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Global Monetary Alert

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EXECUTIVE SUMMARY:
New evidence that the economic downturns in Europe, Asia and Latin America, are impacting now the US (ISM in August below 50) has checked the US dollar.

This situation together with UK Parliament having some “success” in blocking a “no deal Brexit” on October 31 has brought a short squeeze on US dollar bullish positions, most acute for the British pound. The Canadian dollar also got a bid from a remarkably bullish and implausible assessment from BoC.

Bottom line: the pound short squeeze and more broadly the euro modest bounce mask should not blind us to how near both currencies are to a cliff-edge. In the UK the chances of a Far Left government have risen

A crisis of democracy in the UK, a faded prospect of a rapid US deal, and European banking woes buttress the cliff-edge concerns.

GBP and euro at cliff edge: beware the trap of short squeezes triggered by Brexit delay and US economic weakening

Ignore the sirens.

A fall in the likelihood of a “no deal Brexit” with its corollary of a raised chance of the Far Left obtaining power (albeit dependent on support from left euro-centrists and Scottish nationalists) is no opportunity to buy the GBP.

Rather, the presently exposed fragility of British democracy stemming from a recently introduced amendment to the constitution, is an occasion for pessimism.

Maybe a small number of traders smart enough to outwit a large number of fellow Pavlov conditioned traders for whom any good news about Brexit delay or softening is a buy-signal will profit from long positions established a few milli-seconds in advance, but none of that is the stuff of serious market evaluation.

UK crisis of democracy

The implications of the present crisis of democracy in the UK, alongside woes only too obvious within the remaining EU, add to a list of factors which should put us all on alert for a plunge of the GBP and euro.

Democracy and freedom are fragile at the best of times; in Europe we are far removed from any such heyday and the symptoms of ailing are painfully evident.

Just look at that scene last Saturday morning (August 31) at the Leipzig Graduate School of Management. Chancellor Angela Merkel, there to receive her honorary doctorate, was lauded (a loose translation from the school’s Latin designation of purpose) by her chosen speaker. Who? The French ex-politico (Finance Minister) found guilty of being a “companion in corruption” of ex-President Sarkozy, subsequently nominated by the EU to her next role as chief of from the IMF, now amongst other existential issues facing massive losses on loans made recently to Argentina.

Thanks to Chancellor Merkel’s deal with President Macron, this ex-politico (yes, you guessed, Christine Lagarde) is on course within weeks to head the ECB. There she is fully expected to continue implementing the radically unsound policies (negative rates, QE, massive backdoor lending) she extolled at the IMF.

Milton Friedman taught us that liberty rests on sound money: God help us in Europe, never mind Mme Lagarde’s praises of Merkel and the prospect of their great relationship ahead. Neither

woman is in doubt about the power of the German hegemon or the rightness of their “European-centrist path”, even though the shock state election results the following day in Saxony (the state in which Leipzig is located) proved a growingly deep resistance to this (the AfD polling almost as much as the CDU).

Welcome to the Europe which a coalition in the UK Parliament of “rebel euro-centrist Conservatives” (now expelled from the party), Liberal Democrats, Scottish Nationalists, and Labour is fearful of leaving in any abrupt fashion (meaning in a way which would anger the European establishment and trigger possible “disruption to the UK economy”). This coalition it seems would prefer a huge continuing “reparations” bill and indefinite membership of a common customs union, ruling out free trade agreements with third party countries and economic renaissance.

How is this coalition suddenly in a position to “wrest” power away from the government of PM Johnson as has occurred this week in the UK Parliament?

Because the last prime minister but one, David Cameron, now reportedly enjoying the fruits of Beijing “connections” (some opponents would say cronyism) agreed to a change in the centuries old (unwritten) British constitution, so that he could tempt the Liberals into a coalition government with him. That was a price he and his fellow Conservatives were prepared to pay rather than concede defeat in the 2010 general election where they failed to secure an absolute majority even against a deeply unpopular incumbent (PM Gordon Brown) in the midst of a Great Recession and global economic/financial crisis.

The change in rule was that the government could no longer at will apply to the Queen (and be granted) for a dissolution of Parliament and calling of General Election. Instead there was the Fixed-Term Parliament Act.

If this had not been enacted, the present crippling crisis of British democracy would not have occurred. PM Johnson could have made clear and certain in recent days (and weeks), that defeat in Parliament for his Brexit strategy would mean a General Election, most probably to be held a few days after the UK would have left the EU.

If PM Johnson had lost the election even under such circumstances, no doubt the new government could have turned the clock back to a soft exit. But a Conservative Party with a coherent Brexit strategy and mobilizing a Dunkirk spirit of voters against EU bullies had a good prospect of winning big.

