



“ One of the symptoms of an approaching nervous breakdown is the belief that one's work is terribly important.

- Bertrand Russell



Summary:

Something remarkable happened two weeks ago. President Donald Trump, with the help of Democrats in the US Congress, managed to strike a deal on the US debt ceiling. An impasse on lifting the debt ceiling would have caused a disaster much worse than any hurricane. The agreement stunned seasoned political experts who, for years, had become accustomed to bitter partisanship and dysfunction in Washington. Trump showed once again that he does not belong to any party or ideology. He is in the White House to promote his legislative agenda and he is ready to make deals. If the establishment Republicans dislike this, then so be it. Trump likes to do deals. However, since this is politics, there will unlikely be a long-term Trump-Democrat lovefest. Democrats (and the media) will be back to hating Trump again quite soon. With the US debt ceiling suspended until mid-December, the major macro-risk for US equities has receded. As the hope for US tax reform is raised, it is hard to see what could stop the S&P500 Index (SPX) from continuing to climb till the end of the year. One main theme last week was better than expected inflation numbers in the US, the UK, China, and India.

Trump and the art of the deal

There is no love lost between US President Donald Trump and the left-leaning media (most of the media in the US). The dislike is so tribal that if Trump were ever to develop a cure for cancer, he would be accused of causing a surge in the population. Yet something remarkable happened two weeks ago that seems to have changed things, at least for now.

Trump, with the help of Democrats in Congress, managed to strike a deal on the US debt ceiling. An impasse on lifting the debt ceiling would have caused a disaster much worse than any hurricane. You will recall my worries in [last month's newsletter](#) about the risks that lay ahead. The agreement on \$15.25 billion in relief for Hurricanes Harvey and Irma, combined with a three-month extension of the government's funding and its borrowing limit, stunned seasoned political experts, who for years had become accustomed to bitter partisanship and dysfunction in Washington. The Senate approved the measure 80-17. All seventeen opponents of the Bill were Republican, many of whom wanted to see steps taken to reduce the deficit. What could have been a contentious and bitterly contested process, became a speedy and overwhelming vote.

It's worth reminding readers that in 2013, Donald Trump had tweeted - "I cannot believe the Republicans are extending the debt ceiling — I am a Republican & I am embarrassed!"

Trump showed once again that he does not belong to any party or ideology. He is in the White House to promote his legislative agenda and he is ready to make deals. If the establishment Republicans dislike this, then so be it. A new interest by Trump to collaborate with Democrats, if necessary against the wishes of his own party's leadership, could see deals on infrastructure, tax reform, trade policy and immigration. Trump likes to do deals. However, since this is politics there will unlikely be a long-term Trump-Democrats lovefest. Democrats (and the media) will be back to hating him again soon.

The debt ceiling has been extended and there is even talk of abolishing it. Well, they can abolish the debt ceiling but what are they going to do about the \$20 trillion of debt? The US Government is projected to spend \$4 trillion this year but it brings in only \$3.3 trillion through taxes and other revenues. The shortfall is known as a "fiscal deficit" and is paid for by new US government debt issued to those who choose to lend money to the US Treasury.

25th Anniversary of "Black Wednesday": From ERM to *Brexit*

UK Prime Minister Theresa May will fly to Florence this Friday to set out her vision of a post-*Brexit* Britain, in her most important speech since the Lancaster House speech in London earlier this year. Then, she set out the broad principles of UK's negotiating position. By choosing Florence and not London, May wants to speak directly to the people of Europe and highlight that Britain is leaving the European Union (EU) and not Europe and that it will always strive to seek closer relations with the people of Europe. People on the Continent (and indeed in this country) are fed distortions of UK's negotiating positions on *Brexit* as presented by the overwhelmingly pro-EU media. May has rightly chosen to correct that. The UK should be doing more to explain its position and this speech is a step in that direction.

