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2019

MONTHLY MACRO OUTLOOK

ThirdRock

KEY MACROECONOMIC DEVELOPMENTS

- Global central banks, led by EMs, have reversed their liquidity squeeze; this has provided some short-term macro lift
- China's monetary policy easing since mid-2018 is likely cushioning a softer landing, although debt challenges remain
- Currency markets are pricing a relatively soft Brexit à la May's (now-dead) deal, but risks of a hard exit are rising

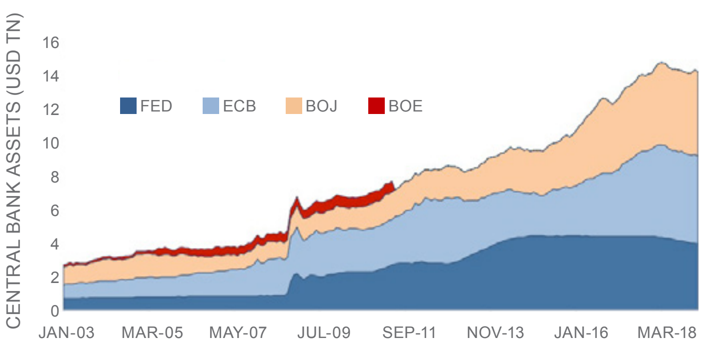
This month, we explore liquidity matters: in particular, we show that central banks are no longer squeezing monetary policy (or reversing it outright), and this has resulted in a possible reversal in tightening financial conditions. Nowhere is this more apparent than in China, when the easing process began in the middle of last year; yet while this stimulus may well arrest the economy's growth slide, it merely postpones resolution efforts for shadow banking and corporate debt, which could come back to bite in the future. Finally, we take a look at Brexit, from the perspective of forex, and conclude that the prospects for the pound remain in caveat emptor territory, although opportunities could exist for a patient investor by picking up UK assets in the event of a hard Brexit.

THE SLOW TIGHTENING OF THE GLOBAL LIQUIDITY NOOSE, AND SOME RECENT RELIEF

As regular readers of this Outlook will be aware, one important outstanding question we have while looking at the global macroeconomic picture is the extent to which the slowdown in economic (especially manufacturing) activity worldwide has already been baked into the cake and, relatedly, whether there are policy actions that may stave off the undesirable recession outcome. And on no front is a decisive policy response more crucial than in the choices that central banks have made—and will be forced to make—in both the recent past as well as immediate future.

Our look at the global liquidity picture will therefore (mostly) take the perspective of central banks, turning over the look at broader financing conditions faced by the private sector only at the end. It's probably best to start by looking at the essentially concerted shift away from unconventional monetary policy—in particular, quantitative easing (QE)—by the world's largest central banks. Although a slow balance sheet runoff has essentially been in place since 2014 for the Federal Reserve (Fed), it was really only in 2018 when we started to see an appreciable shrinkage of its asset holdings (Fig. A). This quantitative tightening (QT) occurred pretty much in tandem with comparable asset sales from the European Central Bank (ECB), along with a pause in asset accumulation by the Bank of Japan (BoJ). Although not available in a comparable fashion after 2014, available data on the shape of the Bank of England (BoE) balance sheet reveals that it has pretty much been in a holding pattern since last year.

FIG. A: MAJOR G4 CENTRAL BANKS HAVE SCALED BACK ON QE-RELATED ASSET PURCHASES SINCE EARLY 2018



Source: Thirdrock calculations, from FRED.
Notes: Assets converted to USD at end-of-period exchange rates. BoE data for comparable series after 2014 no longer available.

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Of course, this shift from QE to balance sheet rollovers to outright QT was well-telegraphed by all the major central banks (except perhaps the BoJ, which has largely remained silent on its balance sheet operations). In principle, such advance notice should not only encourage confidence when QE was in operation—the signal from a predictable pattern of asset purchases was meant to inspire confidence in the continued flow of easy credit—but also allow market participants to plan well ahead for the eventual rollback of the respective programs.

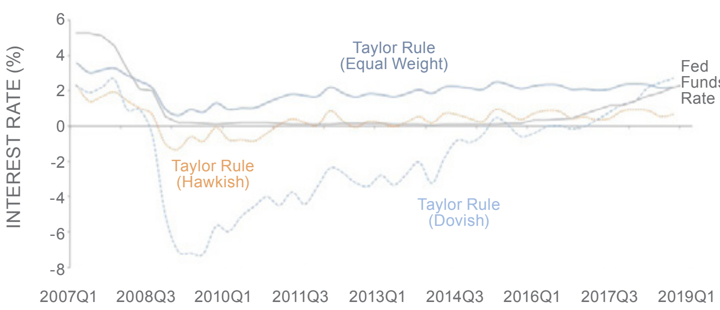
But that has not stopped a number of high-profile accidents along the way. It took a marked shift in sentiment as a result of Mario Draghi's famous "whatever it takes" pronouncement before markets ended their run on Euro Area peripheral sovereign debt. Then in 2013, the so-called "taper tantrum"—which began when the Fed first began its slowdown of asset purchases—led to severe capital outflows from emerging markets. Most recently, Draghi again surprised markets by reopening a limited QE program within the Euro Area, even as markets were anticipating future moves toward monetary policy tightening.

