June 29, 2016

High Conviction Macro Trades for a Post-Brexit Environment

Post-Brexit Environment: Europe remains in a state of political limbo until a new prime minister takes charge in the UK. Ultimately, we believe the next UK government will fulfill the results of June 23rd's popular, non-binding referendum and proceed with invoking Article 50. This will begin the 2-year process by which the UK exits the European Union. But even Brexit leaders suggest divorce is unlikely before 2019. Given the dearth of pro-growth policymaking in Berlin and Brussels, this is likely the best path forward for the UK.

As the acrimonious reactions of EU officials fuming over the repudiation by the UK electorate subsides, **we believe pragmatism will rule the day**, preventing the EU from shooting itself in the foot by erecting trade barriers on the UK. Unlike Greece, which arguably offered more liabilities than benefits to Berlin in terms of currency and sovereign default risks in bailout negotiations, the UK has its own currency and much more leverage going into talks. In terms of trade, the UK is the EU's largest single export market in goods. It is Germany's third largest trading partner after the U.S. and France. Meanwhile, the UK will look to preserve its share in EU markets, which accounted for 47% of its exports in 2015.

We believe there are several attractive investment opportunities in the present, post-Brexit vote environment. We recommend going long oil, UK and Russian equities and short the yen. We are specifically recommending long positions in: 1) oil (DIG), 2) UK small caps (EWUS), 3) Russian small caps (RSX), as well as 4) a long on the ultra yen short exchange traded fund (YCS).

Long Oil (DIG): Brexit Mayhem Creates Entry Opportunity

In April we reiterated our confidence in being long oil and noted that we would "certainly use any near-term pullbacks" to take advantage of an expected recovery in the price to $62.50. Today, we use an exchange-traded fund such as Proshares Ultra Oil & Gas (Ticker: DIG) to play such a scenario.

We believe Brexit and the recent swoon in global financial markets has provided an attractive entry point. The vote sent the oil/gold ratio to 28.5 barrels per gold ounce this week, while the price of crude fell below $46/bbl on Monday.

Bottom line: We recommend going long the exchange-traded fund, ProShares Ultra Oil & Gas (DIG). DIG closed at $35.26 on Tuesday. Our target price is $50.45/share for an approximate gain of 43%. Our stop/loss threshold is $29.97.

Long UK (EWUS): The Brexit process will likely be a drawn-out one, but to the extent that it means the dismemberment of a failing economic union, which is how we view the European Union, it is a long-term positive for the UK economy.

One of the main rubs between the EU and the UK, "the free movement of people," will likely remain contentious. Angela Merkel stated before the Bundesrat on Tuesday that the UK would be made to understand that any free trade deal with the EU must include the "free movement of people." Meanwhile, the Leave camp has made clear that immigration has now become a 'redline' for the UK.

Merkel is most likely politicking.

We do not believe the EU will forsake trade with the UK, one of its largest export markets, over the fact that the UK wishes to pursue its own immigration policy. Brexiters are reportedly now keen on a pursuing a "Norway, plus" association with the EU, which may incorporate some sort of points system on immigration. This is sensible.

Ultimately, we believe Merkel will be persuaded to acknowledge the UK's sovereignty on the issue, without upsetting the status of UK subjects working in the EU and damaging trade ties which could make both sides poorer.

Additionally, we believe the Tories will remain in charge and expect former London Mayor Boris Johnson to become the next Prime Minister before October.

With Johnson's ascension, UK fiscal policy could improve as corporate and personal tax rates are likely to be reduced. With the UK already engaging in a competitive "race to the bottom" on corporate tax rates (its 20% corporate tax, which may decline to 17% by 2020, has spurred corporate tax cuts in Scandinavia in recent years), we see the potential for further improvements to personal tax rates under Johnson. Like Nigel Lawson, Johnson agrees that the top marginal tax rate on income should be reduced to 40% from 45%, currently.

The recent weakening of the pound on the back of Brexit may temporarily help British exports. And to the extent it helps provide some reflationary relief to the UK economy, it is a slight tailwind at the moment. Importantly, we do not see Mark Carney at the Bank of England likely to injure risk-taking through contractionary rate policy during the next six-to-twelve months.

We believe UK equities are poised to appreciate by at least 20% from current levels.

Bottom line: We recommend going long the exchange-traded fund, iShares MSCI United Kingdom Small-Cap (EWUS). EWUS closed at $32.42 on Tuesday. Our target price is $40.52/share for an approximate gain of 25%. Our stop/loss threshold is $28.53.

Long Russia (RSXJ): Russia stands out a beneficiary of rising oil and improving geopolitics.

We agree with Wilbur Ross that after the Brexit referendum, EU unanimity on continuing anti-Russian sanctions will likely break down during the next twelve months. Diplomats already acknowledge that the UK's departure leaves Germany with one less ally in the EU to stand up to rising pressure from countries such as Italy, Greece, and Hungary to drop the sanctions.

That is not to say the geopolitical outlook is without significant risks.

The pledge by Petro Poroshenko's Ukrainian government for new elections in Ukraine, under the Minsk II Accords, appears no closer to coming to fruition than six months ago. Merkel blames violence from pro-Russian separatists in the Donbass region as the reason why. Meanwhile, recriminations continue to fly from both sides of the conflicts.

The importance of Ukraine will continue to weigh strongly on the minds of Russian nationalists, realists and hawks.