This month also marks the 25th Anniversary of the UK leaving the Exchange Rate Mechanism (ERM), the precursor to the Euro). September 16, 1992 - the day Britain left the ERM - came to be known as "Black Wednesday" due to the market turmoil and the losses it caused to the UK Treasury. Arguably, the event also marked the beginning of the exit of the UK from the EU.

The decision to join the ERM was championed by John Major, who was then Chancellor of the Exchequer in Prime Minister Margaret Thatcher's cabinet. As per the rules that governed the ERM, member countries agreed to fix their exchange rates with each other. Since Germany had the strongest economy in Europe, each country set its currency's value in Deutschmarks (DM). The exchange rate was allowed to fluctuate in an acceptable band of +/- 6% of the agreed upon rate.

In October 1990, Britain finally entered the ERM at an exchange rate of 2.95 DM/GBP. Britain was obliged to keep the exchange rate in the 2.78 to 3.13 DM/GBP range. Shortly thereafter, Major replaced Thatcher as Prime Minister and the fixed exchange rate system was the centerpiece of his economic plan to combat inflation in the economy. With British monetary policy now tied by the exchange rate agreement, the government couldn't adjust the money supply and to a certain extent, the policy worked. Between 1990 and 1992, inflation decreased from +9.5% to +3.7%

In 1992, however, Britain started sliding into recession due to falling house prices. Unemployment spiked to +12.7% from

just +7.7% two years prior. If Britain were not part of the ERM it could have full control of its monetary policy and would cut interest rates to deal with the crisis. But in this case, doing so would push the currency's value below the agreed upon ERM range. As economic conditions worsened, high inflation and deteriorating economic activity made GBP less attractive and it kept falling to the lower limit in the ERM. The British government was bound by the rules of the ERM to protect the value of the Pound from breaching the agreed upon limits. It had only two options

- Increase interest rates – attract money flow and get the GBP higher
- Buy GBP with foreign exchange reserves.

However, both these policies, were further aggravating the UK's already serious economic downturn. Interest rates reached +15% (albeit for less than 24 hours), particularly impacting the housing market. With rising rates, mortgage repayments became unaffordable and default rates increased.

Britain was left with no option but to leave the ERM, a decision that was hastened when GBP came under speculative attack by the likes of Hedge fund manager George Soros. By mid-morning on "Black Wednesday," the selling of the Pound was so intense that the Bank of England (BoE) was buying £2 billion of its currency an hour. Jim Trott, former chief dealer for the Bank of England, described the day as "stunningly expensive." The cost to the British taxpayer was estimated at roughly £3.3 billion.

In hindsight, joining the ERM proved to be a disaster for the UK and leaving it started a glorious decade and a half of growth and prosperity. Britain was in control of its monetary policy once more; the Pound was devalued, helping to pull the economy out of recession.

The ERM was a mechanism effectively run by the Bundesbank, in Germany, with interest rates set according to German needs. Does that sound familiar? Member nations couldn't cut interest rate haphazardly to deal with an economic crisis. Does that also sound familiar?

Prime Minister Margaret Thatcher suspected a Europhile plot to force Sterling into a single currency and had long opposed entering the ERM, insisting that markets should set the price of the currency. She was proven right.

So who were the advocates of ERM?

The clever heads at *The Financial Times*, *The Economist*, John Major, Gordon Brown, Michael Heseltine, Neil Kinnock, to name a few. Notably, they all are opposed to *Brexit* this time around.

Where to invest?

With the US debt ceiling suspended until mid-December, the major macro risk for the US equities has receded. As the hope of US tax reform is raised, it is hard to see what could stop the S&P500 Index (SPX) from continuing to climb till the end of the year.

