MacroResearchBoard
mrb partners STRATEGIC TRADER
Independent Investment Strategy
October 13, 2016

All About Politics

Politics has dominated the news flow in recent months, in both the U.S. and Europe. Increased ideological polarization between parties, unrestrained debates, and pressure for a populist shift in power have made investors uneasy. Extended structural imbalances are approaching some sort of breaking point, heightening social unrest and political instability in many countries (a topic of a recent **MRB *Theme Report***[1]). The global economy is reasonably firm and the job recovery is broadening (particularly in the U.S.), but the risk of a disruptive shift in power is still difficult to handicap.

To help provide some context in what has at times seemed to be a chaotic investment landscape, we updated the *MRB Stylized Investment Cycle* last week[2]. This framework was derived from historical average performance and duration (in weeks) of the global stock/bond ratio over the four decades preceding the start of the bull market in 2009. The eight distinct phases of this framework are depicted in **chart 1** on page 3. Although the average of past performance can help provide a crude roadmap, we find it much more useful (particularly during this cycle) to understand the macro fundamentals and investor psychology needed to spur markets to transition from one phase to another.

A major difference during this cycle has been that regional debt crises and deleveraging pressures have pushed investors outside their comfort zone. This has dramatically slowed risk-taking, making the evolution between bull market phases more challenging. The

MRB *TradeBook* *p.2*

- We are maintaining a mild pro-growth tilt but advise against becoming too aggressive, at least until after the U.S. election. For now, focus on "safe beta" or "safe pro-growth" bets.
- Those seeking near-term insurance should buy the VIX index. Implied equity volatility is low and likely to rise over the next few weeks.
- U.S. stocks will likely initially sell off on the uncertainty caused by a Trump victory and rally slightly on a Clinton win. Thereafter, rhetoric about global trade and the timing/implementation of economic policies will be critical.
- Although macro trends will largely drive overall U.S. sector performance, the economic plans of the two presidential candidates have important ramifications for various sub-sectors.
- The U.S. dollar is likely a win/win initially in either election outcome, albeit for different reasons. However, the victor will have a material impact on the longer-term outlook for the currency.
- The brief calm in the U.K. has ended and Brexit trades are back in play. There are some short and long opportunities that still have legs.

[1] MRB *Theme Report*, "*A Perfect Storm For Political Instability (Part I)*", September 27, 2016 and "*A Perfect Storm For Political Instability (Part II)*", September 28, 2016

[2] MRB *Theme Report*, "*Stylized Investment Cycle Update: A Fairly Unique Cycle*", October 5, 2016

MRB *TradeBook*

View print version with reference charts (pdf format)

Current Trades	Initiation Date	Gain/ Loss (%)	Exit Point[1]
Equities			
CLOSED Long Global Benchmark/Short Bloomberg Luxury Goods	12-Nov-15	**10.00**	–
Global: Short Consumer Discretionary/Long Benchmark	11-Feb-16	2.15	-4.0%
U.S.: Long Banks/Short Benchmark	11-Feb-16	5.42	-4.0%
Long U.S. Telecom Services	11-Feb-16	12.78	10.0%
Long Global Capital Goods and Software & Services	17-Feb-16	17.97	10.0%
CLOSED Banks: Long China/Short Australia	12-May-16	**20.00**	–
UPDATE U.K.: Short Small Caps/Long Large Caps	23-Jun-16	**9.04**	**5.0%**
UPDATE U.K.: Short Consumer Discretionary/Long Benchmark	23-Jun-16	**8.60**	**5.0%**
Banks: Long US and Euro Area/Short Canada	11-Aug-16	3.18	-7.0%
Long India & Indonesia/Short Russia	23-Jun-16	-5.45	-7.0%
Foreign Exchange			
Long SEK/EUR	10-Mar-15	-5.18	–
Long U.S. Dollar Index (DXY)	06-Nov-15	-0.25	92.0
Short CAD/USD	22-Jul-16	1.03	–
Fixed Income			
Long EM U.S. Dollar-Denominated Debt/Short 10-Year U.S. Treasurys	10-Oct-13	6.27	Spread: 4.2%
Long U.S. High-Yield Corporate Debt	08-Oct-15	11.74	Yield: 7.3%
Alternatives			
Long German Real Estate[2]	23-Nov-10	33.08	–
Shadow Trades			
Bank Stocks: Long Euro Area/Short U.K.	06-Jul-16	–	–
Emerging Market Stocks: Long Asia/Short Commodity Producers[3]	11-Aug-16	–	–
U.S. Stocks: Long Financials/Short Real Estate	08-Sep-16	–	–
Short Gold	08-Sep-16	–	–

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[1] Exit points for equities and stock/bond ratios are expressed as the % gain/loss generated if trade is stopped out. See reference charts for details.

[2] Proxied by German house prices

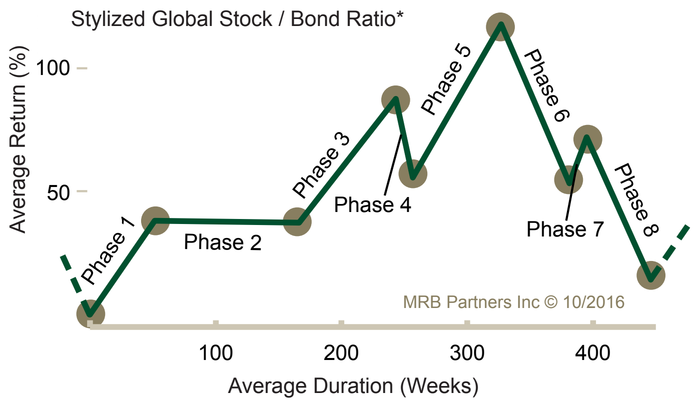
[3] Market cap-weighted; commodity producers: Brazil, Chile, Colombia, Peru, Russia and South Africa (i.e. we omitted the commodity producers in emerging Asia)

Note: Gain/losses are based on daily closing values. Gain/loss is calculated in U.S. dollars unless otherwise stated; recommended trades are intended to be held for a minimum of three months, and may last more than a year. Nevertheless, we use exit points in order to control risk. *Shadow Trades* are investment opportunities that we plan to implement once timing is appropriate.

low growth and inflation backdrop means that there has been less of a cushion to absorb the repeated shocks this cycle, and there has certainly been no shortage of shocks. Even over the past two years, financial markets have been forced to digest the violent collapse in commodity prices, the potential for Grexit, fears of Chinese yuan devaluation, concerns over the U.S. economic expansion, and finally a U.K. Brexit referendum. The result has been that the global stock/bond ratio has been trapped in an extremely volatile trading range, rather than being able to transition into another sustained upleg (**chart 2**).

Looking ahead, the macro backdrop is generally supportive for global equities over bonds, but investor anxiety is likely to remain elevated, at least in the near run. Specifically, central banks have reiterated their reflationary commitment and global growth indicators are showing some encouraging signs, albeit from subdued levels. In particular, global earnings trends are starting to improve now that the commodity and U.S. dollar drags are wearing off. The holdback is that the next upleg in the stock/bond ratio needs to be driven by investors buying into the durability of the global expansion, making them willing to extend their investment horizons. Investor sentiment has firmed modestly since February, but remains fragile, at a point when there are still a number of economic and political hurdles ahead over the next year that have the potential to trip up risk assets (**chart 3**).

