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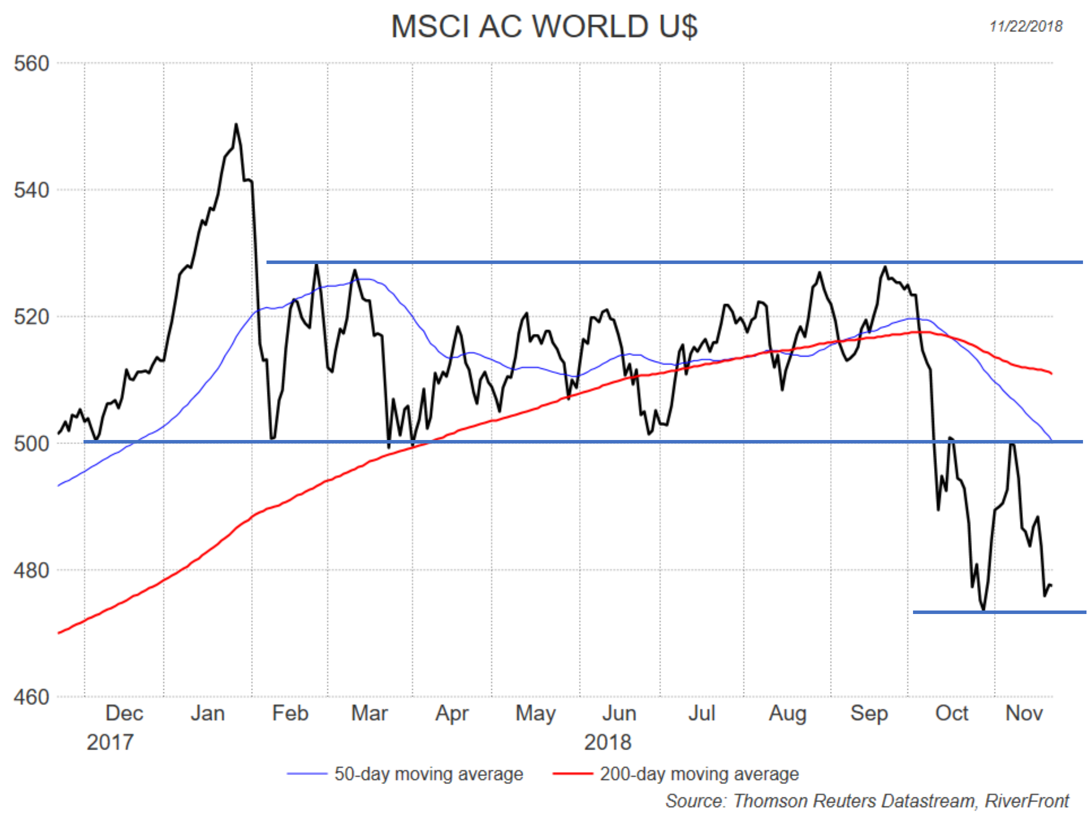
The Bounce, the Brits, and Brexit

A Bloody Mess!

The title of our piece two weeks ago was '*All Clear? Judge the Quality of the Bounce'*. We articulated the reasons for fundamental optimism but cautioned about the short-term technical outlook. "*In our view, a healthy bull market is one which resumes relatively quickly with a strong bounce that recovers 2/3rds of the recent decline. A bounce which fails to recover one third of the recent decline is a technical red flag."*

The chart below is the MSCI Index of world stocks, which traded in a tight range from February through September (500–530). The bounce in early November failed to recover two thirds of the decline from late September and has since gone back towards its low. All eyes will now be watching to see if the October low can hold. On balance, we think it can hold, if our fundamental view proves right and global growth stabilizes. From a technical perspective, the chart still looks 'ugly'; for it to improve, the October low would need to hold and the index ultimately break above the 500 level.



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Global stocks are reflecting slowing economic data in Europe, Japan and China, and are anticipating the same for the US as the stimulus wears off and higher interest rates start to slow demand for housing and autos. The chart pattern also suggests to us that investors are building in an increased probability of a global recession. We are more positive and believe that there is a good chance that global stocks will bottom around these levels as value investors are likely able to find what they see as bargains at current levels. We too are looking for opportunities where we believe investors have become too pessimistic.

BREXIT: PRIME MINISTER NOW FIGHTING FOR A 'LEAST BAD' OUTCOME…AND HER JOB

Last weekend, the governments of Europe and the UK ratified a Brexit deal, the result of hard-fought negotiations. It outlines the terms under which the UK can separate from the European Union, and then agrees to a timeframe for negotiating a future trade agreement. The next stage is for the British parliament to vote on it.

For the ‘Remainers’, those who argued and then voted against Brexit, this is the bitter “I told you so” moment. Unwinding a 40-year economic and legal framework has been arduous. The European Union has wanted to offer a reasonable deal, while ensuring that the UK cannot boast of a better deal by leaving the union. There is almost unanimous consent that the British economy and most of its people will be worse off with this deal than had the referendum not taken place. Prime Minister (PM)Teresa May’s government has likely secured the best deal available. The irony is that, as a Remainer voter herself, this deal may well result in her losing the PM job.

May’s task now is to sell this to her own party, which is going to be extremely hard. The Conservatives have 315 of the 650 seats in the British parliament. Former Foreign Secretary Boris Johnson is the high-profile leader of some 90 Conservative party members of parliament who publicly oppose this deal, along with 10 coalition party members of the Democratic Unionist Party. In our view, Johnson sold the British people a ‘pipedream’ that was never feasible, and he continues to do so. Unfortunately for PM May, the numbers seem overwhelming. Her main argument, dubbed “Project Fear” by her adversaries, is that there is no other deal available, and that a vote against this treaty is a vote for a “hard” Brexit. Hard Brexit is where the UK finds itself with no basis for conducting trade with its largest trading bloc, a scenario that would be utterly chaotic.

The very disastrous potential of a hard Brexit is what makes May’s job almost impossible. On one side, the Euroskeptics are saying that the EU will not want the chaos and that a better deal will be available when she is gone. On the other side, pro-EU cabinet ministers are claiming a softer Brexit, whereby the UK leaves the EU but remains in the ‘single market’ for trade, is still a possibility. We disagree with both views because the prime goal of the EU is to preserve the Union and not to incentivize those who want to leave. If May can’t get the votes, she will likely resign, or be forced out, and the Conservative party will tear itself apart trying to agree on her replacement. The stakes are high and, yes, it’s a bloody mess!

Conclusion for markets: As we have argued from the beginning, Brexit is bad news for the British stock market in US dollar terms due to both a weaker pound, and huge uncertainty for British businesses. We therefore maintain an underweight position relative to global benchmarks. Since its high in 2014, the pound has lost a quarter of its value versus the dollar, and the UK market has underperformed the rest of Europe. Any deal that keeps trading lines open and ends the uncertainty will likely mark the low point for the pound, but it seems that there is more uncertainty in store in the coming months.

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