CROSSBRIDGE CAPITAL

Market Viewpoints

Manish Singh

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A government big enough to give you everything you want, is big enough to take away everything you have.

- Thomas Jefferson

The *Brexit* vote can be about many things but, at its heart, it's a vote about the sovereignty of the national Parliament of the UK. Whilst those on the continent (particularly in peripheral Europe), may have come to trust Brussels more than they trust their national Parliaments, at least in the UK sovereignty is cherished and protected. In the eyes of a *Brexiteer*, the European Union (EU) undermines that sovereignty. I expect the UK to vote (albeit very reluctantly) to Remain in the EU. However, a vote by the UK to Remain should not be construed as an approval of "business as usual." There was never a necessity for the EU to be anything more than a "free trade" alliance and one can't deny that the EU's reach has exceeded political necessity. Whether or not the UK leaves, change is coming. Globally, if loose monetary policy alone remains the saviour, then I am concerned that we may see the next recession in the US in the not so distant future, as job growth slows and drags down with it wages, capital investment and consumer spending. The Negative Interest Rate Policies (NIRP) being deployed by central banks, seem ill-judged and a waste of valuable time. Negative interest rates are simply a distraction from what must be done to accelerate growth. The demand has to be injected directly into the economy and not intermediated through the financial markets.

The UK and Europe: An island apart

First things first. I still expect the UK to vote (albeit very reluctantly) to Remain in Europe (EU) on Thursday. However, a vote by the UK to Remain, should not be construed as an approval of "business as usual." I am glad Wolfgang Schäuble, the German Finance Minister gets it. Last week, he suggested that Europe must not respond to a possible *Brexit* by pushing for deeper EU integration, saying voters would consider such a response to a Leave vote "crazy." He told an investment conference in Berlin that there would be no popular support for more centralised EU decision-making if the UK voted to leave the bloc, "except maybe in Luxembourg."

In my conversations with friends on the Continent, on the topic of the UK 's attitude to Europe, I often hear the question: Why is it that the British think of themselves as different from the rest of Europe? A great episode from history, as presented by British historian Andrew Roberts, goes some way in answering this question.

In February 1848, Europe was in uproar. King Louis-Philippe of France was overthrown in Paris, where a mob looted the Tuileries Palace. There were anti-government revolts in Sicily, Naples, Tuscany, Piedmont and Sardinia. In March, the Austrian Chancellor Prince von Metternich fled Vienna disguised as a woman. Pope Pius IX was forced to grant democratic reforms in Rome. A Republic was proclaimed in Venice. Right across Germany there were revolutions. In Prussia, King Frederick William IV was even forced to flee Berlin.

In Britain, it was feared that a similar mood of Republican unrest might seize the nation. By 11.30am on April 10, 1848, all eyes had turned to Kennington Common in South London, where a petition of 1.2 million names was due to be presented to the UK Parliament by a demonstration numbering perhaps hundreds of thousands of people. Would Queen Victoria's throne go the same way as so many European ones?

The Establishment feared rioting and revolution. 85,000 special constables were sworn in to protect Waterloo station and the Houses of Parliament; the Bank of England was ringed with troops and the British Museum barricaded.

However, all that happened was that it rained. Kennington Common presented "a scene of drizzly pathos." So few people turned up, that the petition was merely driven across Westminster Bridge in four taxicabs. Many of the names on it, when investigated by parliamentary officials, turned out to be forgeries. Parliament refused to consider it.

The reason for this stark contrast between the British historical experience and the Continental one, was that Britons had already long enjoyed what European liberal revolutionaries were fighting for. The British already enjoyed equality before the law, freedoms for the press, religious toleration, limited government, a Bill of Rights and so on. The UK's development had been different from the rest of Europe. The UK was also ahead in beheading monarchs (King Charles I in 1649), a good century and a half before anyone on the continent suffered similar fates. King Louis XVI of France was not sent to the guillotine until 1793. In the last 250 years, while the French had gone through two monarchies, five republics and three invasions, and Germany two republics, one monarchy, one dictatorship and two occupations, Britain had only had one constitutional monarchy, no occupation, no civil wars and no coups. Change in the UK had been evolutionary rather than revolutionary.