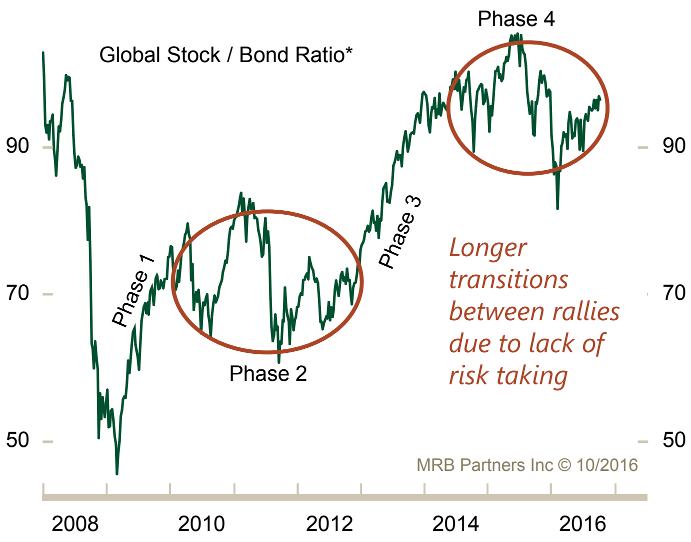
Chart 1 *MRB Stylized Investment Cycle*



Phase 1: **Policy-Induced Rally**
Phase 2: **Awaiting Validation**
Phase 3: **Lower-Conviction Rally**
Phase 4: **Countertrend Pullback**
Phase 5: **Higher-Conviction Rally**
Phase 6: **Bear Market Begins**
Phase 7: **Countertrend Bounce**
Phase 8: **Final Flush**

* Based on the four cycles in the global stock/bond ratio between 1974 and 2009

Chart 2 Current Investment Cycle

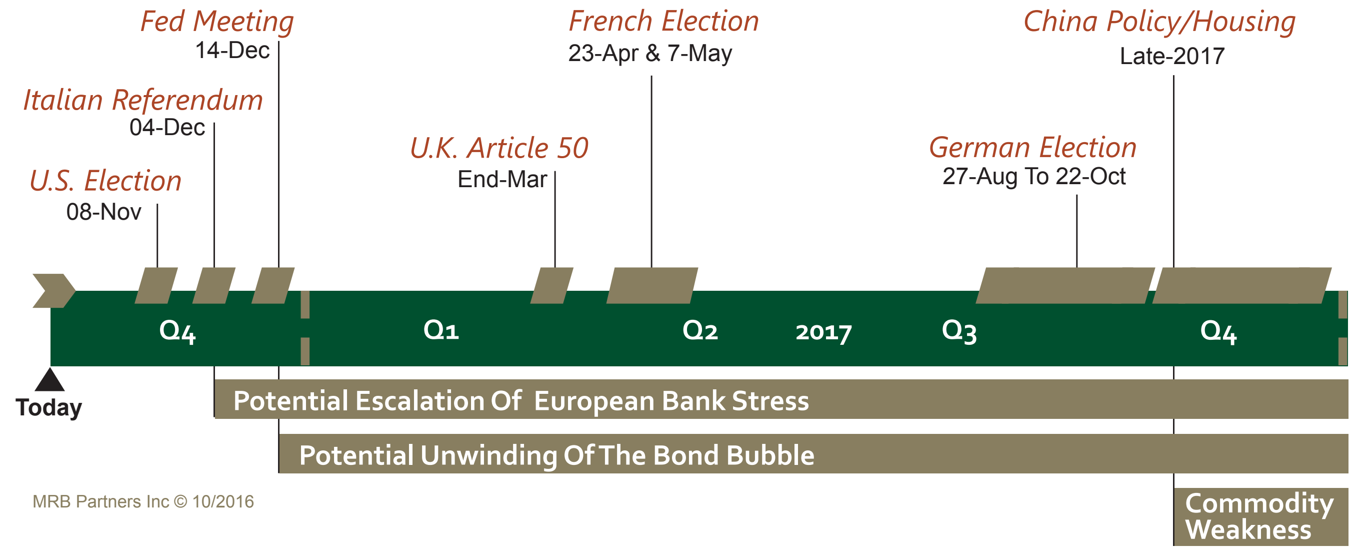


* Global MSCI stock market total return index divided by 10-year G7 government bond total return index; rebased

Fortunately, some of the immediate political threats may be receding somewhat. Specifically, the risk associated with the Italian referendum in creating further euro area banking system strains faded last week, now that Prime Minister Renzi has suggested he will not resign even if he loses. Also, polls have widened in favor of Clinton over Trump for the next U.S. President. Much could happen over the next month, but the risk of heightened uncertainty and the potential for investors to panic have diminished for now. The offset is that U.K. Brexit was brought back to the forefront last week, with U.K. Prime Minister Theresa May warning of a ***hard Brexit***. Although she softened her tone a bit this week, this risk has been heightened (see below).

The macro backdrop is generally supportive for equities

Chart 3 Timeline Of Political And Economic Risks


Fed Meeting
14-Dec
Italian Referendum
04-Dec
U.S. Election
08-Nov
French Election
23-Apr & 7-May
U.K. Article 50
End-Mar
China Policy/Housing
Late-2017
German Election
27-Aug To 22-Oct
Q4
Q1
Q2
2017
Q3
Q4
Today
Potential Escalation Of European Bank Stress
Potential Unwinding Of The Bond Bubble
Commodity Weakness

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Netting out the macro and political forces currently at work, we recommend maintaining a constructive but cautious investment stance. We have a mild pro-growth tilt but will refrain from being too aggressive, at least until we are through the U.S. election and potentially the Italian referendum. We would also like some greater clarity on the U.K. government's Brexit plans. In the interim, our focus remains on "safe beta" or "safe pro-growth" bets. These assets benefit from an ongoing global economic expansion, but have healthy growth and/or policy tailwinds, relatively stable cash flows, and still offer a reasonable valuation cushion[3]. In this group we place global technology, U.S. telecoms, and financials in select markets, along with U.S. high-yield corporate bonds and EM debt (**chart 4**).

Political risks are still hard to handicap

Final Word: *We remain generally constructive on the macro and investment outlook over the next 6-12 months, but acknowledge that there is currently an abnormally large number of event risks on the horizon that could prove disruptive. Thus, we recommend focusing on "safe beta" or "safe pro-growth" bets until some of the near-term political hurdles have been crossed. For those seeking near-term insurance, implied equity volatility is currently low and likely to rise as we approach the U.S. election. Below we outline the impact that the U.S. election outcome will likely have on U.S. equities and the dollar. We also update our various Brexit investment recommendations.*

Maintain a modest pro-growth bias

Investment Theme

U.S. Equities: Positioning For The Election

This has been anything but a typical U.S. Presidential election cycle and the outcome could result in several important ramifications for financial assets. Recent polls have Clinton back well ahead in the race for President, while the betting odds continue to

