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MELLON ON THE MARKETS

By Jim Mellon

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Brexhausted!

I'm now back in Spain after being in the UK on the day of and the morning after the referendum. Wow – what a result!

I went to the area just outside Parliament where the TV and radio stations had set up and had been broadcasting all night till the morning of June 24th. It was surprisingly quiet, with only a glimpse of Liam Fox skipping down the path, and a quick handshake with Nick Ferrari and Andrew Pierce.

Then I held a celebratory breakfast at my pub in Notting Hill for (mostly) likeminded people, though my sister Claire didn't look too happy. This was in sharp contrast to her Danish husband, Lars, who was absolutely delighted!

We had been trading all night, and luckily, our instinct that the Soros doomsday scenario was far too pessimistic proved right. We covered all of our sterling shorts, and also our DAX and S&P shorts and went long. Then, in and out, playing the range till the volatility abated and markets began to settle down.

My sense is there might be a little bit more volatility, but that markets are more or less accurately priced, with the exception of the US, which is still too expensive. Oh, and of course, this excludes bond markets, which are suffering from collective delusion and central bank manipulation.

I was sure Cameron would have to go – and I don't really believe he went voluntarily. I think he was pushed by Tory grandees. He was stupid to call the referendum in the first place, and then to deliver such an abject set of 'reforms'. He also compounded matters by being such a promoter of the backfiring 'Project Fear', which essentially doomed the Remain campaign. As for his mate, George Osborne, he's as toasted as a muffin.

I was interviewed a fair bit over the last week or so, and I kept making the economic case for Leave – one that, in my view, had not been well articulated, as the Leave camp preferred to focus on sovereignty and, of course, immigration.

There is no doubt that immigration is a big issue for many people who felt disenfranchised and who couldn't see any benefits from the free movement of people. The *scale* of inward migration to the UK has been too high, and the strain on the exchequer and on public services has been too severe.

It is also a fallacy to suppose that immigrants are net contributors to the public purse. My friend James Ferguson has done great work showing that the entirety of the British government fiscal deficit of between £70 and £80 billion is due to transfer payments (the UK has already got all of its money back from the banks).
Of this, about 40% is payments to workers on short working hours (16 hours, generally) who are "topped up", and much of that goes to EU immigrants, a minority of whom "game" the system. This is something that needs to be addressed – and presumably can be in the coming months or years.

My general view is that not much will happen immediately; life will go on. The economy was already slowing, with or without Brexit, and the pound has been overvalued for too long, especially with the large current account deficit that we run, particularly with Europe. And as for housing, it has been stopped in its tracks by Osborne's meddling and by the fact that it remains overvalued.

So, a sterling rate of 1.35 to 1.40 against the US dollar seems right to me. As for the stock markets – which ended higher on the week of the referendum than at the start (so much for the doom-mongers!) – the UK and continental ones seem about correctly priced. And Japan is mighty cheap.

So what will happen now?

I think Britain will delay the invocation of Article 50 (the two year stopwatch) for as long as possible, probably six months to a year. In that time, there will be frantic negotiations to try to do five things:

1) Get some outline trade deals done – and I think this could be done with the US, despite Obama's ill-judged intervention. It is much easier for us to do such deals with the US and others, believe it or not, than for the EU. This is because we don't have all the vested interests of European nations with respect to, for instance, agriculture and "culture" (i.e. non English) industries.
2) Offer to pay £5 billion a year into the EU budget for 10 years, without requiring anything back. This will still be a good saving for the UK.
3) Immediately have a fiscal stimulus. To spike Ireland and Luxembourg's guns, go to a 10% corporate tax rate at once. This will encourage more multinationals to come to the UK. It is easily affordable.
4) Put the Scottish question to bed. I am pretty sure that in the same way that turkeys don't vote for Christmas, the Scots (with an average subvention of £3,000 per head, a poorly diversified economy, and a declining oil industry) won't go for independence. This, despite Nicola Sturgeon's defiant stance. In any case, they won't get into the EU (Catalonia being the main reason), and they wouldn't be allowed either the pound or the Euro. (The Bawbee, maybe?)
5) Most importantly we need to do a deal with Europe, in outline and BEFORE the invocation of Article 50.

My preferred deal would be for some form of "associate" membership, which might consist of the following:

1) Visa free travel and a LOTTERY for the admission of up to 100,000 EU citizens a year into the UK, who would have rights to work and to stay permanently. Or an Australian style points system for the same numbers. In return, the EU would allow an equivalent number of British people to have the same opportunity in the EU. This would allow the absorption of immigrants at a more acceptable rate.
2) A free trade customs Union continues, but the UK is free to make its own bilateral trade deals.
3) The UK and EU agree to work together on common standards, and a range of other issues.

Why would the EU agree to this? Well, a "punishment" of Britain is unlikely to work. It would, in my opinion, only encourage more referenda in other EU countries.

A form of associate membership would restore some sort of stability, and allow for face-saving for all parties concerned. Other countries inclined to leave (Denmark, Sweden, Holland) could seek this similar arrangement.

I intend to write this idea up properly in the next couple of weeks, and Master Investor subscribers will be the first to get it.

This may just work out OK, and I am hopeful. My instinct is to buy selectively in the next few days.

My top tip short term is **Lloyds Bank (LON:LLOY)**, which fell by a fifth on the day but looks cheap and rock solid. I also like the **Nikkei**, which for some bizarre Japanese reason fell more than the UK market on the Brexit news.

Fun times ahead!

Happy Hunting!!

Jim Mellon

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