Move Again: The Forthcoming Deal and the Rise of Sterling (31/01/19)

"Even if the last move did not succeed, the inner command says move again."

Seamus Heaney, 1996, Address to the graduates of University of North Carolina at Chapel Hill

Few, if any, are neutral on the issue of whether the United Kingdom remains in the EU or leaves in the heated constitutional debate in the UK. Your analyst is no exception, and regular readers will know of the inherent bias in any analysis that comes from an author much more interested in the restoration of a representative democracy than the financial positives or negatives associated with that constitutional change. That may be a perverse hierarchy of needs to many of my correspondents, but it's my hierarchy of needs and it thus conditions how I see and write about the current situation.

I would suggest that it's an ordering of preferences, whether you share it or not, that explains not just what is happening in the UK, but also what is about to happen in the political earthquake that will be the European parliamentary elections (from May 23rd to May 26th). The rest of this article relates to how the UK and EU will come to an agreement, stop a hard Brexit and seek to avoid further accelerating the forces of decentralization in the EU. If the analysis is correct, there are gains to be made by buying both a very undervalued Sterling and very undervalued UK equities, and avoiding investments in Euro denominated assets.

I think it is obvious, even to the most ardent remain voter, that the UK cannot form part of a further centralised EU; the only decision is whether to leave now or to leave when the centralization project in the EU is much further progressed. If a thin majority of people cannot accept the current level of destruction of UK sovereignty, it seems virtually impossible to see them accepting the level of destruction necessary to complete the centralization of the EU. This need for the UK to act has thus not been compelled by changes to the UK constitution, but by changes to the EU constitution.

The cause and effect here are crucial for investors to understand. If it is the change in the EU constitution which is driving the process, then there are plenty more EU countries where we can expect political conflict between the centralisers and the sovereigntists as the centralization process continues. It is also why it is crucial for those European politicians backing centralization to get the UK out of the EU quickly and with the minimum, not the maximum, disruption. This will be to the particular benefit of Sterling, but still leaves the battle raging within the EU between centralisers and sovereigntists. Good for Sterling, then, but also bad for the Euro.

It would be extremely dangerous for the EU to attempt to retain as a member a major state such as the UK, already cautious about the current degree of lost sovereignty, as the move towards economic, then monetary, then fiscal and finally political union continues. For the good of the EU centralization project it is essential that the UK leaves. There is thus a pressing need to get the UK out of the EU and to do so without further weakening the case for centralization. While some might think that this means inflicting the maximum economic pain on the UK, in payment or as retribution for its constitutional choices, that analysis ignores a much more dangerous threat to EU centralization - the bankruptcy of Ireland.

Since the introduction of the Euro the EU has been forced down a path of greater fiscal integration and, if there is to be no taxation without representation, greater political integration; these are the consequences of a monetary union. With such a major constitutional transformation underway in the EU, the people of each individual country have to either do something or accept the centralization process that leads to something akin to a United States of Europe. The UK, through a referendum
and then a general election, has chosen to ‘move again’ - to not just stop the clock on that constitutional drift, but to push the clock back toward more power for its increasingly devolved parliamentary system.

It would have been strange indeed if a people who have consistently voted for more devolution over the past 20 years had not made a constitutional choice to forego the compulsory centralization upon which the EU is now embarked. But, of course, the UK is the only country to have been permitted such a choice through a referendum as the centralization process has accelerated. Elsewhere the desire to restore parliamentary democracy to sovereign parliaments or continue with the centralization of power is not an issue that has been put to the peoples in referenda; the last move did not succeed but there is no scope to move again. This is yet to come and it is a process that can accelerate dramatically depending upon the result of the European parliamentary elections. If this is a biased assessment of what is going on in the EU, I would suggest that it is a biased assessment shared by President Macron of the French Republic:

“The German taboo is financial transfers; the French taboo is treaty change. Ultimately, if we want Europe, both will happen. I want to reassure everyone of that, but we must stop being afraid of the people. In terms of our approach, we must simply stop building our Europe in isolation from them. But we mustn’t fall into the trap of the populists or extremes, which consists in saying: “let’s ask the question in a simplistic way: yes or no?”. We know the answer: it is always “no”, whatever the question. We need to overhaul the European project, through and with the people, with much greater democratic stringency than a mere binary question.

That is why, if we want to move forward again, I’d like us to hold democratic conventions that will be an integral part of Europe’s radical reform. Once we’ve defined the simple terms of a roadmap shared by the main governments ready to move in that direction, I’d like us to be able – for six months next year, in all the countries that so wish – to organize a huge debate on the same issues and identify the priorities, concerns and ideas that will fuel our roadmap for tomorrow’s Europe.”

