than offsetting the imposition of tariffs), this is hardly likely to lead to a collapse in trade. That said, investors should be mindful that some goods exporters will be subject to more punitive tariffs under this 'hard Brexit' scenario – such as automobiles, clothing and agriculture – and the supply chains of these sectors should be studied. Beyond the first two years, the larger threat to trade stems from potential non-tariff costs – more costly burdens of proof for regulatory compliance and customs legislation – particularly in the financial services sector. These could be severe.

On what terms might we exit?

We do not believe that retaining access to the single market on beneficial terms will be easy to negotiate. The Norwegian model should be unpalatable to those who voted for Brexit: Norway must make a sizeable contribution to the EU budget and pass EU laws on to their own statute books without any representation in the bodies which draft them. The Albanian/Balkan model referred to by Michael Gove is not realistic either. Albania wants to become a full member of the EU, but the EU does not wish to lift visa restrictions. Its deal is arguably a matter of international aid and not something that will be offered to a large, developed nation – and certainly not one that has just bid them *adieu*. This leaves us with a complex series of bilateral directives à la Switzerland. However, Switzerland does not offer a replicable model either, not least because most of its directives were agreed before 2006, when becoming a member of the EU was still a 'strategic goal' of the Swiss government.

The risk to financial services

Importantly, the Swiss have never managed to negotiate a deal on financial services access, and most large Swiss financial firms conduct cross-border business in Europe by obtaining a regulatory passport from their UK subsidiaries. Now, the EU exports more goods to the UK than it imports, so it is likely that some variety of deal will be reached here. But the UK has an enormous trade surplus in financial services with Europe. Given that various EU institutions have tried to repatriate with new legislation a number of financial activities over the last five years (both successfully and unsuccessfully, due to the UK's recourse to the European Court of Justice – which it will now lose), the likelihood of a deal on financial services – a sector on which the UK's economy is still heavily dependent – is decidedly uncertain.

How will equity markets react?

UK- and EU-focused financial stocks have already underperformed their more globally diversified peers this year, although how much of that is due to Brexit and how much to subsiding fears of a China-led emerging market recession (thereby benefiting the global financial plays) is difficult to say. Still, given the threat to UK firms from an EU clampdown on financial services activity

[1] Against a trade-weighted basket of currencies as of the morning of 24 June.

undertaken outside EU jurisdictions, we expect the recent underperformance to become more pervasive. Similarly, the loss of a 'regulatory passport' will undoubtedly make doing business on the continent from outside of its jurisdiction much more costly for banks, asset managers and insurers. At the time of writing, bank stocks look set for double digit losses on day one.

The volatility of the FTSE 100 has not diverged from other global large cap indices and there has been little evidence of a potential Brexit impacting the relative performance of the FTSE 100. After all, it is far more an index of global giants that happen to be domiciled in London than a barometer of the domestic, or even the European, economy. The 25 companies in the index most exposed to domestic revenue streams have underperformed, but half of that can be explained by the substantial rally in oil and gas and mining stocks – again, a global trend extraneous to Brexit. Much of the remaining underperformance can be explained by the UK-focused financials, as discussed above. However, in the last few weeks overseas investors have lowered their allocations to UK and European equities. If this trend intensifies, the FTSE 100 could be affected by such broad-brush asset allocation calls. We also expect this to weigh on continental bourses. Early indications suggest significant volatility in all European markets.

We have identified a much stronger relationship between domestic economic uncertainty and the equity risk premium of the FTSE 250 and small cap indices, which would mean lower stock market valuations as uncertainty increases. However, one should note that a substantial valuation cushion has already been priced in: the relative price/earnings ratio between the 250 and the 100 is at its lowest in over six years. This seems to already suggest a sharp divergence between the UK and global business cycles.

How will the Bank of England react?
Although a spike in the equity risk premium would dominate price movements, the effects would be partially mitigated if the Bank of England cuts base rates. Governor Mark Carney has made his fears well known. And given the rare unanimity among academic economists that Brexit will weigh on growth for at least the first two years, it is likely that his colleagues on the Monetary Policy Committee (MPC) will also feel the need to cut rates. However, after markets reacted poorly to interest rate cuts into negative territory at the start of 2016, we believe that the policy rate will not be cut below zero. If further monetary stimulus is deemed necessary, extraordinary measures will be redeployed.

Some pundits have speculated that the MPC would be forced to raise rates if sterling fell further on Brexit in order to stem rising inflation. This seems highly unlikely. Firstly, our analysis suggests that the rate of inflation rises by about 0.4% for every 10% fall in the value of the pound; sterling would have to fall a very long way before it caused the inflation rate to become problematic. Secondly, policymakers are more concerned about inflation expectations, rather than inflation itself, and expectations are somewhat less sensitive. Thirdly, such a response would run contrary to previous actions: sterling lost 30% of its value between 2007 and 2009, yet the MPC continued to cut rates by a cumulative 5%; similarly, in 1998-99 the pound fell by 10% and again the MPC did not abandon its path, with interest rates settling 2% lower.