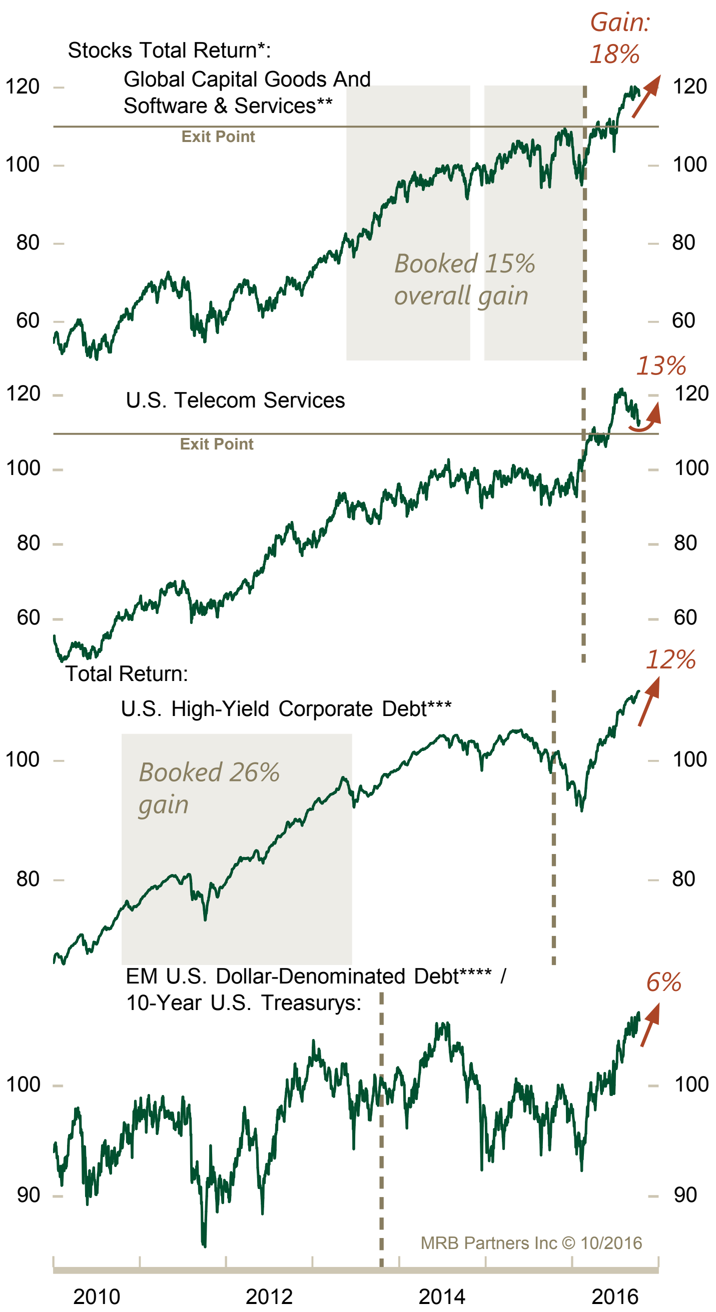
[3] MRB ***Equities Research Highlight***, "***The Hunt For Secure Dividend Yields***", August 16, 2016

point to a Republican majority in the House. Still, much can happen over the next month. We have published several research reports in recent weeks highlighting the risks and opportunities for investors, particularly within U.S. equities (**table 1**):

Broad Equity Market: Investors would generally prefer Clinton over Trump, but favor a split Congress to provide balance, despite the risk of gridlock[4]. U.S. stocks will likely initially selloff on the uncertainty caused by a Trump victory and rally slightly on a Clinton win. However, corporate earnings growth should continue to improve over the next few months in either event, helping to provide some support for equities. Also, ***if*** Trump dampens his anti-trade rhetoric and instead focuses on fiscal stimulus and tax cuts, equities could rally on a 6-12 month horizon. However, his economic plan is designed like his environmental plan, focusing on short-term gains at huge longer-term costs. Still, tax breaks and leverage-fueled growth could provide some cyclical support to equities and high-yield bonds, even if it is structurally unsustainable. Clinton's economic plan provides more of a framework for sustainable growth, with less emphasis on boosting near-term growth.

Recommendation: We remain mildly overweight equities versus bonds on anticipation of a Clinton victory. However, if Trump were to win, we would expect a near-term selloff in equities and drop in bond yields. His rhetoric towards globalization and details of an economic plan will be critical for the outlook over the subsequent 6-12 months. Investors looking for insurance should buy the VIX index since implied volatility will likely rise as we near the election.

Chart 4 MRB *Tradebook*: Safe Beta Trades



* U.S. dollars; source: MSCI
** Market cap-weighted aggregate
*** Source: BofA Merrill Lynch
**** Source: J.P. Morgan Chase & Co.
Note: Total return rebased at initiation of trades; shading denotes when MRB previously held trades

Health Care: Politics are likely to have less of an impact on the overall U.S. heath care sector than investors fear[5]. Also, the sector offers valuation support, with the relative forward P/E ratio approaching its mid-1993 low. However, politics will likely have some impact on the sub-groups within the sector, making

[4] MRB ***U.S. Research Highlight***, "***The U.S. Election: More Tweak Than Change Is Likely***", September 13, 2016

[5] MRB ***U.S. Research Highlight***, "***U.S. Healthcare Stocks: Campaign Rhetoric Vs Political Realities***", September 27, 2016

Table 1 **Potential Winners & Losers Under Each Candidate**

	Clinton Victory		Trump Victory	
Sector/Issue	**Positive For**	**Negative For**	**Positive For**	**Negative For**
Health Care	**Managed care companies** and **hospitals**	Pharma, biotech, **specialty pharma companies**, and **PBMs**	**Pharma, biotech,** specialty pharma companies, and PBMs	**Managed care companies** and **hospitals**
Energy & Utilities	**Renewable energy companies (wind & solar)**	Conventional E&P companies, coal miners, and utilities with large coal-fired assets	Conventional E&P, companies, **coal miners, oil services,** pipelines, and utilities with large coal-fired assets	**Renewable energy companies (wind & solar)**
Financials		**Large banks, large insurers, investment banks**	**Large banks, large insurers, investment banks**	
Infrastructure	**Construction materials**, machinery, and engineering companies		**Construction materials**, machinery, and engineering companies (***albeit vague***)	
Defense			**Defense contractors**	
Consumer Discretionary	Auto components, automobiles, consumer durables & apparel	Hotels, restaurants & leisure retailing		Hotels, restaurants & leisure retailing
Education	Book publishers			

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selectivity more crucial. Specifically, a Clinton victory would result in few changes to the existing heath care system, but push for further Medicaid expansion and increase the number of people accessing health care services. Clinton would push for government to take a more active role in controlling prescription drug costs, and drug distributors would face increased political scrutiny of their role in the supply chain. Conversely, Trump would move to at least partially repeal Obamacare. However, he would present fewer threats to drug and distribution pricing power, given the Republican Party ideology to protect market-based pricing.

Clinton benefits managed care and hospitals, while...

