CROSSBRIDGE CAPITAL

Market Viewpoints

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Under capitalism, man tries to exploit man using voluntary exchange; under socialism, man exploits man using government force

- Will Spencer

Summary:

Imagine an election in the US without a Democratic or Republican candidate. That's what we have in the runoff for the French Presidential election on May 7. Emmanuel Macron, the favourite to win, will find that winning is the easy part. Despite Macron's success in the first round, the death of populism has been greatly exaggerated. 48% of the votes in the first round went to candidates hostile to the EU and globalization, causes that Macron champions. On the one hand, Macron is not beholden to the Left and so, theoretically, is free to make decisions that are unpopular with them. There is hope that he will act unselfishly and not cave in to leftist sentiment. On the other hand, successive Presidents and Prime Ministers in France have announced their intentions to change and reform the country, only to be successfully opposed by those who have something to lose. UK Prime Minister Theresa May surprised everyone last week by calling a snap general election for June. With her party 23 point ahead in the polls, May is expected to win this election in a canter. May has called the election because the country is coming together, but Westminster is not. The Tories have long been written off as English right-wingers, winning only token representation beyond the English borders. Polls indicate that all this is about to change and the Tories are on track to becoming the formal opposition to the SNP in Scotland and the biggest party in Wales.

Britain goes to the polls (again)

Harold Wilson, the former Labour Prime Minister of the UK famously said - "a week is a long time in politics." Were he alive today, he would realize that he was understating it. These days, a week can be a lifetime in politics. Prime Minister Theresa May surprised everyone last week by calling a snap general election for June. With her party 23 point ahead in the polls, May is expected to win this election in a canter.

One has to go back to Harold Wilson and 1970 to draw a parallel with when an incumbent Prime Minister, sure of a victory, called a snap election. Wilson's party was 12 point ahead in the polls at the time - but he lost. Could this happen again?

The only meaningful question being put to voters now is this: Do you trust Theresa May to deliver? A YouGov poll for *The Sunday Times* suggests that by a margin of 48% to 26%, voters back her decision to call the election and more than half of those with an opinion, believe a landslide would be good for the country. A swing of five percentage points from Labour would give the Prime Minister a 100-plus majority, but that also implies being some 16 points ahead in the national vote. The Conservatives are currently 22-25 points ahead nationally. Such a lead has not been seen since the 1930s. In 1970, the Tories won as the challenger, this June they will win as the incumbent.

May has called the election because the country is coming together, but Westminster is not. The Prime Minister's call for a snap election is more than justified and represents astute leadership. The Tories have long been written off as English right-wingers, winning only token representation beyond the English borders. Polls indicate that all this is about to change and the Tories are on track to become the formal opposition to the SNP in Scotland and the biggest party in Wales. Strong showings in Scotland and Wales would help May secure a big majority in Westminster. It would establish the Tories as a truly national party.

A large majority in the House of Commons would also free May to strike a determined approach (and where necessary, sensible compromises) in *Brexit* negotiations with the European Union (EU). She would be able to stand up to both the ultra Eurosceptic backbenchers and the "Remainers" within her party. May does not wish to rely on marginal groups of MPs, whether Labour or Tory, to get any sort of *Brexit* deal through. She wants to have a solid majority of Tory MPs, so that she can confidently rely on this majority and not be hostage to any minorities.

Macron will beat Le Pen, and then what?

Imagine an election in the US without a Democratic or Republican candidate. That's what we have in the runoff for the French

Presidential election on May 7. Emmanuel Macron, the favourite, will find that winning is the easy part. Macron is like that ice-skater trailing the pack, hoping that the others all fall over; and fall over they did – Sarkozy, Juppe, Fillon, Hollande, Vals.

Despite Macron's success in the first round, the death of populism has been greatly exaggerated. 48% of the votes in the first round went to candidates hostile to the EU and globalization, causes that Macron champions.

The next generation seems more Eurosceptic and less globalist than the current one. Marine Le Pen beat Macron 25.7% to 21.6% in the 18 to 25 age group. Youth unemployment seems to be a reliable indicator of political restiveness in the current turbulence. Nearly 25% of France's youth are shut out of the labour force. In comparison, the youth unemployment rate is 10% in the UK and 6% in Germany.

On the one hand, Macron is not beholden to the Left and so, theoretically, is free to make decisions that are unpopular with them. There is hope that he will act unselfishly and not cave in to leftist sentiment. On the other hand, successive Presidents and Prime Ministers in France have announced their intentions to change and reform the country, only to be successfully opposed by those who have something to lose.