With central bank communication over regular, plain-vanilla interest rate policy already fraught with such ambiguity and risk of misinterpretation, it is hardly surprising that successfully conveying the wide array of unconventional operations—which, recall, includes not just the purchases of long-term government debt, but also possibly purchases of agency securities, corporate bonds, and even "forward guidance" (central-bank speak for jawboning, but largely regarded as cheap talk)—runs an even greater risk of falling flat on its face.

Be that as it may, the reality is that—however the news is taken by markets—the reliance of markets on the major central banks as the buyer of last resort would now need to come to an end. This translates, of course, to the loss of one important source of financial liquidity in the post-crisis era. The hope was always that the handoff would be smooth, which would then allow central banks to embark on the next phase: the normalization of their policy rates. This, again, is entirely sensible and prudent; by raising rates now, central banks ensure that they have enough room above zero to cut when the inevitable recession arrives (presumably in the next few years).

The decision to raise rates to maintain sufficient firepower for the future is further corroborated by mechanistic monetary policy rules, such as the famous Taylor rule. There are as many variants of the Taylor rules as there are independent-minded central bankers out there (and perhaps more), but the standard approach places weights on the extent to which the Fed is missing its inflation target (how far above or below two percent the current inflation rate is), versus how much output is above or below, and adjusts the nominal interest rate in a manner that caters to hitting both of these targets. We consider a rule that places equal weights on these two objectives (as recommended by John Taylor, the Stanford economist that is the originator of the eponymous rule), and two others, one that places a three-times-larger weight on the inflation gap (a hawkish rule), and the other that places the larger weight on the output gap (a dovish rule). This simple exercise reveals that the current Fed Funds target range of 2.25 to 2.5 percent is pretty close to at least two versions of the rule, and excessively high only if one places a large weight on price stability (Fig. B).

FIG. B: TAYLOR RULE ESTIMATES MOSTLY SUGGEST THAT CURRENT FEDERAL FUND TARGET RATE IS APPROPRIATE

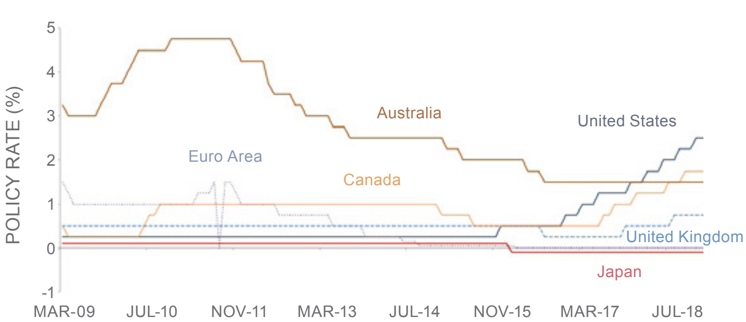


Source: Thirdrock calculations, from BLS and CBO/FRED and Laubach & Williams (2003, updated)
Notes: L-W output gap data end in 2018Q1, data for rest of 2018 repeats Q1 estimate. Inflation gap calculated from core PCE and 2% target, and output gap data are two-sided estimates from Laubach & Williams. Hawkish (Dovish) rules substitute equal inflation (output) weights of 0.5 with 1.5.

“ We are in the early stages of a reversal, with financing conditions up substantially from the respective lows for DMs and EMs. ”

Of course, the Fed is not the only one paying attention to Taylor-type policy rules. A handful of other DM central banks have also begun their respective rate hiking cycles. In contrast to the rollout of QE, however, the rate normalization process has been far less uniform (Fig. C). The United States, by virtue of being the most advanced in its business cycle, was able to raise rates earlier than Europe (which had its own recovery pushed back as a result of a double-dip recession following its sovereign debt crisis). And the United Kingdom, which had previously been among the strongest performers among the G7 economies, had to hold off on raising rates as expected in 2016, as the BoE sought to steer the economy in the immediate aftermath of the Brexit referendum.