...Trump is better for pharma and drug distributors

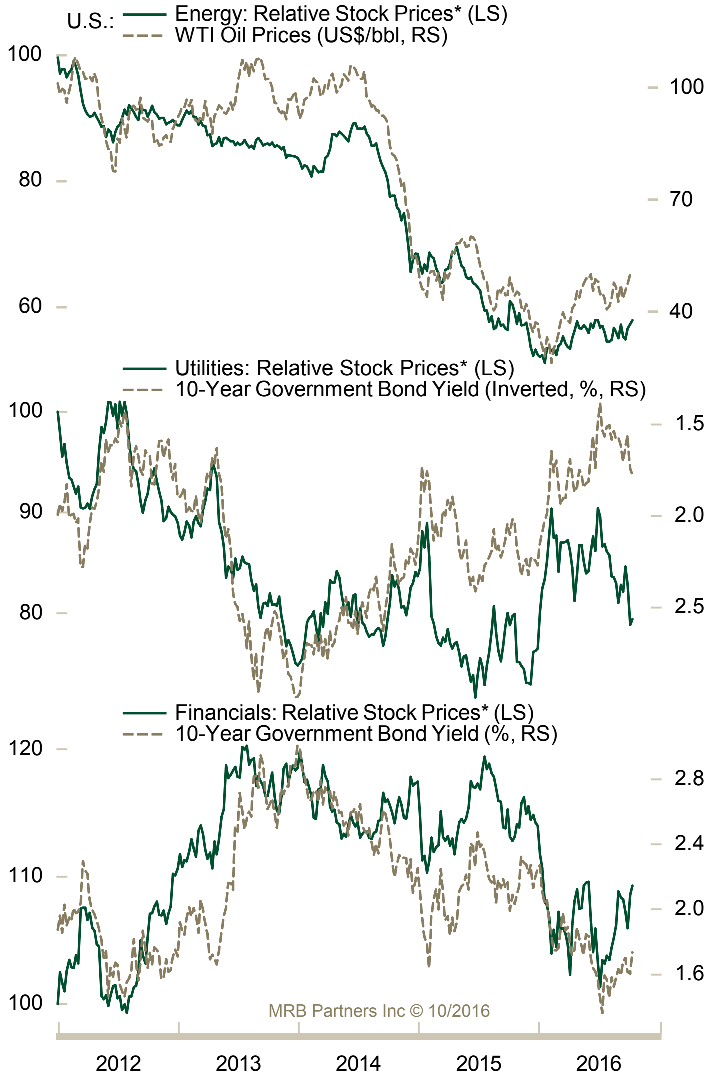
Recommendation: In anticipation of a Clinton victory, we remain favorable towards the U.S. health care sector, with a preference towards managed care companies and health care facilities (i.e. hospitals), while avoiding specialty pharma and drug distribution companies. Those betting on a Trump win, should have the reverse industry preferences and less exposure to the overall health care sector.

Energy: The performance of the overall energy sector will be driven much more by global oil and gas prices than politics (**chart 5**). In this regard, we expect the oil market will remain characterized by oversupply, helping to soon cap the bounce in prices and erode the appeal of the overall sector[6]. That said, the November election will have important long-term implications for how the U.S. approaches climate change, which will impact various stocks within the energy sector[7].

Clinton is an advocate of environmental policies and supports renewable energy. Her Clean Energy Challenge and plans to turn the U.S. into a clean energy superpower would accelerate the move towards renewable energy and benefit the business prospects of solar and wind power firms. Conversely, fossil fuel plays such as conventional exploration & production (E&P), energy services, and coal-mining companies would see their growth potential constrained due to Clinton's opposition to offshore drilling and mining on federal lands. That said, fracking would not be hurt as many fear, since natural gas is the cleanest burning fossil fuel available for power generation.

Trump sees the fossil fuel industry as an important vehicle for job growth and favors removing regulatory barriers to oil and gas development. Trump would boost prospects for conventional energy plays. Coal companies would get a lift from his plans to roll back environmental regulations. A number of energy names, ranging from E&P to energy services and pipeline companies would also benefit from Trump's America First Energy Plan. On the flip side, Obama's signature policies on climate control will likely be dismantled. Wind and solar companies would fare less well given his hostility towards climate change regulation.

Chart 5 Macro Factors Drive Relative Performance Of Major Sectors



* Rebased; relative to U.S. equity benchmark; source: MSCI

Clinton benefits renewable energy, while...

...Trump supports conventional energy plays

Recommendation: We continue to avoid the overall energy sector. However, within the sector, renewable energy stocks will fare better with a Clinton victory, provided these companies can improve their earnings performance. Conversely, a Trump win is best for conventional energy plays and would provide a near-term boost for coal stocks (which remain an appealing Trump hedge), although structural forces will remain a longer-term drag.

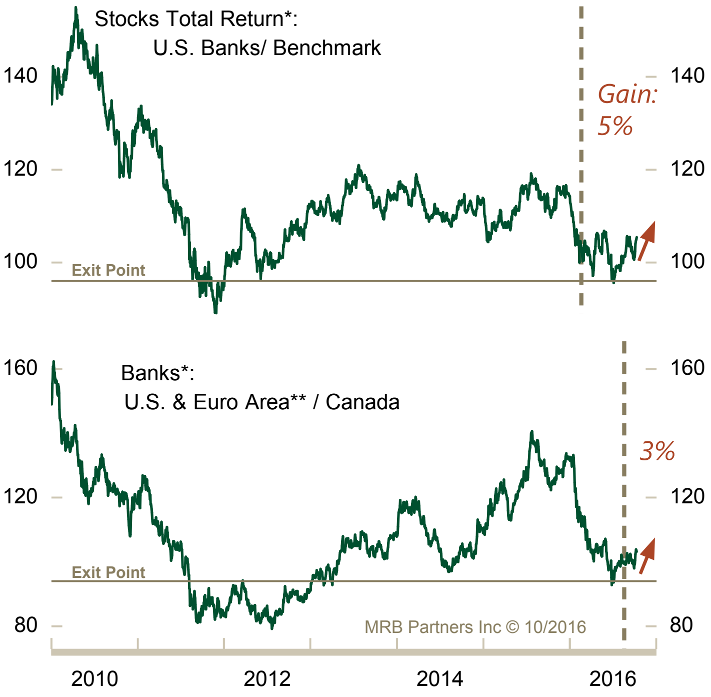
[6] *Weekly Macro Strategy Report*, September 30, 2016

[7] MRB *Equity Sectors Research Highlight*, "*U.S. Energy and Utility Stocks: The Politics Of Climate Change*", October 11, 2016

Utilities: The outlook for bond yields will be the dominant performance driver of the U.S. utilities sector (**chart 5**). However, on the margin, Trump will be more favorable for utilities, given his plans to cut environmental regulations[7]. Conversely, utilities with large coal-fired assets would face headwinds from a Clinton victory. Increased subsidies for alternative energy providers add more renewable capacity and increasingly stringent environmental regulations force power companies to restructure their generating portfolios towards cleaner sources of electric power.

Recommendation: We are not favorable towards the utility sector given that valuations are unappealing, at a point when we expect bond yields to rise and investors to seek more growth exposure following a Clinton victory. For those looking for a hedge against a Trump win and the likelihood of a near-term selloff in equities and drop in bond yields, we find more appeal in the U.S. telecom sector, which offers a better valuation cushion (**chart 4** on page 5).

Chart 6 MRB *TradeBook*: Bank Positions



* U.S. dollars; source: Datastream
** Equally-weighted aggregate
Note: Total return rebased at initiation of trade; vertical line denotes when MRB initiated trade

Financials: The dominant driver of banks and the overall financial sector will be the health of the economy (which supports credit growth and higher collateral values) and the slope of the yield curve. We are reasonably upbeat on growth prospects and the sector is cheap, making it appealing. Nonetheless, Trump is viewed as being more beneficial for the banking industry, given his plans to roll back regulations. Also, he may push the Fed to lift rates and steepen the curve, within an unknown chance of succeeding. That said, Clinton is a moderate when it comes to the financial sector. Her policies would result in additional costs for financials, but in most cases they are modest. Also, the Fed would resume its tightening campaign, helping to lift bond yields. Finally, even Clinton-supporter Elizabeth Warren has shifted focus to individuals instead of companies.

