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MACROCOSM

It's Starting to Feel a Lot Like Brexit

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Another phony politicized media narrative, when stocks and bonds are deeply undervalued.

UK and European markets are panicking, and it has overflowed to the US, driving the S&P 500 to a slightly lower intraday low than the prior one in June. In the UK, it's because of *tax cuts proposed by new Prime Minister Liz Truss* that are being characterized universally as "utterly irresponsible." On the continent, its because of the *election Sunday in Italy of a conservative coalition* widely branded as "fascist."

- Markets would seem to be ratifying the judgments rendered in global media – the idea being that tax cuts in Britain and more nationalism in Italy will lead to some combination of inflation and sovereign credit risk. *But markets are often wrong, and identifying such moments is what we all do. In June 2016, markets ratified a similar media panic about Brexit. We said then that markets were wrong, and indeed the immediate steep shock to equities – 11% in the euro area, and 9% in the UK – was reversed entirely in two weeks, and in two days, respectively* (see "On the Brexit Referendum" June 24, 2016).
- *Markets are wrong again, and wide equity risk premia – challenging the record wides during the lockdown panic of 2020 – are offering a terrific value proposition for bottom-fishers* (see the charts on the following page, and "The Tide Turns in Ukraine" September 12, 2022).
- Atypically, European and UK ERP's are very wide *despite* high competing sovereign bond yields. This unusual situation creates the opportunity, for those willing to bet that the present panic will quickly recede, to win, if they are right, in either stocks or bonds.
- Concerning the Truss tax cuts, their size has been exaggerated in most media accounts to include the value of cancelled tax hikes put in place by the previous government. But be that as it may, the standard narrative about these tax cuts is that they are a dead-weight loss to revenues, without any possibility at all of generating economic growth that might partially or completely offset.
- That's especially false – and hypocritical – because the standard narrative never objects to government spending increases on such grounds. To be sure, government spending may have some kind of cost-offsetting multiplier effect. But then why not admit the same thing for tax cuts? Indeed, it is axiomatically more likely that tax cuts will produce offsetting revenues because they remove marginal disincentives to labor, investment and tax avoidance.