President Macron, Sorbonne Speech, September 26th 2017

“I don’t want a new European treaty discussed behind closed doors, in the corridors of Brussels, Berlin or Paris.”

Speech by President Macron, Athens, September 7th 2017

As yet, sixteen months after those fine words, no such ‘roadmap’ has been proposed, no ‘democratic conventions’ have been held and it seems, based on the President’s own definition, that the ‘main governments’ have not stopped ‘being afraid of the people.’ If the ‘inner command’ is to move on, such a move is not possible in the way President Macron thought so essential. There are good reasons for this failure, mainly the distraction of Brexit and Chancellor Merkel’s 2017 election result, but wherever the blame lies, it remains a major failure as it has given no outlet to those Europeans frustrated that they still do not know what their future constitution will be and what is planned ‘behind closed doors in the corridors of Brussels, Berlin or Paris’. If the people have an ‘inner command’ to ‘move again’, how do they now do so if, as President Macron asserts, the elected representatives of the people are ‘afraid of the people’?

The path from now to the elections in May 2019 is a dangerous place to be, if you wish to continue the centralization of the EU. The failure of President Macron to ‘hold democratic conventions’ to establish the final constitution for the EU and push it forward through the ‘main governments’ leaves us where the President of the French Republic believes we must not be with the future constitution of Europe being “discussed behind closed doors, in the corridors of Brussels, Berlin or Paris".
rising discontent with that process of centralization behind closed doors will now be expressed by voters in the European Parliamentary elections, for there is no other way to ‘move again’.

All polls show a massive swing in votes towards those parties expressing a need for a decentralizing Europe and not a centralizing Europe. It is against this political earthquake within the EU, just sixteen weeks away, that the EU now has to choose between a hard Brexit or a deal which places some limitation on the duration of the Irish back-stop and thus very probably secures a soft Brexit. A hard Brexit with attendant economic dislocation for the UK may indeed ‘encourager les autres’ to remain part of the centralizing process, but it also brings an economic dislocation to the EU in general and Ireland in particular. Indeed, for Ireland it raises issues of solvency that would be a major headache for the ‘main governments’ keen to bring all remaining 27 members of the EU towards greater centralization and stop the rise of the decentralisers.

The EU estimates that a hard Brexit would result in a 10% contraction in the Republic of Ireland’s GDP. That is not a great surprise, given the disruption associated with not just Ireland’s trade with its major trading partner but also the disruption to its trans-shipment of many products through the UK. Such a contraction in GDP would be very challenging for a country with one of the highest non-financial debt-to-GDP ratios in both the EU and the world.

<table>
<thead>
<tr>
<th>Country</th>
<th>Non-Financial Debt-to-GDP Ratio</th>
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<tr>
<td>Luxembourg</td>
<td>438%</td>
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<tr>
<td>Belgium</td>
<td>340%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>336%</td>
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<tr>
<td>Ireland</td>
<td>314%</td>
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<tr>
<td>France</td>
<td>314%</td>
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<tr>
<td>Portugal</td>
<td>306%</td>
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<tr>
<td>Greece</td>
<td>293%</td>
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<tr>
<td>Sweden</td>
<td>284%</td>
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<tr>
<td>Denmark</td>
<td>265%</td>
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<tr>
<td>Spain</td>
<td>265%</td>
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<tr>
<td>Euro Area</td>
<td>261%</td>
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<tr>
<td>Italy</td>
<td>256%</td>
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<tr>
<td>Finland</td>
<td>247%</td>
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<tr>
<td>Austria</td>
<td>227%</td>
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<tr>
<td>Germany</td>
<td>175%</td>
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<tr>
<td>Hungary</td>
<td>162%</td>
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As the table above shows, Ireland already has one of the highest debt burdens in the Eurozone; a simple calculation results in that ratio rising to 348% of GDP, if GDP contracts by 10%, and it would almost certainly go much higher as there is also a major rise in government debt associated with any such recession. Within the Euro Ireland does not have the ability to bend through the actions of its own central bank or a lower exchange rate and thus a high debt-to-GDP level is particularly dangerous - as we discovered in many parts of Europe in 2011-2012. A 10% contraction in GDP would likely see Ireland’s non-financial debt-to-GDP ratio spiraling closer to 400% of GDP than 350%.

In 2011-2012 EU members with much lower total non-financial debt-to-GDP ratios found their interest rates soaring as investors questioned whether, without the assistance of a local central bank to print money, debts could continue to be serviced. As it happened, of course, the ECB was prepared to play such a role. However, at least for the moment, it is not further increasing its role in funding fiscal deficits across the EU.
The EU might hope that another massive ECB balance sheet expansion could save the politicians’ bacon, but it’s a huge risk to take in late March with the EU parliamentary elections due in May. Economic pain inflicted on the UK may act to encourage other peoples to surrender their sovereignty in the centralization process, but surely it would be more than outweighed by the sacrifice of Ireland by the ‘main states’ in a show of power to enforce centralization through a hard Brexit? How does another solvency crisis in the EU, and another show of brute force against a democratically elected government, as we have already witnessed in Greece, help the process of centralization?