FIG. C: THE RATE HIKE RECORD AMONG DM CENTRAL BANKS HAS BEEN LESS UNIFORM COMPARED TO BALANCE SHEET NORMALIZATION

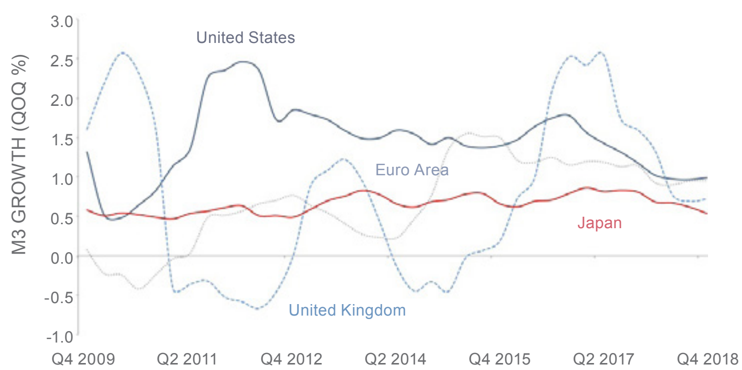


Source: Thirdrock Compilation, from Central Banks/Datastream.
Notes: Official central bank policy interest rates. Declared central bank inflation targets differ (AUS, CAN: 2 +/- 1%; EUR: < 2%; GBR, JPN, USA: 2%).

The picture has been no more coordinated among the smaller DM central banks: while the Bank of Canada started hiking steadily around the middle of 2017, the BoJ and Reserve Bank of Australia have yet to adjust their policy rates, likely because they hold the belief that their respective economies are not quite at escape velocity for them to do so.

All those interest rate increases, of course, is exerting a further effect on liquidity conditions, which are already tighter as a result of QT. Indeed, even for DM economies that have not yet hiked their interest rates proper, the growth rate of the broad money supply—a measure of currency in circulation together with most forms of liquid deposits—has fallen considerably since 2017 (Fig. D). This drop has been most precipitous in the United Kingdom (no prizes for guessing why), but is at a half-decade low in all the G4 economies. The picture is hardly any better among the BRICs, where money supply growth is about half of what it was ten years ago (the saving grace is that, since mid-2017, liquidity has popped back up in most countries within this group, with the exception of China; more on that below).

FIG. D: MONETARY POLICY TIGHTENING HAS LED TO AN APPRECIABLE SLOWDOWN IN THE GROWTH RATE OF THE BROAD MONEY SUPPLY

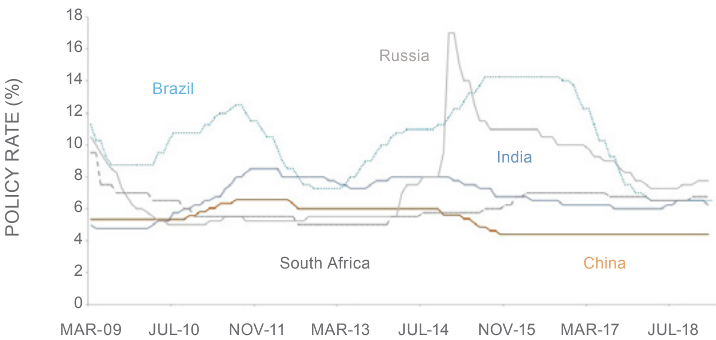


Source: Thirdrock calculations, from OECD MEI/Datastream.
Notes: MA(4) of seasonally-adjusted QoQ period average of M3 money supply growth.

The undue effect that EMs have had to suffer through in response to DM policy action reprises a theme that we have brought up before in previous Outlooks. As DM central banks have pursued policy tightening, their EM equivalents have had to scramble and follow suit, in spite of the relatively weaker position of their economies (recall, Brazil and Russia only exited recession within the past couple of years). This is the usual EM curse, but one would have thought that their relative maturity would have insulated them better this time round. The pounding of EM assets through most of 2018 is a stark reminder that, by the thinking of financial markets at least, this is not yet the case.

Consequently, EM monetary authorities have moved more decisively toward easing, at least in the aftermath of their enforced hikes in the second half of 2018 (Fig. E). The Reserve Bank of India, under its new governor Saktikanta Das, nudged rates down two months after his appointment in December, and although the People's Bank of China has not directly adjusted their policy rate, it has relied on other tools—notably the reserve ratio, which was first cut in the middle of 2018 and is now 2.5 percentage points lower—to effect easing (more on that in the next section). Globally, almost three times as many EM central banks have cut rather than raised rates this year (with Chile, Honduras, Pakistan, and Tunisia bucking the trend). It is clear that EM central banks are now well-placed to lead the reversal in the global liquidity tightening plans that were initiated by their DM counterparts.