Trump is better for large banks, but Clinton won't be that negative

Recommendation: The ***MRB TradeBook*** has a long position in U.S. banks versus the benchmark as well as against Canadian banks (**chart 6**).

Infrastructure: Clinton and Trump both plan to undertake substantial infrastructure spending programs, although Trump may be limited by budget constraints. However, there are limited pure plays on this theme since most machinery and engineering companies have sizable exposure to commodity end markets. Instead, construction materials firms are probably better positioned, although we would broaden it to the global industry to add diversification.

Construction materials stocks are appealing

Recommendation: Global construction materials stocks are appealing.

Defense: Both presidential candidates plan to increase defense spending. Trump has larger (albeit vague) expenditure plans, but he may be restricted due to mushrooming deficits from his desire to also slash taxes and undertake substantial infrastructure spending.

Trump is more beneficial for defense stocks

Recommendation: Our equity sector team is neutral on U.S. aerospace and defense stocks, as increased government spending will be offset by elevated valuations. Nonetheless, we acknowledge that these stocks are likely to get an initial boost from a Trump victory, making it a hedge with limited downside risk.

Consumer Discretionary: In the near-term, consumer discretionary stocks will be influenced by the ability of the U.S. economy to create jobs and the outlook for bond yields. However, politics could play an indirect role from a longer-term perspective. Clinton's tax and benefit policies focus on redistributing incomes to lower and middle class families, which have a higher-propensity to spend. Conversely, Trump's initiatives disproportionately benefit the wealthy, with the potential exception of infrastructure spending (depending on the details), which Clinton also offers. The offset is that both candidates are proponents of lifting the minimum wage rate, which will squeeze margins in some consumer services such as restaurants.

Clinton is better for consumer discretionary and education plays

Recommendation: We are constructive on the U.S. economy, but expect bond yields to edge higher and find the consumer discretionary stocks relatively expensive. Netting these forces out leaves us neutral on this sector. However, on balance, Clinton's economic plans are slightly more favorable for these stocks.

Education: This has been largely a secondary issue in the election campaigns, despite investment being a critical longer-term element to temper escalating social and political instability. That said, Clinton has proposed providing free public college tuition for families who earn less than US$125,000. This should help increase enrollments. Trump's voucher program and suggestion of negotiating fees with colleges will have a negligible impact.

Recommendation: There are very few listed equities that touch on this theme, but a Clinton win should prove beneficial for book publishers due to the potential for increased enrolments.

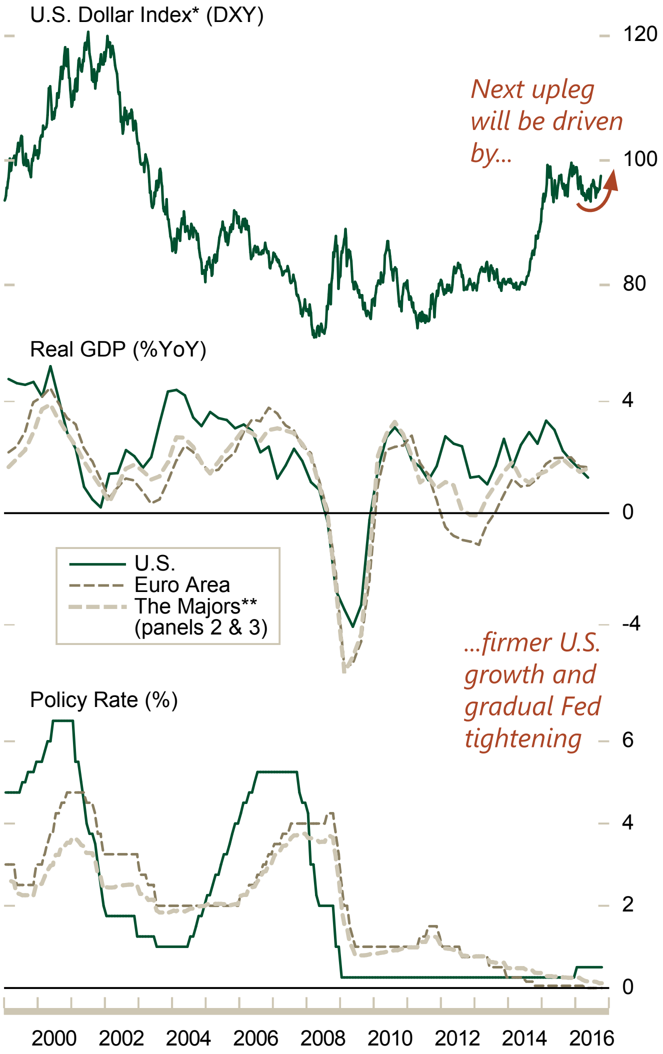
Clinton and Trump are good for the dollar, but for different reasons

Theme & Trade Updates

Clinton Vs Trump: Is The U.S. Dollar A Win/Win?

The U.S. dollar has started to gain strength recently, benefiting our long position in the DXY index. Looking ahead, the outcome of the U.S. presidential race could have dramatic ramifications for the U.S. dollar, given the dramatic difference in economic plans of the two candidates. However, either outcome will likely support the dollar ***initially***, albeit for different reasons (**chart 7**):

Chart 7 U.S. Dollar: Breakout Coming



Next upleg will be driven by...

...firmer U.S. growth and gradual Fed tightening

* Source: Bloomberg
** GDP-weighted aggregate of Australia, Canada, euro area, Japan, New Zealand, Norway, Sweden, Switzerland and the U.K.

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Clinton Victory: Clinton's economic plan is mildly pro-growth, without resulting in sizable deficits. The boost to the economy is largely through infrastructure spending (which we expect will need to be increased somewhat) and a gradual redistribution of incomes to those with higher propensity to consume (via her tax plan and infrastructure-related jobs). This should marginally widen the relative growth gap of the U.S. with the rest of the world, benefiting the dollar. However, the more significant support will likely be from widening interest rate differentials, as the Fed resumes its tightening campaign in December and by helping to slowly bring forward rate hike expectations.

In this backdrop, we would expect appreciation of the U.S. dollar to be gradual and more narrowly defined. The currency should perform best versus the euro, yen, and commodity currencies (i.e. those where central banks will need to keep interest rates anchored to support growth, rather than follow the Fed). Conversely, currencies of non-commodity exporters, including those in emerging Asia, Mexico, and Sweden may modestly outperform as the global trade cycle is likely to edge up and Clinton is not focusing on anti-globalization policies.