This *Brexit* vote can be about many things but, at its heart, it's a vote about the sovereignty of the national Parliament of the UK. While those on the continent (particularly in peripheral Europe), may have come to trust Brussels more than they trust their national Parliaments, at least in the UK sovereignty is cherished and protected.

The UK doesn't have a written constitution. It's only constitutional principle is the sovereignty of Parliament: The principle that Parliament cannot be bound by any higher authority. In the eyes of a *Brexiteer,* Europe undermines that sovereignty. European laws have a direct effect on all European citizens and its legislation is superior to that of its member states. A Parliament is either sovereign or it's not. There is no in-between.

There was never a necessity for the EU to be anything more than a "free trade" alliance and one can't deny that the EU's reach has exceeded political necessity. Whether or not the UK leaves, change is coming.

***Brexit*: the ins and outs**

With only a day to go, we are finally at the dreaded EU referendum vote in the UK. The UK leaving the EU has wider ramifications, as speculation of a "domino effect" could roil the markets no end. Euroscepticism is on the rise and it therefore makes it impossible to judge how the other EU nations might respond to a *Brexit*.

Who knew that the French were more Eurosceptic than the British?

A pan-European survey by the Pew Research Centre early this month found that 61% of French voters have an "unfavourable" view of the EU, compared to 48% in the UK. Professor Brigitte Granville, a French economist puts it very succinctly. She says that the mechanisms of monetary union have upset the Franco-German strategic marriage, wounding the French psyche. The EU was sold to the French people as a "partnership" of equals with Germany. But it has been very clear since 2010 that this is not the case. Everybody could see that Germany decided the outcome in Greece.

The Central European governments that have sharpened their criticism of the EU in recent years, might feel emboldened by a British decision to quit the EU. If *Brexit* were to happen, an orderly exit as prescribed in the EU treaties, would be the least damaging option. The UK would remain part of the single market and would still be subject to EU laws for another two years, while negotiating the terms of separation. However, that may not be the case, as some in the Leave campaign have pledged the UK would unilaterally abolish EU laws and seek a new deal with the EU in terms of trade and access to the single market. This would raise the uncertainty and risk a great deal if it came to pass.

In any case, it seems the risk of *Brexit* is tapering off, if recent polls are any indication. According to the recent polls, the surge in support for the Leave campaign appears to have been reversed. A recent *YouGov* poll put Remain one point ahead, while *Opinium* put the two sides neck and neck. History is also on the side of the Remain campaign.

Past referendums in Britain have tended to produce a late move to the status quo, by as much as 6 points. According to *YouGov's* Peter Kellner:

- A 1975 UK-wide referendum on the Common Market: *Gallup* polls during the final weeks of the campaign showed the lead for "staying in Europe" at 28%. The result: a 34.4% gap (67.2% in, 32.8% out) i.e. 6 point swing to the status quo
- A 2011 UK referendum on the voting system: The final opinion polls showed a 22% lead for the status quo, first-past-the post system. The final result - a victory margin of 35.8% i.e. a swing of 13 points to the status quo
- A 2014 Scottish referendum on independence: On the eve of the referendum, polls showed an average 5% lead for Scotland remaining in the UK. The final margin of victory was 10.6%, i.e. a 6 point swing on voting day

Why the swing to the status quo?

One explanation may be that many people do not follow the referendum news at all until the last few days. They are busy people making a living, often motivated by economic self-interest. They are the kind of people who hold no strong views about the referendum. They end up deciding instinctively, that it is safer to leave things as they are than to vote for change. In this referendum, their worries about prosperity will, in the end, perhaps trump their dislike of immigration, and they will favour remaining in the EU.

Where to invest?

The US Federal Reserve (Fed) is in no hurry to raise interest rates and neither should they be. As I have said often in the past and also in last month's newsletter, I suspect that even in July the Fed may sit on the fence and only raise rates at its September meeting. However, if loose monetary policy alone remains the saviour, then I am concerned that we may see the next recession in the US in the not so distant future, as job growth slows and drags down with it wages, capital investment and consumer spending.