FIG. E: EM CENTRAL BANKS FOLLOWED THE DM HIKE CYCLE RELUCTANTLY, AND A NUMBER HAVE NOW MOVED TOWARD EASING



Source: Thirdrock compilation, from Datastream.
Notes: Official central bank policy interest rates. Declared central bank inflation targets differ (BRA: 4.5 +/- 2; CHN, RUS: 4; IND: 6; ZAF: 3-6).

Now, the entire point of all this central bank policy action was that there was a belief that there would be a smooth handoff of lending to the private sector. Has this occurred? It certainly seemed so at the start of 2018. However, financing conditions over the rest of 2018 tightened considerably, and it did so regardless of whether one looked at the developed or emerging world (Fig. F). Interestingly, the easing of financing appears to have occurred just a shade earlier in EMs; this owes, perhaps, to the more proactive actions among EM central bankers.

Regardless, there is now a quarter's worth of evidence that we are in the early stages of a reversal, with financing conditions up substantially from the respective lows for each group. Whether this tentative trend persists will, in our view, be the strongest determinant for whether the global economy slips into a recession either very late this year or next year. It's probably worthwhile pointing out that this view, while conventional, is not universally shared. The Economic Cycle Research Institute (ECRI), for instance, believes that economies go into recession when they enter—and fail to exit—a "window of vulnerability," instead of being tipped into it by unexpected shocks. We actually see less difference between their view and our more standard one; in this case, our argument is simply that the shock would be entirely endogenous. Put another way, the decision by global central banks to forestall additional tightening this year will have far greater influence on real economic activity worldwide, than the fiscal policy choices of governments. Or, for that matter, the credit creation choices of private sector banks, which are demonstrably still heavily reliant on the availability of easy credit by central banks.

The idea of skirting a recession in the short run, of course, does not necessarily recommend itself as the best policy for the longer run. The entire point of raising rates was to afford more wiggle room for the traditional magnitude of cuts over the course of past recessions (usually in the 5 percentage-point range). This would require a handoff, of public to private sector-led credit provision. And early 2018 offered the best shot for such a handoff. Even with the generous benefit of hindsight, it is difficult to conceive of when policymakers could have chosen a better time to tighten conditions: economic activity was roaring, and inflation, while still largely contained, was beginning to threaten. The policy rate rises were themselves controlled and well-telegraphed.

So while we—and financial markets—will certainly be gratified by some delay in the weakening of economic conditions, policymakers do run a real risk that should an unexpected (rather than policy-induced) shock hit the world economy, we would be in real trouble when looking for tools to dig ourselves out. That is a problem for another day, however. For now, there is a real possibility that, should global policymakers succeed in their liquidity relief efforts, bullish conditions may persist through till at least the end of the third quarter of this year. Looking for low-cost hedges to a more concerted downturn remains sound insurance, but asset markets may have one last wind yet.

In the longer run, though, it behooves investors to be prepared for the fact that many global central banks will have insufficient ammunition to combat the next recession down the line (this includes to some extent unconventional monetary policy tools, since balance sheets have yet to be fully unwound, and negative rates have only proven to work up to a relatively small lower bound). Governments will then need to turn to fiscal policy. This will have clear implications for bond prices, especially for sovereigns that do not possess sufficient fiscal room to expand their deficits considerably. If so, expect the usual run-to-bond-safety valve to be challenged, at least in high-debt economies.

FIG. F: FINANCING CONDITIONS FACED BY THE PRIVATE SECTOR TIGHTENED CONSIDERABLY IN 2018, BUT HAVE LOOSENED SINCE

Source: Thirdrock calculations, from GS Global Investment Research
Notes: Inverted FCI takes the inverse of the index and renormalizes by multiplying by 100, so that increases (decreases) indicate looser (tighter) conditions. FCIs are weighted averages ofpolicy rates, LT riskless bond yields, corporate credit spread, equity prices, and trade-weighted exchange rate (all when available).