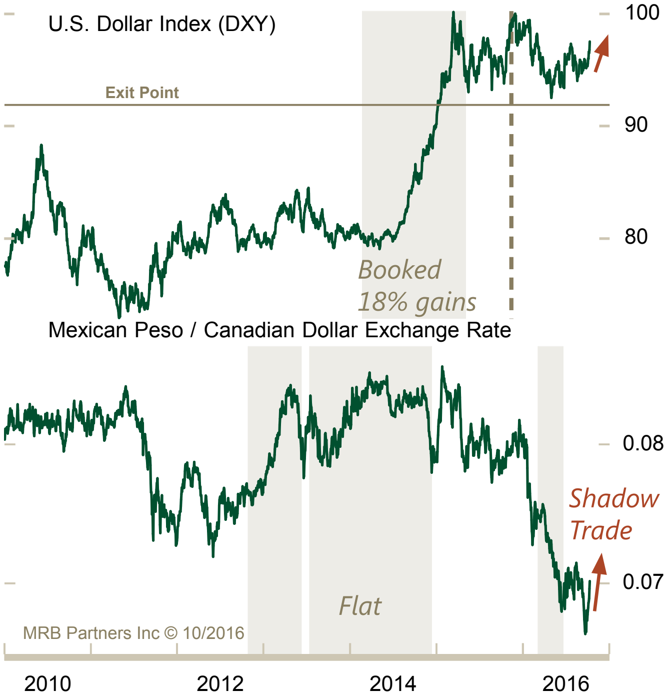
Trump Victory: A win by Trump could also benefit the U.S. dollar initially, but largely for deflationary reasons. He would create a tremendous amount of uncertainty on a number of fronts and make foreign investors much less eager to hold U.S. assets. However, Trump's anti-trade policies would likely lead to sharp deterioration in the outlook for export-oriented economies, causing their currencies to depreciate. The initial tailwinds for the U.S. dollar could persist on a one-year horizon if he focuses on fiscal spending (rather than tax cuts) and pressures the Fed to hike rates.

Clinton's economic plans should support gradual dollar strength

However, over the longer-run, a Trump victory would be structurally bearish for the U.S. dollar. His proposed deep tax cuts would disproportionately benefit the wealthy, who have a low propensity to consume. In turn, this would result in substantial deficits with only a marginal increase in economic growth (i.e. the U.S. is already low on the Laffer

Curve[8]). Combined with a substantial leverage-financed infrastructure spending program (if approved), it would send the country on a path for a sovereign debt crisis[1]. At the same time, his anti-immigration and anti-trade policies are bearish over the long-haul for the currency. While his plan may temporarily protect a few low skilled jobs, it effectively uses taxpayer dollars and/or saps consumer discretionary incomes to subsidize and protect inefficiencies. This is stagflationary. The erosion of competitiveness of the nation and long-term potential growth will make the U.S. dollar less attractive. In fact, any nation attempting to pull back from globalization will weaken itself over the long-haul and provide a structural short opportunity for currency traders. To this end, the U.K. pound has already felt such a backlash, while we expect the U.S. dollar would experience it over a multi-year period.

Chart 8 MRB *TradeBook*: Currency Positions



Note: Vertical line denotes when MRB initiated trade; shading denotes when MRB previously held trades

In this environment, the initial bounce in the U.S. dollar would be against a different mix of currencies than with a Clinton victory. Specifically, the strongest gains would be versus non-commodity exporters (particularly Mexico and Canada), while the euro, Swiss franc and yen should hold relatively firm as investors seek non-U.S. alternatives. The Russian ruble would also benefit, but because of Trump's desire to align himself with Putin. Over the longer-term, we would expect the world to accelerate its evolution away from using the U.S. as the world reserve currency and towards basket of the majors (including China) as part of a new monetary regime. The dollar would structurally weaken. While most economies would weaken from a reduction in globalization, the U.S. dollar may lose its reserve currency status, especially if it leads the charge and pushes its government debt limits.

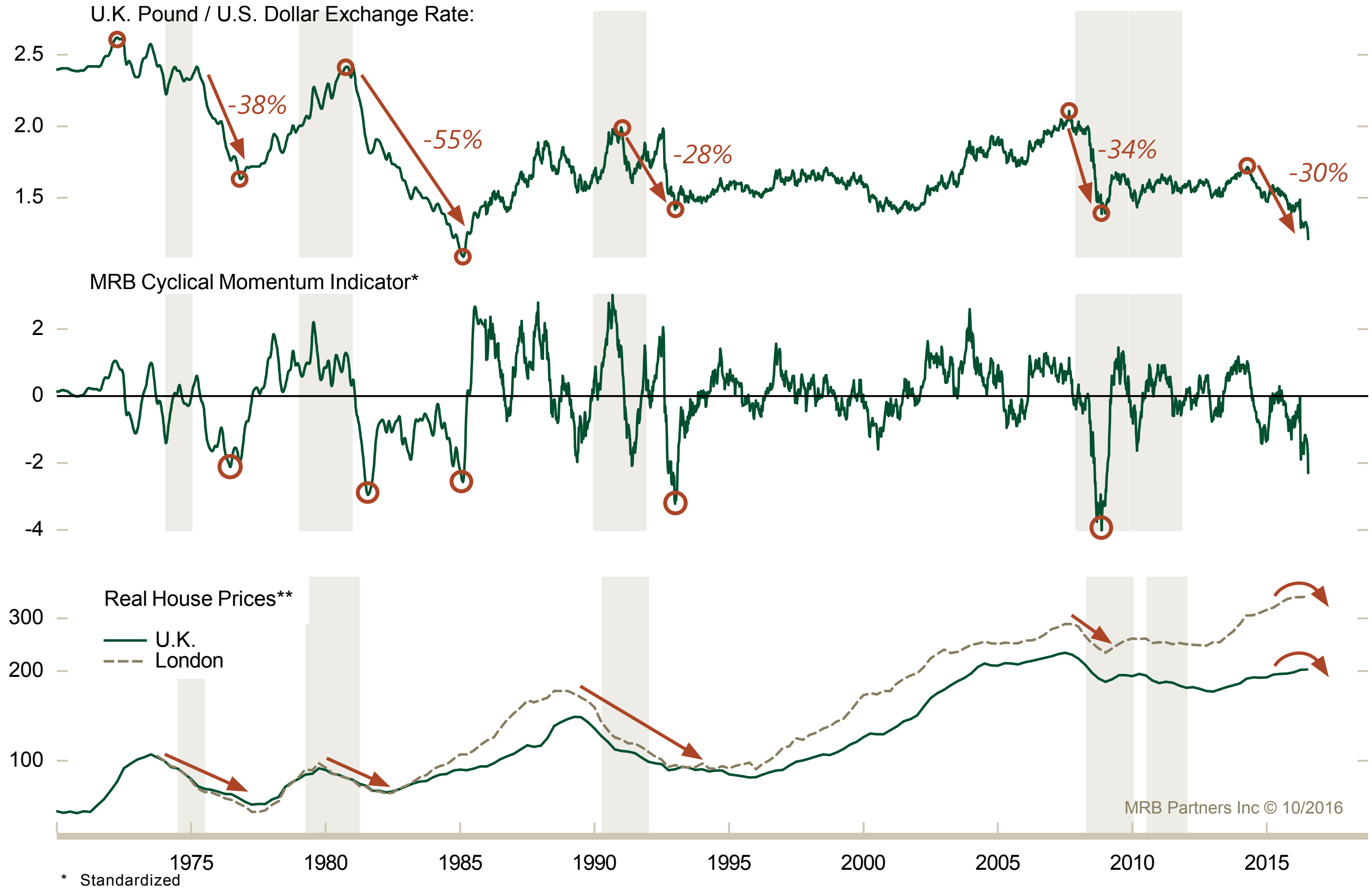
Trump would cause a short dollar boost followed by a structural decline

Note: The Congressional outcomes will undoubtedly influence the impact of the next President on the U.S. dollar by tempering their economic plans. This may mute the magnitudes of potential swings in the U.S. dollar, but it is unlikely to alter the directional profile.

