High stakes poker

News Analysis

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The UK formally activates Article 50, beginning what is set to be a very challenging negotiation process.

Markets have stabilised in the last week, after the brief blow off caused by Trump disappointment, the decline in commodities and profit taking in equities. Risky assets have cautiously gone up, credit spreads have tightened and the decline in core government bond yields has stabilised. Commodities have been the big mover, with oil jumping around 5% since last week. It has felt like a quiet week, but there has been at least one momentous event.

Theresa May activated article 50 in the UK, officially triggering negotiations for the divorce between the UK and Europe. There has been a lot of media coverage and a fair amount of handwringing, but our view on the story has not changed. It is going to be an incredibly challenging process, and it will generate huge uncertainty. It is instructive to read that Theresa May has threatened a reduction in co-operation on counter-terrorism in the event that the EU does not play ball. This highlights a high stakes poker game that cannot be constructive for investment or general sentiment towards UK assets.

Turning to Europe, time spent with key policy makers within the European Central bank (ECB) early in the week has given us the sense that the ECB is deliberately pushing back on the idea that rates will rise soon. The ECB is clearly uncomfortable with price action at front end European rates where yields have risen to price in a rate cut on a one year forward looking basis. The second derivative of this more dovish spin from the ECB is that the periphery is looking ever more attractive. French election risk has receded further into the background and on no new news we hasten to add. Despite our base case belief that Emmanuel Macron will ultimately win the election, we are alive to the risk this event still poses for markets. There is a nagging fear that we have yet to pass the point of maximum stress on this story.

Looking ahead, we continue to observe that the low volatility environment we have been in since the start of the year cannot continue for much longer. Markets have completely discounted delivery of any significant policy in the US. Expectations for stimulative domestic policy delivery from Trump and the Republican Party have plummeted. We are not ready to jump on board on this theme just yet and would observe that the balance of risks now lies towards more delivery rather than less. We will be spending more time in Washington in April, as understanding progress towards tax reform, a budget and potentially an infrastructure program will be key. In addition, we would also caution that some form of Border Adjustment Tax is definitely on the table. Markets are very much unprepared for this eventuality.

Key thematic positioning remains in place. Having said this, we are alive to the risks that lie ahead. After a quiet week for economic data, things will get tasty again with another big dump of data at the start of April. If you add this to the multiple risk events that are coming up, the French election, Brexit negotiations, tax reform, it makes for a healthy pipeline of opportunities for risk taking.

Have a great weekend, and don’t get caught out by April Fools!