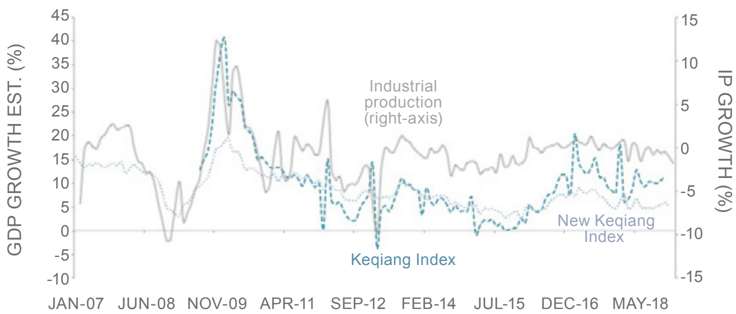
CHINA: SQUEEZING BLOOD OUT OF STONE

One undeniable reality for even the most ardent China apologist is the fact that Chinese growth has decelerated substantially since the middle of last year, and that this downturn is one of the major reasons why the world stands on the brink of a more broad-based slowdown. Skeptics might even claim that China is in outright recession, and its elevated official growth rate is only a result of fiddling with the statistics. While we understand why certain quarters may hold such a position, it strikes us as both unsupported by the data—alternative growth metrics that are much harder to fake, such as electricity consumption or freight traffic volumes, have not collapsed—and inconsistent with a bevy of academic research (which has argued that historical Chinese national statistics have underestimated as much as exaggerated growth, so the reported rate should thus be viewed as a smoothed average).

Setting aside the possibility of recession, it is nevertheless the case that a significant contraction is underway. It's worth noting that, for the past four decades, China has not experienced the traditional two-quarter-negative-rate recession that is typically observed elsewhere. But a contraction regime—which we define as an extended dip in growth below 3 percent—is part of the post-1980 Chinese economic experience, and the more fundamental question is how close we are to this state of affairs (or are we already in it?) at the present time. This question is important, not only because of the spillover effects that a Chinese contraction would have on the rest of the world—especially commodity-exporting economies—but also because a better sense of how close the economy is to freezing up will give us a better sense of how Chinese policymakers may respond.

To this end, we begin by reviewing a number of alternative measures for Chinese activity (Fig. G). The slowdown is most evident in industrial production, which has continuously slid as the (reported) GDP growth rate has ticked down. But this slowdown preceded the recent headlines about trade wars and oil shocks; rather, it has more-or-less been in place since the middle of 2017, and it is not unfair to argue that the deceleration is at least in part an engineered slowdown emanating from a scaling back of the industrial manufacturing sector, in an attempt to promote consumption and the services sector. There are additional reasons to believe that the slowdown is not universal. Recent movements in the Keqiang index—which approximates output based on real activity indicators—point to a pickup coinciding with the more relaxed monetary regime put in place around the middle of last year, and the New Keqiang index—comprised of additional measures of activity drawn from the services sector—also displays a slight uptick in recent months. While we await a more definitive trend in the data to establish itself, it is nonetheless fair to infer that the idea of a massive slowdown in the Chinese economy is probably exaggerated.

FIG. G: CHINESE PROXIES POINT TO A SLOWDOWN, BUT NOWHERE AS SEVERE AS IN MID-2015, WHEN THERE WAS A MARKET ROUT



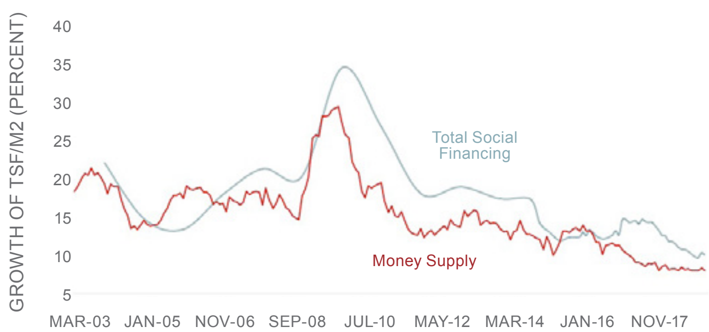
Source: Thirdrock calculations, from China National Bureau of Statistics and Conference Board /Datastream.
Notes: Keqiang index proxy for GDP constructed from rail cargo volume, electricity consumption, and bank loan disbursements. New Keqiang index proxy alters weights for the industrial sector and includes additional nonmaterial service sector indicators.

“ In the longer run, it behooves investors to be prepared for the fact that many global central banks will have insufficient ammunition to combat the next recession. ”

As alluded to above, one important reason why this slowdown may have been arrested is because of the very proactive policy measures adopted by Chinese authorities over the past half-year or so. While much recent commentary has focused on the fiscal policy stimulus—primarily large-scale tax cuts and fee reductions announced at the opening of the National People’s Congress—the stimulus that has already percolated through the economy has been monetary in nature, beginning with the steady reduction in banks’ reserve ratios, followed by further easing in other regulatory requirements (such as the acceptable ratio of nonperforming loans, along with a tempering of the strict crackdown on shadow bank lending).