Final Word: *We are long the U.S. dollar index (DXY), which is up 1% (note that we previous booked 18% on our long U.S. dollar position,* ***chart 8****). If Clinton wins the election, we will likely maintain our exposure. If Trump wins, we will look for details of his economic plan to*

[8] 2016 The Laffer Curve explains the relationship between economic activity and the rate of taxation. It suggests the existence of an optimum tax rate that maximizes tax revenue. In short, when tax rates are lifted too high, economic activity becomes restrained and aggregate tax revenues are reduced. In contrast, when tax rates are already low, cutting them further does not boost economic activity materially and overall tax revenues fall. The U.S. is currently on this part of the curve.

Chart 9 U.K. Pound: Crushed Brexit Fears



* Standardized
** Shown in log scale; deflated by RPI; source: Nationwide Building Society
Note: Shaded for ECRI designated U.K. recessions

time selling into any initial strength. For those looking for a pro-Clinton currency bet with greater upside potential, we continue to recommend going long the Mexican peso versus the Canadian dollar[6] (i.e. the NAFTA cross).

Theme & Trade Updates Brexit Trades: Back In Play

The fallout in the aftermath of the June U.K. referendum vote was halted by the formation of a new government and a decision to delay filing Article 50 before starting the Brexit process. That said, the calm ended last week when Prime Minister Theresa May stated that a ***hard Brexit*** would occur by the end of March (**chart 9**). She suggested that no special provisions will be negotiated for the financial sector, taking a combative approach with banks and London to rally support among average Brits. Fortunately, the Prime Minister appears to have backed off somewhat this week by allowing Parliament to have an input into her terms, albeit it is still fairly vague what this means.

The economic pain of Brexit has not even begun

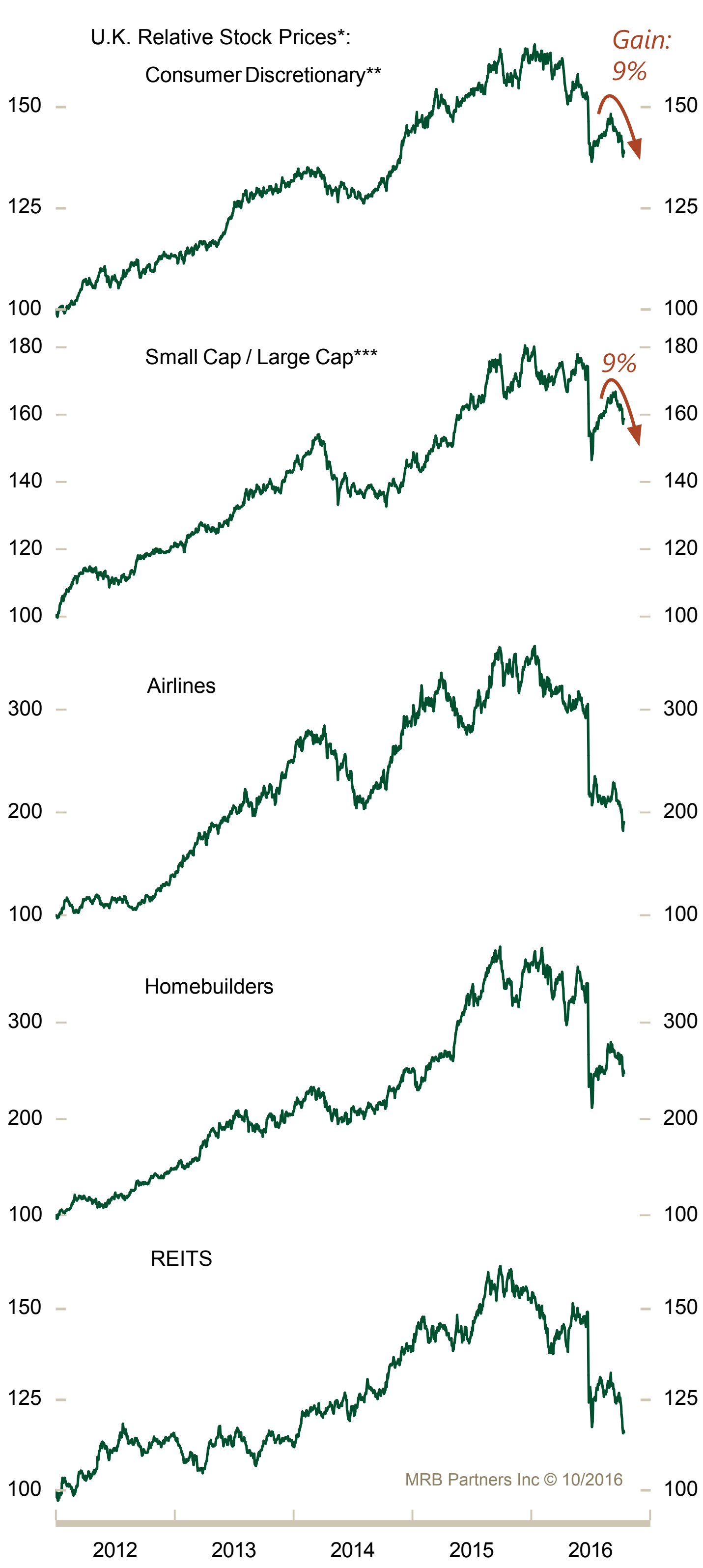
Regardless, an eventual Brexit will entail a loss of open access to the EU market, with adverse effects for U.K. goods and services exporters. Living standards would be impacted by layoffs, relocation of businesses, and higher import prices. However, the major threat is that weakness in the economy could become amplified by the bursting of the housing and credit bubble, causing a painful deleveraging cycle. MRB has published several research reports on the impact of Brexit[9], including one on U.K. equities earlier today[10]. For absolute return investors we have offered both long and short opportunities and are revisiting these positions, given recent events (**chart 10** and **chart 11**).

Short Opportunities:

- **Short GBP/USD:** The pound has now become cheap and oversold versus both the U.S. dollar and the euro, suggesting that significant economic weakness is now priced. That said, we doubt any rebound will be material or sustained, given that relative growth and interest rate differentials should both work against the currency. Also, the pound tends to melt either during or immediately following U.K. recessions, in part because real U.K. home prices have fallen during every recession since the 1970s (i.e. U.K. real estate is a boom/bust market and amplifies swings in the economy). The typical peak-to-trough decline during past recessions has been 35-40%, which (if repeated) would cause the currency to retest its 1985 low. We are underweight the pound in our asset allocation recommendations, although only have short exposure in the ***MRB TradeBook*** as part of our long DXY trade (see above).

- **Short U.K. Consumer Discretionary/Long Broad Market:** We added this pair trade following the U.K. referendum outcome (up 9%). The consumer discretionary sector has underperformed as it includes domestically-focused retailing, housing and leisure

Chart 10 Short Brexit-Related Trades



* Local currency; rebased; relative to the U.K. equity benchmark; source: Datastream

** Local currency; rebased; relative to the U.K. equity benchmark; source: MSCI

*** Local currency; rebased; source: MSCI

[9] MRB *Theme Report*, "*The Brexit Aftermath: Impact On Global Growth And Strategy*", June 29, 2016; MRB *Theme Report*, "*The Brexit Dominos*", July 7, 2016; and MRB *U.K. Report*, "*Betting On U.K. Fallout: An Update*", August 24, 2016.

[10] MRB *Equities Research Highlight*, "*Implications Of A "Hard Brexit" On U.K. Equities*", October 13, 2016

stocks. We paired the sector against the U.K. benchmark which is comprised of defensive stocks (40% of total market cap) and globally-exposed cyclical sectors (25%) that benefit from a weaker pound. We are now tightening stops to protect 5% of the profits.

