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A Game of Chicken?

- **Investors seemingly still engaged in the markets whilst fearing the future**
- **OECD cuts growth forecasts**
- **ECB cuts forecasts but promises to help**
- **Eurozone government bonds and corporate credit well supported**
- **Brexit – another seminal moment of political madness**
- **Any sign of an increase in a probability of a second referendum would lift domestic plays in the equity market, and sterling**

In a conference panel discussion this week in Singapore, we found ourselves amongst friends as we debated events in the markets. One of the panellists characterised times like a 'game of chicken'. Investors know they want to get out of markets, but they also fear missing out on the last phase of the rally. As another panellist more brutally put it, we are on a runway over a cliff, but the Federal Reserve just lengthened the runway!

When you feel that maybe too many people agree with your view it's a good time to challenge your beliefs. Is the world really that bad? Well, below we set out our views on recent developments in the eurozone and Brexit. in both cases the outlook looks bleak however to be fair, in both instances' policymakers have the potential to make a positive difference. In the case of the eurozone, the ECB will probably remain accommodating well into the future. Near zero rates and a funded financial system could be something of an antidote to the weak outlook for growth. In the UK the challenges to growth from the mess called Brexit could be at least be offset by a significant fiscal boost from the UK government.

Should it be just about taking a tactical view to take profits but with an eye to getting back into the risk markets with a passion? Our highest conviction is that the world is beset with what seem like insurmountable problems. You cannot wish away the debt. You cannot wish away the dynamics of populism. You cannot wish away climate change. Moreover, you cannot wish away the fact that global economic growth is structurally slowing. As a sobering data point, the OECD last week announced cuts to their 2019 global GDP forecast from 3.5% to 3.3%. They more than halved their 2019 GDP forecast for Germany to just 0.7%.

A sharp U-turn from the ECB
Markets were taken aback by the sharp about-turn in ECB policy at its meeting last week. The ECB cut their forecast for 2019 GDP growth to 1.1% from their December estimate of 1.7%. The change of view was one of the most significant shifts ever recorded in such a short space of time. The downgrade was mainly on the back of weaker exports as global growth slowed. Ironically latest surveys for the region's services sector point to resilience in domestic activity (as we mentioned last week). Nonetheless, the

ECB clearly feel the threat to its inflation credibility is still very real with their forecast inflation stuck below the ‘near 2% per annum’ target through to 2021.

The ECB's policy shift has come in two forms. First further support for bank lending by announcing further ‘targeted long-term re-financing operations’ The ECB will provide banks with cheap two-year loans from September 2019 through to March 2021. These measures will be included as part of the support programme for the required liquidity buffer for banks, replacing earlier expiring financing. The ECB has also committed to keeping rates unchanged until at least the end of this year. ECB President Mr Draghi will leave office without ever having raised rates as ECB President.

The ECB may feel it has bought itself some time to assess how weak growth might be this year. On the back of the ECB's downgrade, the euro moved sharply lower on the day, and Italian bond yields fell to their lowest levels in nine months. Eurozone stock markets remain of concern to investors. The chances are good that the ECB will succeed in supporting lending to domestic business, but the eurozone economies fate still lies in progress on trade talks, the prospects for the Chinese economy as well as the manner of Brexit. All the challenges for the eurozone should ensure that any ECB interest rate hike remains a distant prospect capping any recovery in the euro at least until the second half of 2019.

Eurozone equities have performed relatively well in the past few months helped by the ongoing weakness of the euro and the cheap valuation. Eurozone bond markets look well supported by ECB policy with corporate credit likely to see good interest from investors.

Brexit - are we there yet?
Here we go again - another ‘crunch point’ comes into view this week. With the clock almost arrived at the legislated Brexit Day, March 29, it must surely be a watershed point even if the can is kicked down the road again. The talks between the British government and the EU on amending the Irish ‘back-stop’ do not appear to have been successful. Hence there is no indication that the UK government can overcome the 230-majority shortfall that occurred in the first meaningful vote earlier in January. A second defeat on Prime Minister May’s proposal we feel is likely to be followed by defeat also for the No-Deal option the following day, which leaves us with some decisions to be taken by parliament with the form and length of extension of the Article 50 deadline. Mrs May is likely to prefer a short, targeted extension that will keep the pressure on euro-euro-sceptics and europhiles to compromise around her draft Withdrawal Agreement. The compromise might include some EU27 concessions at the last moment at the end of May/June (the Prime Minister hopes) when confronting a more dramatic cliff-edge to the end of membership. There is not much new news here for UK financial markets as the arguing continues and attrition wears down all but the ardent fanatics.

The more intriguing scenario is one of a significant extension of the negotiations (to end 2019 or 2020) either because the EU27 refuses to offer a short delay, or that the UK parliament has taken control of the process from the Prime Minister. Clearly, in those circumstances, Prime Minister May could choose to resign, but it would, in any event, take the negotiations in an entirely different direction including away from a ‘No-Deal’ pandemonium. Such an outcome could lead to the EU offering a Norway style single market arrangement or simply continued membership of a customs union. It might also allow support for some form of a second referendum to grow. If the latter were to come to pass, we feel it could see sterling move up to a new trading range around USD1.40 and likewise benefit the mid-sized companies represented in the FTSE250.

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