All these moves have translated into a tentative shift in domestic financing conditions. Undeniably, the broadest metric of credit and liquidity available to agents in the broader economy—what the People’s Bank terms total social financing (TSF)—has fallen since the highs in the immediate aftermath of the global crisis, when Beijing opened the taps to insulate the economy from spillover effects due to the crisis (Fig. H). This was scaled back starting around 2010, and TSF growth fell to rates of around the high teens. This growth then downshifted again over the course of 2018, ending the year at around a 10 percent growth rate.

FIG. H: TOTAL FINANCING AVAILABLE TO THE ECONOMY HAS STEADILY FALLEN SINCE THE CRISIS, BUT APPEARS TO HAVE STABILIZED RECENTLY



Source: Thirdrock compilation, from PBOC/Datastream.
Notes: Total social financing is aggregate financing to the economy from the financial system, and includes bank loans, corporate bonds, nonbank lending, and local government bonds. Data prior to 2016 (2014) available only at quarterly (annual) frequency. Money supply is for M2.

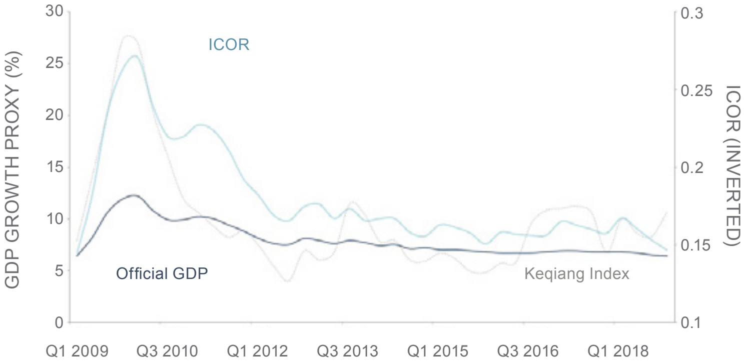
Astute chart-readers will also undoubtedly notice the divergence between changes in the money supply and TSF. While growth in TSF is usually somewhat faster than that of the money supply, what is relevant here is that the continued, steady reduction in the growth rate of the former over the course of 2017 was not immediately accompanied by a reduction in TSF growth (indeed, TSF expansion remained elevated through most of that year). This divergence is almost certainly attributable to the infamous shadow banking section, which underwent a crackdown in 2018.

Now that crackdown looks to be slowing down, both on the basis of anecdotal feedback from the ground, as well as what is evident in the data; TSF growth has actually risen since the beginning of the year. Of course, part of that uptick is simply the effects of the relaxation of regulation on bank lending ratios. Still, policymakers appear to have belatedly come to the realization that a rapid, broad-brush clamping down of the sector would have unwelcome repercussions at a time when the external environment is no longer as favorable for tight money policy. Better to selectively target only the most egregious practices within the shadow lending sector and allow the remaining players time to get their ships in order.

More generally, the government now appears to be more sensitive to a more fine-tuned approach to effecting monetary policy, at all levels. This is most evident by the requirement that commercial banks boost their lending to small and medium enterprises (SMEs), which indirectly implies a scaling back of lending to large, state-owned enterprises (SOEs), which had been the norm (to the tune of SOEs accounting for more than four-fifths of all new loans generated). Critics of the banking system had long recognized the bias of bank lending—especially in state-owned banks—toward the large SOEs, owing to their implicit government backing, and hence perceived safety (even if at the cost of lower margins). This had become an ever-greater constraint to the continued expansion of more dynamic private-sector-driven SMEs, and is one important reason behind the tilting back of Chinese investment toward public-sector firms since 2016, after close to a decade of reduction in the public share.

This point, astutely made by the Peterson Institute's Nick Lardy, is important because large Chinese SOEs are notoriously inefficient, relative to SMEs. Returns on assets in the public sector are dwarfed by that of the private sector—the spread in recent years between the two has been as high a 6 percentage points—and so it is unsurprising that the efficiency of capital usage in the economy has fallen sharply (Fig. I). The inverse incremental capital-output ratio—changes in output for a given change in investment, a proxy for the quality of capital deployment—have languished at post-crisis lows. It should therefore be no surprise that output has followed capital usage efficiency downward.

FIG. I: THE EFFICIENCY OF CAPITAL USAGE HAS FALLEN ALONGSIDE THE DECLINE IN THE GDP GROWTH RATE



Source: Thirdrock calculations, from China National Bureau of Statistics/Datastream.
Notes: Keqiang index proxy for GDP constructed from rail cargo volume, electricity consumption, and bank loan disbursements. ICOR is calculated as the investment share of output divided by the GDP growth rate.

