



Holland Macro Views – UK Market Risk + Political Cycles

Socialism + The Big Short?

Steve Eisman made a name for himself by shorting US subprime. His negotiation of that crisis being portrayed in a dry, but informative book and a very entertaining film. Recently, Eisman has made it known he has short positions in four UK banking shares. As a company who has spent considerable time picking over the US banking bargains left in the wake of the subprime collapse of that sector, that Mr Eisman has entered our fishing waters (the UK) is interesting to say the least.

Whilst some of the comments in this note relate to UK banking shares, there is a wider point we hope all will read/hopefully find of use. We observe that whilst a true Socialist Government in the UK might not be a high probability event, its likelihood and far reaching effect is underestimated by investors.

[“Corbyn is a bigger risk that a hard Brexit”](#) – Steve Eisman, 21st Jan 2019

Over the last few months as UK banking share prices have fallen, we have reiterated our view as to their cheapness, noting how mispriced we think they are against most likely future levels of earnings power and the similarities between the UK and US financial sectors. However, there is a key phrase in that sentence you have just read – ‘most likely’. Often, we have rounded up a conclusion on UK banking shares with a paragraph such as the one below extracted from our November piece:

“We believe that either in or out of the EU the UK economy will do just fine. As such we conclude that much of what we are listening to is uncertainty rather than genuine risk. The real economic risk comes courtesy of Messer’s’ Corbyn + McDonnell and the longer-term consequences of their policies” **Holland Views: What you win when you win / UK banks Nov 2018**

It is the last caveat that we have been spending a lot more time thinking on in recent weeks, i.e. what is the probability of a genuinely Socialist Labour Government and the effect it might have on the share prices of domestic banking and other companies that otherwise we are inclined to favour? It may not be a black swan event but it sure has shades of grey about it. The more recent rallies in UK share prices (banks included), whilst no doubt benefitting from global factors also seems to reflect a relief that a hard Brexit is being avoided and is thus seen as good news. This has resulted in the share prices of Lloyds and RBS being at similar levels to that before the current Brexit chaos really got into full swing.

As a firm that looks for long term value and mispricings, one that has previously given the view that such prices represent compelling value – can or should we adapt that view now? Especially considering we would only be doing so due to a situation that might be considered unlikely to transpire. This is the curse of a researcher perhaps – we will likely be damned either way! However, we have always tried to think more like investors rather than analysts. As such we think it right to reflect on the fact that in the short term the risk reward on these companies is likely worse than a year ago when the odds of a Labour Government were very low.

UK Economic Outlook – Reality and Probability collide

The ‘most likely’ political outcome we will suggest a year from now is of a continued Conservative-controlled Government, but it was also ‘most likely’ this time last year also. However, such phrases do not reflect real life probabilities. Maybe a year ago the chance of a continuing Tory government in 12 months’ time was 90%, maybe today it is 60%. Both scenarios can be expressed as ‘most likely’, but one has the chance of a Labour-controlled Government at 4x the level of the other. This is how we are thinking about the UK banking sector and wider stock market today. The reward for long term share ownership could still be very good, but the shorter-term risk more elevated than it was.

Your author recently spent days away with a few friends, none of which work in finance. Lunchtime discussions inevitably turned to Brexit and politics. At the end of the debate I asked each person in turn who our next Prime Minister will be. The list included ‘Gove’, ‘Hunt’, and Sajid Javid. All logical answers that were repeated even when I added “...and after the next election?” Not a single person said Jeremy Corbyn. As investors we need to be thinking probabilistically, not emotionally or even logically, as logic would tell us others would see it our way. Thus, we should be trying hard to separate what we think *should* happen from what actually *might*. The following two URLs put a little perspective on this, giving the odds of both a Labour Government (almost even-money) and of Jeremy Corbyn being the bookies favourite to be the next Prime Minister (9-2):

<http://sports.williamhill.com/bet/en-gb/betting/e/9702490/Next+Prime+Minister.html>

<https://www.oddschecker.com/politics/british-politics/next-uk-general-election/most-seats>

As well as looking at turf accountants’ odds, we would also do well to consult political history. How often does a slim majority 3-term Government that is in a state of crisis and fighting amongst itself in an unprecedented manner retain power? Very rarely we suggest.