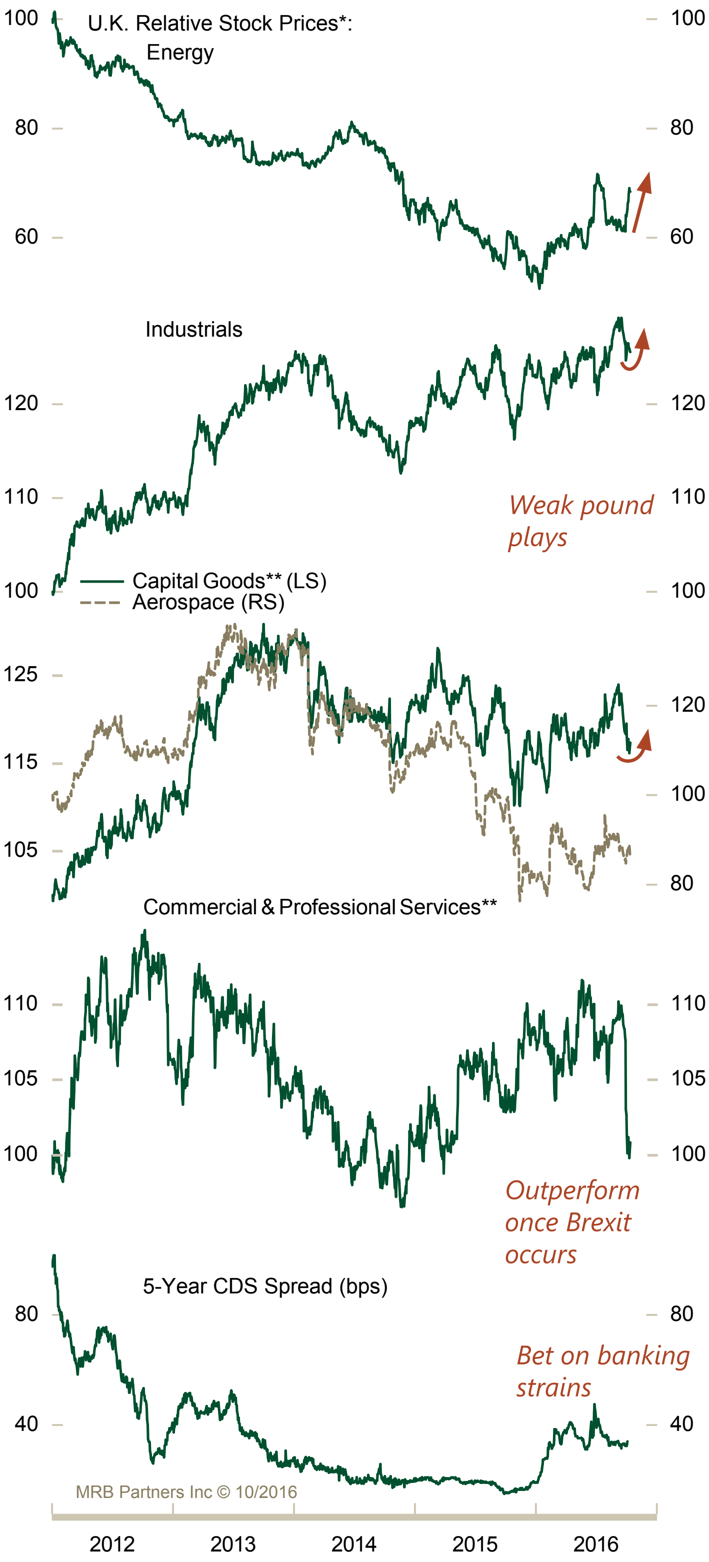
❍ **Short U.K. Small Caps/Long Large Caps:** We pulled the trigger on this equity pair trade upon the announcement of the referendum outcome (up 9%). Small caps have more cyclicality and greater domestic orientation, which will lead to underperformance as the U.K. economy deteriorates. Moreover, relative valuations are unappealing. For now, we are tightening stops to protect 5% of the profits.

❍ **Short U.K. Airlines/Long Broad Market:** Airlines stocks (particularly discount airlines) are a pure play on a currency depreciation and economic weakness, both of which will hurt airline demand. This is an equity proxy for a short pound position, particularly one that is driven by U.K. economic weakness, rather than U.S. strength. We do not have a formal position but recommend maintaining a short bias.

❍ **Short Homebuilders & REITs/Long Broad Market:** These stocks were punished on the referendum outcome. This is largely because of how visible the real estate bubble has become. The bounce in the weeks that followed has abruptly ended and another downleg is underway. Those that are short real estate stocks should maintain the position but use trailing stops to protect gains, given these stocks are now deeply oversold.

Note: Banks have ***not*** been our preferred short bet since the industry includes large global names and was already very affordable heading into Brexit. Also, the BoE is trying to protect profitability of U.K. banks through creative unorthodox policies and by not dropping policy rates into negative territory. Although we expect banks to eventually face strains, this is not a near-term issue.

Chart 11 Long Brexit Related Trades



Weak pound plays

Outperform once Brexit occurs

Bet on banking strains

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* Local currency; rebased; relative to the U.K. equity benchmark; source: Datastream

** Local currency; rebased; relative to the U.K. equity benchmark; source: MSCI

Long Opportunities:

- **Long Global Exporter Stocks /Short Broad Market:** Global exporters will benefit from the competitiveness boost from a weaker pound. Those with substantial domestic costs will also benefit from wider operating profit margins. For the most part these are included in large caps (see above), as well as the industrials and energy sectors.

- **Long Commercial & Professional Services/Short Broad Market**: These stocks have been smashed but could become appealing once Brexit is underway. The relocation of corporate headquarters and corresponding shift in employment should benefit some commercial and professional services stocks (at least in relative terms), given that these companies will help facilitate the transition.

Avoid U.K. domestic risk assets and favor the exporters

- **Long CDS Spreads:** U.K. CDS spreads are still historically low, especially relative to levels experienced during the double-dip euro area recession in 2011-2012. As such, they provide relatively cheap insurance for investors looking to bet on a U.K. recession. The caveat is that banking system strains need to develop before U.K. CDS spreads will widen substantially.

Trade Updates

MRB *TradeBook* Housekeeping

Recent market volatility has triggered stops on two of our existing trades:

- **Short Bloomberg Luxury Goods Vs Broad Market:** This position experienced a mild selloff in recent weeks, triggering our stop and causing us to book a 10% gain. We are moving this trade to the ***ShadowTrades*** and will look to re-enter in the upcoming months. The global luxury complex was in a bubble that has already started to burst in response to the Chinese crackdown on luxury bribes and the abrupt slowdown in commodity-related wealth accumulation. Political pressures to rebalance extreme income inequality around the globe are likely to add further headwinds in the years ahead.

- **Long Chinese Banks Vs Australian Banks:** This pair trade rallied materially since we initiated it in May, but the recent pullback has triggered our stop. Consequently, we are booking a 20% profit on this position and will move to the sidelines for now. While Chinese bank stocks are priced for a bleak outcome that is unlikely to materialize, we are becoming more concerned about the potential for a downturn in the Chinese property market next year and renewed hard landing fears[11].

Phillip Colmar | Santiago Espinosa

[11] **MRB *China Research Highlight***, "***How China's Property Boom Goes Bust (Again)***", October 11, 2016

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Independent Investment Strategy

October 13, 2016

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