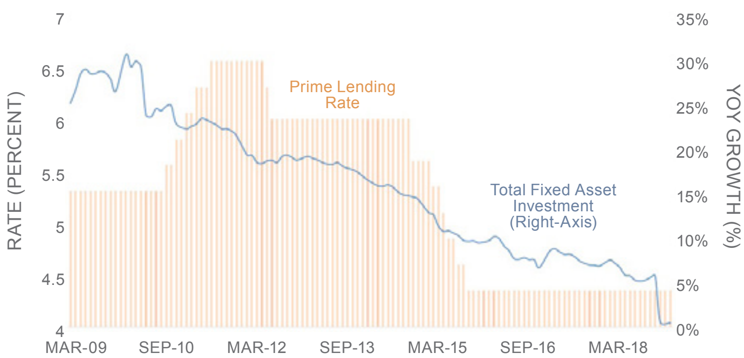
The pivot toward SMEs—or, perhaps more accurately, the removal of bias away from SOEs—is now evident in the data, at least insofar as lending is concerned. Even amidst the drawdown in domestic credit, there has been a stalling in lending to the largest SOEs, with little retraction in lending to their smaller compatriots (data comparing lending to private SMEs are, unfortunately, unavailable) (Fig. J). Importantly, this shift began in 2018, before the more recent policy announcements; so as long as lending patterns continue to evolve in favor of smaller firms, there is still hope that the fine-tuning of liquidity provision may yet reap benefits in terms of improved economic efficiency.

FIG. J: DOMESTIC CREDIT GROWTH HAS ALSO STABILIZED, WITH CREDIT TOWARD LARGE SOES EVEN FALLING SINCE LATE 2018

Source: Thirdrock calculations, from PBOC/Datastream.
Notes: Nominal borrowings of state-owned enterprises from the central bank and YoY change in total domestic credit extended by depository institutions.

But Chinese administrators will definitely have their task cut out for them. Blunt lending instruments, such as the lending rate, have—in parallel with how changes in the ICOR have accompanied reductions in output growth—become less efficacious over time. In particular, the prime lending rate had been cut since the fourth quarter of 2014, but growth in investment has stubbornly remained on a downward trend (Fig. K). Not that this reduction in growth is wrong or intended; after all, reducing the economy's reliance on investment as an engine for growth is one of the objectives of the rebalancing plan. Still, if fixed investment is not responding much to the interest rate channel, growth can only be maintained by other components of aggregate expenditure picking up the slack.

FIG. K: TOTAL FIXED ASSET INVESTMENT HAS STEADILY FALLEN DESPITE SEVERE CUTS IN THE LENDING RATE



Source: Thirdrock calculations, from NBS and PBOC/Datastream
Notes: Total fixed asset investment sums investment in primary, secondary, and tertiary sectors.

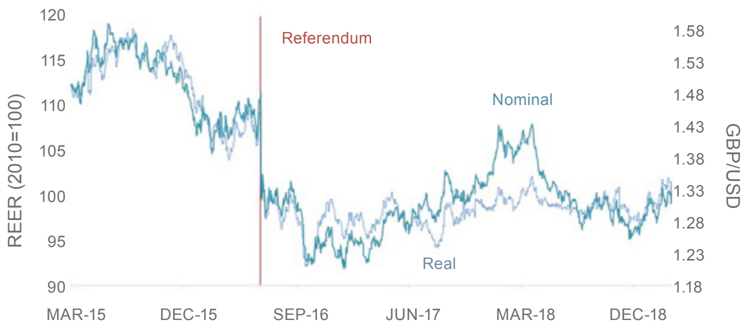
In the final analysis, China's objective of engineering a soft landing while its economy rebalances (and simultaneously faces external shocks in the form of trade-related uncertainty) may well look like a doomed effort. Avoiding further debt buildup and reducing shadow banking activity look, from the outside, to be contradictory to the more recent credit relaxation moves. At the very least, these constant policy readjustments and realignments look very much like a three-steps-forward, two-steps-back sort of maneuver. But nobody said the process would be easy, and the Chinese have always maintained a pragmatic approach to economic management, at least ever since Deng Xiaoping's claim that reform would entail "crossing the river while feeling the stones." The implication for investors is to be careful when betting against China. The runaway performance of Chinese equities in 2019 is a reminder of this risk.

POUNDING THE TABLE ON BREXIT

Okay fine, it's a terrible pun, but there is hardly a better way to look at the jumbled state of Brexit than with a generous dose of humor. And try as one might, as the pinky-swear-final-no-more-delays deadline for finalizing Brexit arrangements draws near (as of now, either Apr 12 if there is no deal or an indefinite postponement, or May 22 with a deal), markets are beginning to refocus on the implications of the event. And nowhere is the focus more intense than in currency markets, given how the pound has borne the brunt of changes in macro fundamentals implied by Brexit.