“Investors underestimated the possibility of a Corbyn government and a hard Brexit due to a psychological effect, because they found the prospect so frightening” Steve Eisman

Focus on Brexit value and Corbyn risks

We remain firmly of the view that there is significant value in UK assets that have been marked down heavily due to the Brexit fears. We will reiterate what we stated in our November piece on this point:

“..we feel this is the greatest opportunity today. For the last few years a hard Brexit is presented by too many people that should know better as some sort of horrific economic car crash. This we feel (even as an office that has both camps in it) is the great mistake that markets are making today – to even partly price in this fallacy”

“our point is merely that the UK economy has been surprisingly resilient in recent years, but also over many decades. This is arguably because it is a modern, versatile economy run by 60m business minded people, who adapt. They do not all sit waiting for a grand central plan (this is the point we think the Ivory Tower doomsters miss). The population is versatile and will adapt, as they all do in their daily lives, but such traits don’t make it into economists’ models” Holland Views – What you win when you win / UK banks Nov 2018

Clearly there much than can (and has been) been written to back up this point or contradict it. We thought yesterday's comments from easyJet were interesting in that regard:

“For the first half of 2019, booking levels currently remain encouraging despite the lack of certainty around Brexit for our customers. Second half bookings continue to be ahead of last year” Johan Lundgren, easyJet's chief executive, 22nd January 2019

This is sector we are told would be in turmoil were it not to have certainty way ahead of the Brexit leave date. Seemingly its customers are somewhat more relaxed about the issue than are Ministers/their Shadows or Central Bank's Governors! We stand firmly by the view that the UK population, its workers and the managers that run its companies are versatile and have planned where they can for most eventualities. However, drama always sells newspapers/clicks and it always will. Our job is to focus on where there is value and to not confuse high uncertainty for high risk. Brexit in almost any form we do not think damages the earnings power of much of UK plc. The real risk lies elsewhere....

Corbyn Risks – Real socialism

Many publications with far greater political and economic insight than us have commented about what Corbyn and his team stand for. We will not repeat nor compete with them. Our view on reading and reflecting on the last few years of opposition policies is that the Labour Party under its current leadership is staunchly socialist to a level that a globalised, modern Anglo-Saxon economy like the UK has not seen for decades. It is this conclusion tied in with the rising odds of it that causes us to reflect on UK banking and other sectors risk and reward.

It is worth noting that UK broadcasters are different to those elsewhere in the world in that in that they are regulated to ensure political neutrality. This is of course a good idea. However, as investors or those that write on the subject, we are under no such restraint – this frees us to assert the following:

This imposed media balance is perhaps giving the population a rose-tinted view as to the acceptability of Labour Party policies, when in fact they are extremist. As an example, the wholesale renationalisation of the entire utility sector with the huge costs and complexity associated with it must be discussed in a balanced way by the Radio 4 Today programme or Question Time. Rather than expose the policy for what it is – a nonsense, out of date, tried by many and proven to fail expensive socialist intervention.

These comments are not meant to be political, but based on hard-nosed experience and reading of a great deal of economic history. Mr Corbyn and McDonnell have for many years sat on the side-lines while they watched the political and economic world move very far from their beliefs. They know this is their one chance to right such wrongs, but experience also tells them that to win enough of the middle ground they will need to be careful and canny with what policies they put forward when. Those that expect more centrist policies to emerge were they to get elected will suffer the same shock as those who never actually expected Trump to enact his policies either. The Labour duo we surmise are a driven pair of ideologists who for a period of time if elected could do real damage to the UK economy. That the odds of them being elected are almost 'evens' and yet the prospect not really taken seriously by investors we think an important observation. One that the aforementioned Mr Eisman is hoping to profit from.