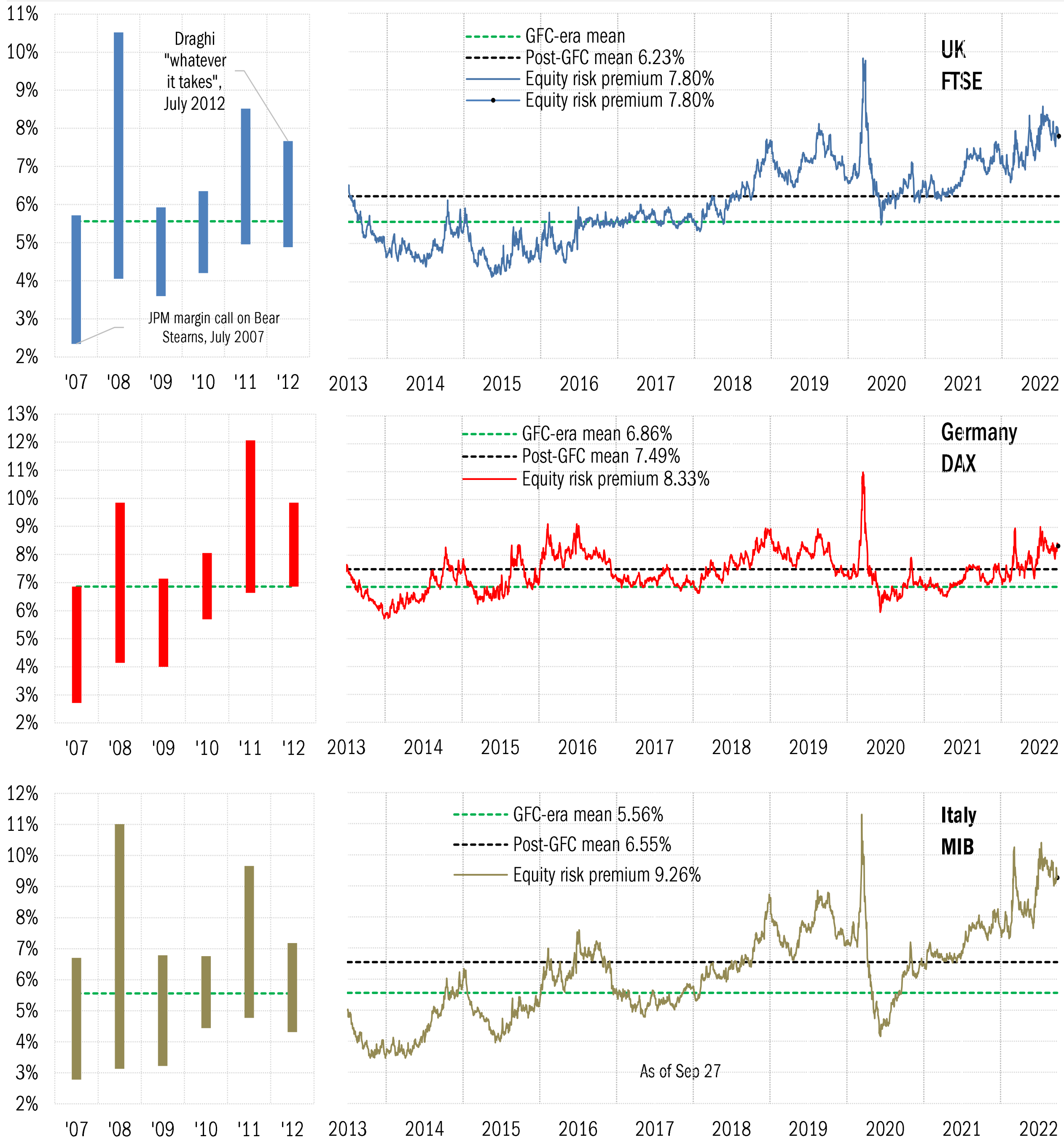
Update to strategic view

EUROPE MACRO, EUROPE STOCKS, EUROPE BONDS: Tax cuts in the UK and the emergence of a conservative governing coalition in Italy have spooked European markets and spilled over in the US. This is like the baseless panic over Brexit in 2016, which proved to be a very temporary market correction driven by politicized media narratives. UK tax cuts are not as large as advertised, because they are in part only cancelling tax hikes already scheduled. They will not be a deadweight loss to government revenues because they will encourage employment and investment; the same amount of spending increases, which would have been applauded by the media, would be more costly. The Bank of England has had to reverse its plans to actively sell bonds, which is a useful brake on the global race to the bottom in tight monetary policy. The Italian coalition is neither fascist, nor seeking to exit the European Union or the euro. These developments are a glimmer of much needed growth opportunity at time when both equities and bonds are deeply undervalued.

Spending increases, on the other hand, create disincentives to the extent that they take the form of income supports, and distortions to the extent that they direct capital and expenditures to government-favored projects that are unlikely to be the highest and best use.

- The worst thing we can say about Truss's policy initiatives is that she is continuing her predecessor's scheme to subsidize energy consumption, perpetuating both over-utilization and the failure to produce more energy (see "U.K. Energy Policy Is a Flop" September 26, 2022).

Equity risk premia: consensus bottom-up year-ahead forward earnings-yield minus 10-year sovereign bond yield



Source: Bloomberg, TrendMacro calculations

- We are encouraged by announcement today that the Bank of England will buy gilts to stabilize the market in this baseless panic. On Monday, it had added fuel to the panic by warning that it would not hesitate to raise rates to fight the supposedly inflationary effects of the new tax cuts. And at its meeting last week it had announced the intention to do the opposite of buying gilts – to actively sell them from its balance sheet. Perhaps this panic has served to pull the BOE back from making more such contributions to the global central banking community's collective reckless inflation-fighting mania.
- Concerning the new governing coalition in Italy led by Prime Minister Giorgia Meloni, well, let's be blunt (at the risk of potentially offending some readers) – labelling as "fascist" those in politics with whom one disagrees is as repellent in Italy as it is here in the US. If you want to invest a moment to truly understand how utterly baseless are the charges against Meloni, and learn something about how slanderous innuendo and guilt-by-association can be used for political purposes at the highest echelons of world journalism, please read this article in Saturday's *New York Times*.
- The simple reality is that the new Italian coalition is nationalist, opposed to uncontrolled migration from Africa at Italy's southern coast, favorable to tax cuts, tough on crime, and opposed to abortion. That all cuts against the standard narrative – but there's no reason to pretend that it's fascism.
- Critically for markets, there's no reason to think it will lead to fiscal ruin in Italy or the dissolution of the European Union or the euro. The coalition has not campaigned on any of that.
- We see both developments, in the UK and in Italy, the same way we have seen Brexit all along. They are moves, probably imperfect in some ways, but nevertheless, in the direction of growth.
- God knows Europe and the UK need a little of that. And we have to curb our enthusiasm about how much difference it can make. But we're quite sure the present panic is completely groundless, and actionable.

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Bottom line

Tax cuts in the UK and the emergence of a conservative governing coalition in Italy have spooked European markets and spilled over in the US. We liken this to the baseless panic over Brexit in 2016, which proved to be a very temporary market correction driven by politicized media narratives. Tax cuts in the UK are not as large as advertised, because they are in part only cancelling tax hikes already scheduled. They will not be a deadweight loss to government revenues because they will encourage employment and investment; the same amount of spending increases, which would have been applauded by the media, would be more costly. The Bank of England has had to reverse its plans to actively sell bonds, which is a useful brake on the global race to the bottom in tight monetary policy. The Italian coalition is neither fascist, nor seeking to exit the European Union or the euro currency. Together, these developments are a glimmer of much needed growth opportunity at time when both equities and bonds are deeply undervalued.