I am yet to be convinced by the use by many central banks of Negative Interest Rate Policies (NIRP) as a monetary tool to respond to a lack of growth and lack of inflation in the economy. Quantitative easing (QE) has achieved its goal of averting a 1930s like depression. NIRP seems like an ill-judged policy and waste of valuable time. Negative interest rates are simply a distraction from a proper analysis of what went wrong, what continues to go wrong and what must be done to fix it. The fact is that monetary policy on its own cannot achieve a level of economic activity close to its potential. Fiscal policy is required and the government has a key role to play.

I believe demand has to be injected directly into the economy and not intermediated through the financial markets, which is what QE and NIRP do. For example, this can be done through an Infrastructure Bond scheme, where the Treasury issues an infrastructure bond and the central bank prints money to buy it. With this money, the government then implements infrastructure projects. The viability of the projects are checked and those that are "shovel-ready" get priority. The increased employment and wages (particularly for lower-skilled construction workers) would lead to higher consumer spending instead of windfall savings, since consumers would see it as “earned” money not "helicopter money" - central banks throwing money out the window.This is also a much better solution than a pure tax rebate that may be saved and not spent. Besides, most infrastructure schemes would offer exactly the potential long-term predictable cash flows and returns that asset managers, sovereign wealth and pension funds seek.

Sadly, any monetary financing of public deficits is, for the moment, taboo. We have weak leaders everywhere who will not take the lead for fear of a backlash and negative ratings. The EU is in bad shape - monetary financing is contrary to EU regulations - and is opposed by all who regard governments’ fiscal difficulties since the recent crisis, as an opportunity to shrink the role of the state.

I do not want to sound as though I am bearish on the US or global growth but I am more concerned now than I have been in the past. A promise of fiscal expansion is necessary to push stocks higher and in the absence of this, the S&P500 (SPX) index will be range bound between 2050-2150. The last two sell-offs in August 2015 and earlier this year, ultimately proved spurious and did little more than harm fund performances. Investors, therefore, will likely be more circumspect about near term market sell-offs before succumbing to pressure. As I have been saying for the last few months, this year is one of very small gains in equities, but these will be magnified if you can pick the dip.

As an investor, it is best to focus on the medium term and not just short-term market volatility. I would advise not to be deterred by such volatility and to build new long positions in favourite stocks or Indices when the opportunity presents itself. Bonds continue to rally and that makes the equity markets more attractive vis-à-vis bonds. The downside to equity markets is limited by an attractive yield and continued central bank support whilst the upside is capped by a mediocre earnings outlook.

In the US, among the sectors, I like Technology, Healthcare and Financials and marginally (and very reluctantly) I prefer European equities to US equities on valuation grounds, given the sell-off we have seen the last few days. US Tech stocks offer great value at a sale price. I have a hunch we will see more M&A activity in the Tech sector with Twitter (TWTR) likely a target after we saw LinkedIn (LNKD) acquired by Microsoft (MSFT). French stocks will likely benefit as fiscal targets are loosened going into the national election due next year, but Europe has plenty of risk ahead: The UK referendum, Spanish elections and an Italian constitutional referendum. Volatility will present opportunities to put on a new trade.

Some of the stocks I hold/recommend holding: Starbucks (SBUX US), Citi (C US), JP Morgan (JPM US), Bank of America (BAC US), Gilead Sciences (GILD US), Allergen (AGN UN), Biogen (BIIB), General Electric (GE), General Dynamics (GD US), Apple (AAPL US), Google (GOOG US), Amazon (AMZN US), Schlumberger (SLB US), Pepsi (PEP US), McDonalds (MCD US), Richemont (CFR VX), LVMH (MC FP), Daimler (DAI GY), Airbus (AIR FP), Roche (ROG VX), Rio Tinto (RIO LN), Halliburton (HAL US), Walgreen Boots (WBA US), CVS Healthcare (CVS US), Home Depot (HD UN), CBS Corp (CBS US), Alibaba (BABA US), Pfizer (PFE US), Michael Kors (KORS US), Salesforce (CRM US), Lloyds (LLOY LN), BNP Paribas (BNP FP), UBS (UBSN VX), Intesa Sanpaolo (ISP IM).

Best wishes,

Manish Singh

Manish Singh, CFA

United Kingdom
9 South Street
London W1K 2XA
United Kingdom

Singapore
One Temasek Avenue
23-05 Millenia Tower
Singapore 039192

Visit our website:
crossbridgecapital.com

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