[Reasons to be fearful 1, 2, 3](#)

We think the effect of Labour policies would be a seismic economic shock from today's starting point, i.e. where London and the UK is a well established global home for money and industries that favour its global outlook, good rule of law and business friendly environment. The knock-on effects of such policies in lack of finance market credibility, higher costs of debt, falling currency/assets prices and capital flight could be enormous. Interestingly this scenario can be seen in the December 2017 Bank of England bank stress test. As we observed at the time, it was as if the BoE was stress testing for this exact scenario, but could not name it!

The very reason for our enthusiasm for UK economic resiliency in the face of Brexit is perhaps perversely relevant in the event of Mr Corbyn getting into Downing Street.

We have observed: *that the UK economy's resiliency in recent years, but also over many decades, is arguably because it is a modern, versatile economy run by 60m business minded people, who adapt.* However this market focused, adaptive economy free of state control is not what Mr Corbyn wants for our future. He wants state run banks, nationalised industries and workers given 10% of quoted companies and maybe even a 4 day week. Those of us that have studied economic history know how such experiments end. As such we have a tendency to assume others know the same and when the time comes to put an 'X' in the box they will surely do the 'right' thing. The opinion polls however and history tell a very different story. To have experienced the UK winter of discontent in 1979 at the age of 30 a voter has to be over 70 years old today! (We can see the hashtags now: #socialismsoundsfunletstryit).

We note also that both Corbyn and McDonnell have been surprisingly good as opposition politicians: They have kept any give away policies for the eve of any election (student loan abolition will surely resurface) and have followed the advice Napoleon was rumoured to have espoused, i.e. *'Never interfere with an enemy while he's in the process of destroying himself'*. Time will tell whether the population reward Labour for the chaos the Government created during Brexit or whether growing sympathy (not the normal political powerbase!) for the Prime Minister helps her party. All we observe is that Mr Corbyn in Downing Street is something UK investors should be genuinely worried about and the odds of such an event are greater than many believe. Below are a few articles from The Economist that talk to Labour policies. We extract from them also:

"According to Mr Corbyn's friends, he learnt most of his economics from Benn (Tony)"

"This year he didn't try to conceal the scale of his ambition to shift the balance of power from capitalists to workers. He insisted that "the bigger the mess we inherit the more radical we have to be", and he provided a fairly comprehensive list of what might be done to clean up the mess. The Labour Party clearly not only believes that it might win the next election but that it might get a mandate for a far-reaching agenda" – Economist commenting on Labour Party conference speech September 2018

<https://www.economist.com/britain/2018/05/17/corbymomics-would-change-britain-but-not-in-the-way-most-people-think>

<https://www.economist.com/bagehots-notebook/2018/09/24/john-mcdonnell-offers-an-ambitious-alternative-economic-policy>

We also attach in the Appendix a piece from Wall Street Journal last year. It observed:

“Voters and pundits may still believe Labour’s moderate members would temper Mr Corbyn’s desire to nationalize industries such as railroads, pile on tax increases and entitlement expansions, and withdraw Britain from NATO. This week’s leadership changes say otherwise. Mr Corbyn’s revolution is purging Labour moderates, making the party less fit for power exactly when there is more danger it can win”. – **Wall Street Journal, Jan 2018**

The ‘Big Short’ thesis

Yesterday Steve Eisman stated the he was now short four UK banks, up from three late last year. He also stated that: *“Corbyn is a bigger risk than a hard Brexit”* and on this point we agree with him seeing the bookmaker’s odds as more telling on the probability of such an outcome than business or investor consensus. Unlike a publisher of research, Mr Eisman can change his mind (position size and conviction levels) as the political facts and probabilities change and we suspect he will be doing just that. Whilst we always advocate a long-term view in our analysis and writings, we think using a more probabilistic approach in some UK shares (banks, housing, consumer names etc.) is perhaps more appropriate during this time.

How does Eisman lose?

How does Eisman lose? Well, clearly, he loses if there is no further economic or political crisis. In such a situation banks share prices will likely either stay flat or arguably rise. But by how much and how quickly?