Instead, there is now the prospect (not certainty) of a chain of events which could bring into power either without an election or after an election a government headed by the Far Left with Mr. Corbyn as Prime Minister.

It is not impossible that Mr. Corbyn could have become PM after a General Election as held the old way, but that would have been much less likely than now. The air of decay and democratic demoralization encourages not a Dunkirk spirit but a cry from the

heart for a cleansing of sort (even if totally unassailable), most of all targeted at an incompetent set of leaders (the Conservatives in recent years) who have had no strategy and bungled according to all accounts the negotiations to date, hence the present mess.

Five scenarios for UK political and Brexit drama

These are the main scenarios which now loom for the Brexit process and change of government in the UK:

Scenario 1: Both Houses of Parliament pass the Brexit Bill (ruling out no-deal Brexit) within the next week (before the start of one month's parliamentary recess). PM Johnson agrees to this bill going to the Queen for signature immediately in exchange for Mr. Corbyn agreeing to a general election in mid-October (around two weeks before Britain's exit from the EU as presently notified and already extended).

At the election, PM Johnson wins an overall majority large enough to face down any remaining Brexit opponents in his own party (shrunk by the purge now taking place) and to forego the support of the Northern Irish unionists.

Re-elected PM Johnson would be then in position to negotiate hard with the EU, extracting most likely a series of mini-deals on the way to a possible EU-UK trade deal. The so-called Withdrawal Agreement would be binned. And incidentally, no longer dependent on the Northern Irish unionists PM Johnson could offer some customs inspections at the Irish Sea ports of entry into the UK rather than at the land border between North and South Ireland.

Even so, an eventual trade deal with the EU would be far from certain especially given the lack of seriousness which PM Johnson has shown towards securing a fast-track alliance with President Trump. (Note that Iranian tanker which the UK allowed to leave Gibraltar despite strenuous US efforts to the contrary) is now suspected of offloading clandestinely to Syria).

Scenario 2: The same as 1 except PM Johnson wins only a tiny overall majority. Even so this government would move ahead with the "no deal Brexit" (in fact a series of mini-deals as described) but its negotiating potential would be restricted (and its hostage status to the Northern Irish unionists would complicate the reaching of a deal with the US, in any case problematic).

Scenario 3: the same as 1 except the ruling conservatives do not win an overall majority even with unionist support. A minority Labour government, dependent on Scottish Nationalist and Liberal support, takes power

Scenario 4; the same as 1 except the date of the election is early or mid-November and Brexit does not take place on October 31 but has been postponed to December. But PM Johnson promises that election victory means that exit from EU will take place within weeks. This is not a practical difference in the bigger scheme though Labour and Liberal parties may gain some electoral momentum from PM Johnson's having been forced to back down from his October 31 pledge, meaning defeat as in 3

more likely. A long pre-election period could work against any Dunkirk momentum helping PM Johnson triumph.

Scenario 5: Labour party does not agree to an early election even immediately following October 31 rather than before. PM Johnson does not agree to seek a royal signature to the Brexit bill before October 31. Maybe even time runs out before the Lords can pass the present Brexit bill mandating delay (allowing for filibuster). The Johnson government attempts to take the UK out of the EU as planned on October 31. The popular tumult is such that this proves impractical. The Johnson government loses a no confidence vote in late October (Parliament back in session) and Mr. Corbyn has a two-week chance (according to the Fixed Parliament Act) to form a government (meanwhile the Johnson government remains in caretaker role). In fact, Mr. Corbyn proves successful in forming such a government which can survive for several months

Implications of scenario analysis for market direction

Scenario 1 is the most positive for the British pound and even the euro beyond the horizon of the Pavlov-conditioned traders (including algorithms). The prospect of Brexit becoming a catalyst to reform of a rotten EU political infrastructure increases in likelihood. A British appeasement of Brussels could have no such effect.

Reversely the other scenarios are bad for the GBP and to some degree the euro.

The dramatic events in the UK parliament this week have increased the probability of scenarios other than scenario 1 and should thereby undermine Sterling unless the tide turns to make scenario 1 much higher in likelihood.

Opinion polls could foreshadow a change of tide (a surge in support for the Conservatives). But they could indicate alternatively that the electorate is indeed blaming the Conservatives for the failure in recent years to devise a successful strategy to EU exit.

Back to the start: the GBP could fall off a cliff rather than recovering – political instability and high inflation adding to the toxic mixture. Why could the EURO also be on the cliff-edge?

Think of the combination of economic downturn; growing European banking crisis danger (a key factor in the depth of sub-zero bond yields); a French politico taking over at the ECB certain to be as dogmatic and more so in the benefits of radical monetary policies whilst pursuing 2 per cent inflation and huge (hidden) transfer taxation and bail-outs; and not least Trump Administration trade action threats, likely to increase as recession spreads to US.