According to multiple media reports this week, on a personal level Trump gets along much better with "Chuck and Nancy" – Democratic leaders Chuck Schumer and Nancy Pelosi than he does with the Republican leadership – John McConnell and Paul Ryan. Trump is frustrated by the GOP's inability to write and pass any substantive legislation that advances his agenda. The most recent one being the failure to repeal and replace *Obamacare*. Since Trump doesn't owe his victory to the Republican leadership you can expect him to do more deals with the Democrats like the one he did on the debt ceiling. Positive media coverage and re-election are the only things he cares about. Trump will take a leaf out of former President Bill Clinton's book and continue to reach across the aisle and explore a compromise solution to vexing issues like tax reform, infrastructure spending, corporate cash repatriation and immigration, to name but a few. Any progress on these issues would be seen very favourably by the market.

One main theme last week was better than expected inflation numbers in the US, the UK, China, and India. As the world's major central banks – The US Federal Reserve (Fed), the European Central Bank (ECB) and the BoE head toward monetary policy shifts and gradual normalisation of rates, the risk of bond yields rising increases. In such a case, I recommended to keep increasing the weight of floating rate bonds in your portfolio. Higher allocation to floating rate bonds should also protect you from inflation surprises, which will lead to steepening of the interest rate curve. However, it's important to bear in mind that monetary policy is still extraordinarily accommodative and will remain so even after the Fed, as expected at its meeting this Wednesday, announces the shrinking of its balance sheet. Tax reform and tighter monetary policy in the US favours US financial stocks (XLF US). I expect the Fed to raise short-term interest rates only at its December meeting and not before. Any short-term surprise in inflation will likely be tolerated. Numerous members of the Federal Open Market Committee (FOMC) have emphasized a willingness to be patient while waiting to see if inflation picks up from earlier this year. Besides Financials, I continue to favour the Technology (XLK US) and the Industrial sectors (XLI).

In Europe, Eurozone growth is likely to continue to outperform consensus expectations to the end of the year at least and core inflation will grind higher to around +1.5% by the end of the year. A rate rise is not on the horizon and the ECB will likely start winding down its Asset Purchase Program (APP) beginning in Q1 next year, with a small deposit rate hike coming at the end of Q3. After having left interest rates on hold in August, the BoE is expected to raise interest rates by 25 basis points at its November meeting. This should keep GBP/USD buoyed and it is likely to trade in the 1.35 to 1.40 range over the next month.

As rate normalisation starts in the US, be wary of its impact on Emerging Markets. It is not of immediate concern, but if you hold an overweight position in Emerging Markets, it may be worth reducing this to equal weight or underweight.

The risk to US equities looks to the upside so what could change all that?

As always the key factor will be Fed and other central banks' balance sheet policy. Will the balance sheet reduction be smooth, or will it cause consternation? There are also external geopolitical events, namely North Korea. There is also the risk of the Trump administration pursuing a more aggressive trade policy that could result in retaliatory actions by its trading partners.

In terms of stocks I like: JP Morgan (JPMUS), Bank of America (BAC US), Citi (C US), BNP Paribas (BNP FP), Barclays (BARC LN), VISA (V US), Blackrock (BLK), Allergan (AGN UN), Celgene (CELG UW), Gilead Sciences (GILD US), General Electric (GE US), Boeing (BA UN), Apple (AAPL UN), Google (GOOG US), Microsoft (MSFT US), Amazon (AMZN UW), Alibaba (BABA US), Baidu (BIDU US), Salesforce (CRMUS), Comcast Corporation (CMCSA), Home Depot (HD UN), CBS Corp (CBS US), Pfizer (PFE US), Estee Lauder (EL US), Glencore (GLEN UN), Rio Tinto (RIO LN), Freeport McMoran (FCX US), Pioneer Natural Resources (PXD), Schlumberger (SLB US)

Best wishes,

Manish Singh

Manish Singh, CFA

United Kingdom

9 South Street
London W1K 2XA
United Kingdom

Singapore

One Wallich Street
#24-05 Guoco Tower
Singapore 078881

Monaco

Le Park Palace,
Bloc A, 8ème Etage
5, Impasse de la Fontaine
98000 Monaco

Visit our website:

crossbridgecapital.com