How will gilt yields react?
We dissect gilt yields into three components: expectations for the path of real Bank of England rates, inflation expectations and the term premium (driven by the compensation demanded by investors for uncertainty as well as changing supply/demand balances). We expect real rate expectations to move lower, although they already moved a long way in the run up to voting day. Inflation expectations should move up to reflect higher import costs, while the term premium may move higher too, potentially offsetting any downward shift in yields due to interest rate expectations. Foreign investors (who hold about a third of gilts outstanding) have been marked net sellers in 2016. That said, UK pension scheme deficits have moved back to near all-time highs and the trend towards more liability matching investment strategies continues apace. This could potentially provide new sources of domestic demand to pick up the slack.

How will sterling react?
Our modelling suggests that the pound is likely to settle between 7.5% and 12.5% lower after the results once the initial volatility subsides. The 7% fall in the pound over the six months prior has been attributable largely to changes in interest rate expectations, with the direct contribution from general Brexit uncertainty much more limited. However, changes in market interest rate expectations this year have been extreme (the expected date of the first rate rise moved from late 2016 to late 2020!), especially for an economy nearing full employment, leading us to suspect that interest rate expectations are reflecting a significant probability of Brexit since February. This will limit the extent of further depreciation.

Conclusion
The result of the referendum leaves a lot of uncertainty. This will weigh heavily on both economic growth and financial markets. As long-term investors we encourage clients not to worry unduly – the politicised hyperbole of the campaign should not be taken seriously. Nonetheless, we face bouts of volatility for at least two years until we know how the UK will interact with Europe economically and financially. We will continue to update clients as events unfold.

Important information

This document and the information within it does not constitute investment research or a research recommendation. Forecasts of future performance are not a reliable indicator of future performance.

The above information represents the current and historic views of Rathbones' strategic asset allocation committee in terms of weighting of asset classes, and should not be classed as research, a prediction or projection of market conditions or returns, or of guidance to investors on structuring their investments.

The opinions expressed and models provided within this document and the statements made are, due to the dynamic nature of the items discussed, valid only at the point of being published and are subject to change without notice, and their accuracy and completeness cannot be guaranteed.

Figures shown above may be subject to rounding for illustrative purposes, and such rounding could have a material effect on asset weightings in the event that the proportions above were replicated by a potential investor.

Nothing in this document should be construed as a recommendation to purchase any product or service from any provider, shares or funds in any particular asset class or weighting, and you should always take appropriate independent advice from a professional, who has made an evaluation, at the point of investing.

The value of investments and the income generated by them can go down as well as up, as can the relative value and yields of different asset classes. Emerging or less mature markets or regimes may be volatile and subject to significant political and economic change. Hedge funds and other investment classes may not be subject to regulation or the protections afforded by the Financial Conduct Authority (FCA) or the Prudential Regulation Authority (PRA) regulatory regimes.

Changes to the basis of taxation or currency exchange rates, and the effects they may have on investments are not taken into account.

Rathbones will not, by virtue of distribution of this document, be responsible to any person for providing the protections afforded to clients for advising on any investment, strategy or scheme of investments. Neither Rathbones nor any associated company, director, representative or employee accepts any liability whatsoever for errors of fact, errors or differences of opinion or for forecasts or estimates or for any direct or consequential loss arising from the use of or reliance on information contained in this document, provided that nothing in this document shall exclude or restrict any duty or liability which Rathbones may have to its clients under the rules of FCA or the PRA.

We are covered by the Financial Services Compensation Scheme (FSCS). The FSCS can pay compensation to investors if a bank is unable to meet its financial obligations. For further information (including the amounts covered and the eligibility to claim) please refer to the FSC website www.fscs.org.uk or call 020 7892 7300 or 0800 678 1100.

Rathbone Investment Management International is the Registered Business Name of Rathbone Investment Management International Limited which is regulated by the Jersey Financial Services Commission. Registered office: 26 Esplanade, St. Helier, Jersey JE1 2RB. Company Registration No. 50503. Rathbone Investment Management International Limited is not authorised or regulated by the PRA or the FCA in the UK. Rathbone Investment Management International Limited is not subject to the provisions of the UK Financial Services and Markets Act 2000 and the Financial Services Act 2012; and, investors entering into investment agreements with Rathbone Investment Management International Limited will not have the protections afforded by that Act or the rules and regulations made under it, including the UK FSCS. This document is not intended as an offer or solicitation for the purpose or sale of any financial instrument by Rathbone Investment Management International Limited. Not for distribution in the United States. Rathbones and Rathbone Greenbank Investments are trading names of Rathbone Investment Management Limited, which is authorised by the PRA and regulated by the FCA and the PRA. Registered Office: Port of Liverpool Building, Pier Head, Liverpool L3 1NW. Registered in England No. 01448919. Rathbone Investment Management Limited is a wholly owned subsidiary of Rathbone Brothers Plc.

Our logo and logo symbol are registered trademarks of Rathbone Brothers Plc.

Contact us

If you would like further information, please contact us on 020 7399 0000 or email info@rathbones.com

Head Office
1 Curzon Street, London W1J 5FB
020 7399 0000

For ethical investment services:
Rathbone Greenbank Investments
0117 930 3000
rathbonegreenbank.com

For offshore investment management services:
Rathbone Investment Management International
01534 740 500
rathboneimi.com

@Rathbones1742
Rathbones Brothers PLC
Rathbones Brothers PLC