Progress in France or any other European country will come only if it denounces Socialism/Big State as a failed experiment. France's government spending as a % of GDP is now at approximately 60%, a steady increase from 40% in 1981. Unfortunately, Socialism is entrenched in French society and politics. Of the five main candidates in the first round last Sunday, only Francois Fillon is not a Socialist, and he lost. Social welfare over the years has entrenched entitlement and eroded the work ethic and political honesty to the point of no return. When unions take to the streets to protect their generous terms of employment, the people tend to agree with them. Support for strikers is often high even among those most inconvenienced by the strikes. The comfortable middle class in France likes to think of themselves as radical stone-throwing students. Those who stand to benefit from reforms the most are the ones who undermine then.

The problem Macron faces is that the negative political consequences of his decisions as President, will manifest themselves long before the positive economic effects are felt. It will require significant political courage to stay the course - something that is in remarkably short supply in France.

The big risk for France - Hollande sought power by making impossible promises and he discredited the traditional Left. Macron also looks to write cheques that he may not be able to cash. If the Centre is also discredited, who comes next?

When it comes to winning power in France, Front National strategists, in private, like to say that 2022 is their real goal. Le Pen is only 48 years old. Her day may yet come.

Where to invest?

In the US, growth is anticipated to be +2% this year and +2.5% next year. The US Federal Reserve raised interest rates in March and I expect at least two more hikes this year - one each in Q3 and Q4. The Fed is gearing up to announce the tapering of balance sheet reinvestments, in a sign they feel that economic growth will accelerate. Meanwhile, in Europe, various economic surveys continue to paint an improving picture of the economy. The economic recovery appears to be broadening. Headline inflation though volatile lately; indicates a trend of modestly higher inflation. However, that may not be enough to worry the European Central Bank (ECB) in any way from changing its monetary policy stance over the next six months.

However, with political risk reducing in Europe, the ECB may indulge in "verbal easing" at its June meeting. European sovereign yields have been rising lately and any further rise in yields will greatly benefit financial stocks. Both US and European financial stocks are a good bet in this respect.

In Europe, the consensus expectations are for an over +40% rise in banks sector earnings followed by +12% in 2018. Besides the regulatory environment may not be getting any tougher, if anything it may get a little easier. Banks would benefit from higher interest rates and steeper yield curves. This is also one reason why European equity indices could outperform the US over the next couple of quarters. Financials make up less than 14% of the US equity market but 20% in Europe. Some markets in Europe, particularly in the periphery (Italy, Spain), have high financials weightings; 37% for Spain and 40% for Italy. Asia ex-Japan also has a high 27% weighting in Financials.

Therefore, in an improving risk and gradually rising yield environment, Europe, Japan and Emerging Markets could all do better than the US. Besides Financials (XLF), Technology (XLK) and Industrials (XLI) are the two other sectors that I like.

Yesterday, US Treasury Secretary Steven Mnuchin unveiled President Trump's new tax plan. The plan cuts the top income tax rate to 35%, lowers the business tax rate to 15%, doubles the standard deduction, cuts the top capital gains rate and repeals the estate tax, otherwise known as the "death tax." The plan will also eliminate all individual tax deductions, except mortgage interest and charitable donations. Mnuchin said that the Tax plan would pay for itself with growth, the reduction of certain deductions and the closing of loopholes. The tax cuts could boost US growth in the short term.

GBP/USD: Sterling rose higher with a bang after the Easter holiday, thanks to Prime Minister May who shocked the markets by calling a snap election. Investors like the pollsters believe that the Tories will sweep the votes. A strong majority government means sensible and pro-growth policies. There is still much to debate about Sterling's course over the medium-term, however, it is very likely it will continue to grind higher, stay in the 1.27-1.30 range until the election and, thereafter, settle into the 1.30 to 1.35 range.

EUR/USD: The improvement in risk appetite has taken the EUR/USD to the 1.09 level and a move higher will largely depend on the Bund and US Treasury yield spread. US/German real yield differentials are back at the same levels that accompanied the Euro's spike close to 1.09 in late-March. Rising Bund yields due to rising growth expectations will keep the EUR/USD buoyed, but do not expect the ECB to bid it up further. ECB President Mario Draghi's comments last week, indicated that monetary policy will remain accommodative. The biggest problem for the ECB is the rising Euro. Inflation is low and the recent strength of the currency only drives price pressures lower. Expect the currency pair to trade in 1.08 - 1.12 range in the short term and hit 1.15 by year end, if political risk continues to recede.

Best wishes,

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