The Dutch referendum on Ukraine, which Prime Minister Mark Rutte characterized as "a disaster" because it rejected an association agreement with the EU by 61%, is likely to be ignored by Rutte. A pro-EU expansionist, Rutte has made clear that he is "totally, totally, totally against referendums." Instead, he is asking other EU ministers to confirm that an association agreement does not mean Ukraine will be joining the EU/NATO anytime soon.

Of course, Rutte is not fooling any of those who rejected the referendum. New Ukrainian Prime Minister Volodymyr Groysman believes EU membership will occur within 10 years, an optimism that he is sticking with even after Brexit. An association agreement is the first step.

The problem with this is that Ukraine remains an economic basket case where austerian policies dominate and long-term solvency seems unlikely without further debt restructuring. Pending litigation in London courts over Ukraine's default on $3 billion in Russian-owned bonds (Russia refused to take part in a 20% write-down of debt in 2015) could become another point of tension between Russia and the West. Ukraine is citing the conflict as one reason for Ukraine's nonpayment, which in a perverse way incentivizes Kiev to perpetuate hostilities in Eastern Ukraine.

Russian expert Stephen F. Cohen sees the new Cold War with Russia potentially evolving into a low-intensity, undeclared war. As the Nation recently put it:

> Cohen points to some recent examples: the emerging permanence of NATO's "exercises" on Russia's borders on land, sea, and in the air; the Obama

administration's refusal to separate physically its "moderate oppositionists" in Syria from anti-Assad fighters recognized as terrorist groups, despite having promised to do so; the demand by 51 State Department "diplomats" that Obama launch air strikes against Assad's Syrian army, which is allied with Moscow, even if it might mean "military confrontation with Russia"; the questionable allegation that Russia had hacked files of the Democratic National Committee coupled with a NATO statement that hacking a member state might now be regarded as war against the entire military alliance; and the EU's renewal of economic sanctions against Russia without any meaningful pretext.

Certainly, if Hillary Clinton wins the November election, conflicts in Ukraine, Syria and wherever else Russian influence is being challenged could escalate. But that is not our base case.

Russia's foreign policy decision to support the Assad government in Syria has helped turn the tide against ISIS. Indeed, Russia has shown diplomatic self-restraint and patience in the conflict, winning respect from certain quarters in Europe and with presumptive GOP nominee Donald Trump.

Perhaps at Netanyahu's behest, Turkish President Recep Erdogan this week delivered an apology for the November downing and death of Russian servicemen along the Syrian border last year. Retaliatory sanctions on Turkey since then have hit the country's tourism and agricultural sectors hard. Erdogan's latest move suggests a thawing of relations may be at hand. This will be positive for both economies.

We continue to believe oil prices will continue to move higher, which will improve Russia's fiscal situation.

As one can see in the chart below, the ruble (on a reversed axis) has been strengthening in dollar terms as CDS prices on Russian sovereign debt have declined. All this has taken place against the backdrop of oil's recovery from its February lows.

Consistent with our ~$62/barrel price year-end target, we expect a strengthening bias for the ruble to persist. Such a trend will allow the Russian central bank to be less hawkish going forward, which will reduce the headwind of high rates for the Russian economy.

Furthermore, we do not expect Russia to abandon its flat-tax setup under Vladimir Putin.

Bottom line: We recommend going long the exchange-traded fund, VanEck Vectors Russia Small-Cap ETF (RSXJ). RSXJ closed at $26.39 on Tuesday. Our target price is $34.50/share for an approximate gain of 31%. Our stop/loss threshold is $22.43.

Short Yen (YCS): In late April, when we discussed the direction of the yen and the Nikkei, we noted the prediction of Eisuke Sakakibara, former vice minister of the Ministry of Finance known as “Mr. Yen. At the time, he saw the yen strengthening to Y105-Y100. The lower bound was a year-end prediction that correlated with the Nikkei sinking to 15,000, which suggested a political tolerance limit for extreme yen strength.

To be fair, Sakakibara predicted that Brexit would send the yen below Y100. On the day of Brexit, the Nikkei fell to 14,952 and the yen began to strengthen dramatically. By Friday, the yen would swing from Y106 to Y99. On June 27, the yen closed at Y101.81/$, a closing price not seen since August 2014.

Mr. Sakakibara believes the yen could appreciate to Y95 during the next six months, given its ‘safe haven’ status so long as global market volatility persists. Such a forecast suggests a nightmare scenario for the Nikkei, a decline below 13,000, which would bring the year-to-date loss for the Nikkei to more than 26%.

We view the safe haven argument valid insofar that the yen/dollar rate has been inversely correlated with the dollar-gold price for much of the last decade. That means when the dollar strengthens in gold terms, the yen often weakens against the dollar and vice versa. While one can view the jump up in gold to $1360+/oz on the day of Brexit (last Friday) as part of an uncertainty reflex, the fact that the yen strengthened to a level not seen since August 2014, suggests that the inverse correlation between the two still holds.

Assuming markets stabilize during the next several months, we could see the gold price move back toward $1250. This would allow the yen to weaken against the dollar toward Y110-Y115 level. Of course, a lot goes into that assumption, such as the UK and EU embarking on an amicable divorce. Given how markets have reacted to the possibility of a bitter divorce after June 23, we believe politicians on both sides of the channel are incentivized for pragmatism.

Bottom line: We recommend going long the exchange-traded fund, UltraShort Yen ETF (YCS). YCS closed at $62.85 on Tuesday. Our target price is $80.05/share for an approximate gain of 27%. Our stop/loss threshold is $54.68.

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