History strongly suggests that in these matters the Government of Ireland will do what it is told by Macron’s ‘main states’. In the GFC the Government of Ireland ‘agreed’ to massively expand its balance sheet to bail out the bond-holders of Irish banks, even though legally those bond-holders had no legal rights to be made whole. Irish government debt rose from just EU70bn in late 2007 to EU319bn at its post-GFC peak. For this good deed the investment institutions of Europe, the key holders of Irish bank debt, no doubt expressed their gratitude, but the people of Ireland continue to labour hard to finance that extra-legal gift to European financial institutions.

Indeed, it may be the embarrassment experienced by European political leaders at forcing such a burden on the people of Ireland that has kept the other EU 26 so aligned with Ireland’s views on Brexit. Today it would be against EU law, under the Bank Resolution and Recovery Directive, for the Irish people to shoulder such a burden on behalf of bond-holders, but that change in direction by the ‘main governments’ came too late for the people of Ireland. So perhaps Ireland will call the shots among the 27, but history strongly suggests that it will be the ‘main states’ that do. If these same states could force Ireland to assume a quarter of a trillion Euros in government debt to help the financial institutions of the ‘main governments’, just how difficult will it be to force Ireland to accept a time-limit on the backstop?

While some will continue to forecast that the best interests of the ‘main states’ are served by inflicting the maximum pain on the recalcitrants who are against further centralization, among which the UK is clearly the leader, the negative impact on Ireland would be so great that such a policy would backfire. Whatever is being ‘discussed behind closed doors, in the corridors of Brussels, Berlin or Paris’, it is difficult to believe that raising solvency issues of yet another EU member ahead of the May EU parliamentary elections is one of them.

There is virtually no downside for the ‘main states’ in agreeing a time-limit to the Irish backstop. There is, indeed, little downside for Ireland in agreeing a time-limit to the backstop. It is a small compromise to make and it would now almost certainly allow the UK to leave the EU without the economic catastrophe for Ireland that would, just ahead of the elections, further undermine the push by the ‘main states’ for further centralization of the EU. To have any hope of meeting those objectives the EU needs the UK out of the EU and out with minimum not maximum disruption.

Your author knows a bit about the hard border in Ireland having lived with it for all of his early life in Northern Ireland from 1964-1988. I also happen to have studied constitutional law at Queen’s University Belfast (a few years ahead of the current leader of the DUP) during a period that included the tragedy of the assassination of our lecturer in constitutional law outside the lecture theatre. The constitution is something most people have the luxury of ignoring until the day you can’t. Perhaps only when you have had to try to establish a workable constitution through such real mayhem can you appreciate that there are better ways to do it. So what we are about to witness on the island of Ireland is something very simple - a de jure border and a de facto border. The only way to enforce a hard border that nobody wants, regardless of their political persuasion, is to move towards totalitarianism as demonstrated in Eastern Germany. That is clearly not possible on either side of the de jure border. Thus we are about to witness the greatest step forward towards peace in Ireland in its long history. We will witness peoples rising above their elected representatives to ignore a de jure border. It is difficult to think of anything more likely to cement peace on the island than such a
co-operation across a political divide. It will then be up to the government of the UK to assess just how hard the de facto border at the Irish Sea will be. That no doubt will be subject to significant debate but the people of the island will be establishing their own border through their deeds while that political debate continues. So the politicians, who are mainly lawyers, will have their say then the people will ignore them and have theirs - what progress.

Expect a deal, expect a soft Brexit, but forget at your peril that the real battles in the war for the centralization of Europe are only just beginning. The combination of a soft Brexit and a hard victory for the decentralisers in the European elections means that Sterling has far to rise against the Euro. For Brexit the recent decision in the UK parliament means we finally know what the art of the possible entails. Ground has been stood and the fool’s errands have ended and now we can all make ‘the next move in the game’.

‘On you go now! Run, son, like the devil
And tell your mother to try
To find me a bubble for the spirit level
And a new knot for this tie.’

But still he was glad, I know when I stood my ground,
Putting it up to him
With a smile that trumped his smile and his fool’s errand,
Waiting for the next move in the game.

The Errand, Seamus Heaney, 1996
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Postal Address: Newbattle House, Newbattle Road, Newbattle, EH22 3LH Scotland

Registered Address: 6 Logie Mills, Beaverbank Business Park Edinburgh, Lothian EH7 4HG, Scotland

Company Number: SC36220