Crossbow Partners
Experience & Discipline

London Trip Report

July 11 - 12, 2018

Executive Summary

European equities are suffering from uncertainty around Brexit, the Italian budget discussion, and a potential trade war

The emerging markets have selectively seen a meltdown of their currencies, e.g. in Turkey, Brazil, Argentina, which could lead to a deeper crisis

Emerging markets equities are trading at the edge of a bear market with China being down over -20% this year

Many managers remain cautious on risk as they except more downside with the escalation of a trade war between the US and China and potentially also between the US and Europe

It is expected that the UK and Europe will agree on a last minute exit deal in order to extend their negotiations through December 2020 – this could result in some short-term relief for the GBP and UK equities

The ECB is expected to normalize its policy in 2019 which will have to result in higher interest rates going forward

The US midterm elections will overshadow the market direction through year end with an expected win for the Democratic Party that may not be positive for equity markets

An update on Brexit

The UK is leaving the EU on 29 March 2019, and negotiations are taking place between the two sides. Brexit Secretary Dominic Raab has been meeting Mr Barnier for more negotiations as the two sides seek to reach an agreement before a summit in October 2018.

In July the government set out how it wants to trade with the EU - and avoid new border checks in Northern Ireland - after a summit at Chequers, the prime minister's country residence.

But the plans have been criticised by Brexiteers and the government faces a battle to persuade Parliament to approve them, even if the EU agrees. The plan prompted multiple ministerial resignations and has since been all but killed off by the EU, with its lead negotiator Michel Barnier ruling out its proposed customs arrangements. British ministers have fanned out around Europe in an attempt to sell the plan. But Mr Barnier has been proven to have the backing of the leaders of the 27 remaining EU counties.

The odds on a fresh EU referendum have halved since the beginning of the year to just 2-1, bookies have revealed. News of the fall comes in the wake of The Independent's petition for a vote on the final deal smashing through the 250,000 signature mark. At the start of 2018 punters were able to get 4-1 on that outcome. The odds had fallen to 3-1 prior to the Prime Minster's Chequers summit, called to thrash out a negotiating position with cabinet ministers.

Should a second referendum get called, the odds of the UK voting to remain are also at record low of 1/8, with 4/1 offered on another Leave vote. That compares to 1/3 remain 2/1 leave at the start of the year, and 1/5 remain 3/1 leave before Chequers.

We asked some funds to come up with their view and the impact on the markets in the last phase of the Brexit drama.

H2O Macro Fund

It has been agreed to extend the negotiation about the future relationship to December 2020, under the condition that the terms of the separation are agreed upon and the political principles of a future relationship are also agreed and voted by both the UK parliament and the parliaments of the remaining 27 EU countries before end of March 2019.

Both the current UK government and the EU countries have a strong incentive to reach an agreement in time to keep kicking the can until December 2020. For obvious reasons, each side should make this process look as if it is very difficult in order to please their respective constituency that they are negotiating hard. Still, the de facto collusion to reach a deal is high in our view. For Theresa May's government it is a simple matter of survival. For the 27 EU countries, it is a matter of avoiding unnecessary volatility. Hence, the probability of a last minute deal should be considered very high.

The next question is the vote of the 28 parliaments. Let's assume that the 27 EU parliaments should validate what would have been agreed. The remaining uncertainty is the UK parliament. Up to now, the Tory party has managed to hold together on the basis of avoiding uncertain general elections and, for the Brexiteers, of misfiring a leadership contest that, if unsuccessful, would have given Theresa May a one-year window of immunity.

For Brexiteers, it has always been a matter of choosing the right time to shoot with a one-bullet gun. From this perspective the vote in parliament of what would be agreed with the EU is the perfect time to pull the trigger. Indeed, a positive vote would open the door to an eventual agreement with the EU which can only slide, over a long 2-year period, towards a much softer version that the Checkers. Such a scenario would also bear all the negative of a long-lasting uncertainty about a final deal in December 2020 that should be detrimental to UK businesses and to the standing of the Tory party in the eyes of its natural constituency of hardish Brexiteers. So the vote in parliament will be that last opportunity to avoid a soft Brexit over a never-ending transition period. It is also the best timing, as a leadership contest and possibly early general elections (where the Tory Party would campaign for a hard Brexit) would have the highest chances of success.

Gemsstock Macro Fund

It is politically driven, and largely binary in outcome, although with prices of assets broadly reflecting a negative bias around an uncertain outcome. The political process in the UK is difficult, because there is no majority within the government for anything, and the government does not have a majority within Parliament. It has taken until now to formulate a plan which is still not broadly agreed on. The path of least resistance is therefor to fudge.

The survival of this government is not a given, and if too much is given for the hardliners we will see a leadership contest. Anecdotally membership has grown in the Conservative party over recent months, as Brexit hardliners have been urged to join the party and so to vote on any future contest (there is a 3 month delay in getting a vote). There has been significant press coverage on the probabilities around a no deal Brexit. We would suggest that the likelihood of that has been largely overstated, simply on the basis that everybody loses and so will be avoided if reasonably possible, subject to the above.

A stop gap deal where much of the detail will be negotiated later is my best guess as to the outcome, to satisfy all parties (UK leavers, remainers and the EU). The UK will leave the EU in March, and in so doing have a deal sufficient to avoid a cliff edge to trade and economic activity. However, uncertainties will continue as to what the final outcome is. As such any deal will see a modest rally in GBP, and a mixed impact on equities. The valuation of GBP is attractive compared to its historic values, although no deal would see significant downside. UK equities are trading at historic wide discounts to Europe, although the impact of GBP is mixed, and the performance of exporters versus locals as expected to worsen under each scenario.

Amia Macro Fund

Ultimately we are in a tricky situation which is almost entirely driven by finding a solution to the Irish Border issue. A Canada type deal would only be acceptable to the EU if a customs border was placed in the Irish Sea and Norhtern Ireland was in the customs union (against UK red lines). An EEA style agreement doesn't solve the Ireland issue as it isn't a customs union and doesn't solve border issues, plus the UK would have no say over its immigration policy. A Chequers arrangement solves quite a few issues but the EU doesn't believe we should be cherry picking from the customs union, it would set a precedent for other EU countries and that it would be unworkable from a technology and anti-smuggling standpoint.

We only need a withdrawal agreement at this stage to progress with Brexit and get a 'deal', then the terms of trade can be discussed in the transition period, and 80% of that withdrawal deal is agreed, Ireland being the largest part of the remaining 20%.

There have been 'fudges' in the process so far and it is more than likely that one will be found to allow the withdrawal deal to be agreed, but this still has to be passed by Parliament and at present this is a 50:50 proposition. We also have the conservative party conference to get through, in which we don't think we will see a leadership battle, but may end up with the Chequers deal being rejected soon after and then a possible leadership race.

From a market perspective it feels like the currency is fairly priced to the risks here. If we have a no-deal cliff face then GBPUSD will go below 1.20 (possibly towards 1.10) and if we get a withdrawal deal agreed we should trade near recent highs above 1.35. The best way to trade this at the moment is through EURGBP and fading the headline moves as retractions are common, with no likely resolution until November at the earliest.

With respect to rates markets the feeling is that we will get no rate moves in the next 6 months while we have the present uncertainty and therefore have roll down and carry trades in the very front end, but we also believe that medium term a solution will be found, investment will return to a low trend growth environment and that potentially we are underpriced for rate hikes over the next 2-3 years that the MPC would like to deliver, allowing them some buffer for a future downturn. Therefore forward steepeners should be sensible trades.