For a while now, we have been of the view that UK banks will follow their US peers as they report cleaner ROE’s and higher dividend pay-outs. The later point in particular being the one that we think will drive share prices higher. This last point (i.e. increasing dividends) is the catalyst we have pointed to which we think will make many investors better accept/believe the value on offer in UK banking sector. As such maybe this reporting season for companies like Lloyds and RBS could have been the one that heralded the big rise in dividends that results in such an investor change of heart? Or maybe not? Faced with the same uncertainty/news flow we are all reading we suspect UK Bank FDs, boards and financial regulators alike will all be inclined to delay any big bank dividend pay-outs that may otherwise have been planned. That may have to wait until next year.

As such whilst will we still see great long term value in a ‘most-likely’ scenario for the UK banks, we can also see the short term risk/reward that Mr Eisman is seeking to profit from:

- His upside: Either a new Labour Government or falling political credibility due to ever increasing delays in EU negotiations = Collapsing credibility of UK plc drives borrowing costs up + asset prices down. Both of which banking shares are a geared play on.
- His downside: Banks carry on trading roughly where they were before. The political high-risk point passes and he closes his short position for maybe a small loss.

In short

Those that understand probability will hopefully see the nuanced view we are trying to present. As the facts that affect the probability of a negative outcome increases, our conviction to own a share that would benefit from a positive outcome must decrease. We have expressed this view via ours and an alternate view on UK banking, but clearly the ramifications to the wider UK economy and stock market are far reaching.

We remain of the view that in most scenarios the value being offered in UK companies like banks + airlines ++ is compelling, but wanted to consider when it might not be. Post sell-offs in other markets and financial sectors there is now alternative value available in banks and other assets elsewhere in the world without the UKs possible short-term political risks. This is the benefit of being a global investor.

Whilst the bulk of our time is spent on business models and understanding the dynamics of long-term compounders, we think sometimes you need to look again at the poker game to make sure the patsy isn't you! We will leave clients to use these reflections/observations as they see fit. Some may dismiss us as "becoming short term" others we hope may have found them of use.

With kind regards

Andrew & Mark

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Appendix

The Corbyn Revolution Advances

Intramural political feuds rarely warrant much attention, but developments within Britain's Labour Party this week are a special case. The country's main opposition that may be the next governing party extended its march to the left.

Party members on Monday elected three loyalists of left-wing leader Jeremy Corbyn to the party's National Executive Committee, cementing Mr. Corbyn's grip. One is Jon Lansman, a self-described "radical socialist" who founded Momentum, the group formed to support Mr. Corbyn against party moderates. The other two are also with Momentum.

Mr. Corbyn's loyalists now hold more than half of the 39 seats on the council, which is comprised of grass-roots members, union representatives and elected politicians. One of the left's early goals is to change party rules to make it easier to unseat moderate Labour members of parliament in primary-style elections.

In a sign of how Mr. Corbyn will use this new control, this week he made Christine Shawcroft the head of the party's internal-discipline committee. Ms. Shawcroft had been suspended from Labour in 2015 for her vocal support of a local politician in London's Tower Hamlets area con-

The left consolidates control over Labour as the Tories fumble.

victed of electoral fraud. Her committee promptly weakened sanctions or shelved several investigations of anti-Semitism among party members at her first meeting.

All of this matters because as Mr. Corbyn drags his party further left, the ruling Conservative Party is falling deeper into disarray. Prime Minister

Theresa May was rocked this week by the bankruptcy filing of Carillion, a construction company awarded dozens of government contracts over many years. On top of faltering Brexit negotiations with Brussels, and against the backdrop of last year's election fiasco in which Mrs. May lost parliamentary seats to Labour, there's a real danger Mrs. May's government could run aground.

That would clear the way for Mr. Corbyn. Voters and pundits may still believe Labour's moderate members would temper Mr. Corbyn's desire to nationalize industries such as railroads, pile on tax increases and entitlement expansions, and withdraw Britain from NATO. This week's leadership changes say otherwise. Mr. Corbyn's revolution is purging Labour moderates, making the party less fit for power exactly when there is more danger it can win.

Source: WSJ, Jan 2018

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