Indeed, the pound correction—which began pricing in the possibility of Brexit as early as the start of 2016—has been truly remarkable. Between the time a referendum would become a reality (with the passing of the EU Referendum Bill in May 2015) to when the outcome of the vote indicated that the results would favor leaving (in the early hours of June 24 the following year), the value of the pound collapsed by 17 percent (Fig. L). Following the vote, the pound has mostly traded sideways (albeit with significant volatility; it staged an extended recovery in nominal terms between the first quarter of 2017 and 2018, before collapsing again thereafter). The entire sorry story has led to significant losses for foreign investors in British assets, despite a respectable performance of the benchmark FTSE over the same period.

FIG. L: FROM THE YEAR PRIOR TO THE REFERENDUM TILL NOW, THE POUND HAS PRICED IN DEPRECIATION OF MORE THAN 10 PERCENT



Source: Thirdrock compilation, from JP Morgan and BoE/Datastream
Notes: Real efective exchange rate for the UK computed from trade-weighted basket comprised of major partners, using CPI. Nominal rate represented as units of base currency (GBP) per quote currency (USD), such that an increase represents an appreciation.

That chatter in markets is now about how the pound will go in the aftermath of Brexit (if or when that happens). Naturally, this will depend on the actual outcome, which could be one of five distinct scenarios: a relatively-soft-but-imperfect Brexit with May's deal (which has failed three attempts and looks to be dead in the water); ultra-soft Brexit under some manner of customs union or single-market membership (which would entail no meaningful changes to the UK's relationship with Europe relative to pre-Brexit, but at the cost of relinquishing voting rights); another referendum (of which chances are slim, and for which remain is by no means guaranteed); a new general election (which is unlikely to alter the eventual Brexit choices that would still have to be made, but may mean remain if the constitution of parliament changes in dramatic favor of Remainers); and a super-hard Brexit to WTO rules (the worst possible outcome that everyone would like to avoid).

While it's difficult to pin probabilities on any of these outcomes without significant error, we would venture that the two most likely possibilities are the ultra-soft or super-hard Brexit. The very soft version of Brexit appears to have come closest to a majority in the indicative votes that Parliament has advanced, and without sufficient progress in semi-soft options, the risk of a hard Brexit grows by the day (a risk that deeply interested external observers like the EU have begun to prepare for). Of course, in some ways this is simply a return to the original choices posed during the referendum, except that there will be no transition buffer this time round. And if all these choices are beginning to sound like differing brands of toilet paper, you are getting a good sense of the nature of choices facing the British economy.

On our part, we believe that forex markets are actually pricing in an outcome similar to May's deal, and were that to become reality, we would expect little medium-term change in the pound (it could well fall immediately following the announcement, but we suspect any such change will be short-lived). But if the ultra-soft outcome comes to pass, a bounce back to pre-2015 levels—or something close to it—is entirely possible, as the pound undergoes a transition in its regime.
If super-hard results, expect another plunge, as the pound undergoes an alternative regime shift, but in the opposite direction.

Overall, we remain guarded about what all this means for UK assets. The bifurcated nature of possible macro outcomes leaves us with little guidance for a data-reliant investor. It is important for investors to recognize that any positions they take, therefore, entails a bet. This is, unusually, the case even in the medium run, when mean reversion often corrects for short-term sentiment swings. With little margin for safety, we can only recommend contingent actions: if hard Brexit occurs, picking up assets in the aftermath may well prove to be a sound investment, but only over the long run.

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INVESTMENT TAKEAWAYS

Equity markets have continued their 2019 rebound and are exhibiting the sort of momentum-led resilience to all manner of macro or geopolitical risks. This sets them up for a sharper correction, although the ballast could remain for a while yet, given easier global monetary conditions (as discussed in this Outlook) and the likelihood that recessionary conditions—even if they were to visit—would almost certainly be delayed till 2020. In contrast, fixed income markets have been much more circumspect, and the inversion of the normally-reliable 3-month/10-year spread—were it to persist—would be another corroborating signal for a recession next year (assuming the inversion persists for at least a quarter, the typical lag between recession and inversion averages a year). Our decision to hold gold, as well as some TIPS, as hedges is looking increasingly sound. Among equity markets, EMs (especially those in Asia) remain attractive to us, although gains in Brazilian and Chinese equities have reversed of late. Still, we retain our Chinese A-share exposure, in the belief that the asset class will only gain in importance over time. We also continue with our rotation away from U.S. technology and consumer discretionary, toward defensive sectors.

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“ We retain our Chinese A-share exposure, in the belief that the asset class will only gain in importance over time, and continue our rotation toward defensive sectors in the U.S. ”

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