CROSSBRIDGE CAPITAL

Market Viewpoints

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Despite a voluminous and often fervent literature on "income distribution," the cold fact is that most income is not distributed: It is earned.

- Thomas Sowell

Lower for longer is the new regime for oil, barring a geo-political conflict that disrupts supply. Saudi policymakers perhaps remember the bitter lessons from the early 1980s, when Saudi Arabia cut its production to prop up prices in the face of rising supplies from non-OPEC producers. Saudi policymakers today are determined not to make the same mistake again. Whatever one may think of the whole *Brexit* issue, it is clearly a possibility and that begets uncertainty. There is no precedent of a nation leaving the European Union (EU). We therefore have no template for how EU-UK economic relations might be post *Brexit*. The EU started as an economic area, breaking down trade barriers. Few leaders in the EU or the UK would want to go back to the time of trade barriers. It will be mutually destructive and therefore unlikely. The current US economic expansion is almost seven years old. This may seem long and we are therefore hearing murmurs of a looming recession. However, this expansion is the worst ever in terms of per annum (p.a.) GDP growth. During 1910-30, when the US experienced one of its worst depressions, Real GDP grew at a +2.6% p.a. pace. During 2009-15, US real GDP has grown at a paltry+ 2.1% p.a., largely due to the absence of any meaningful fiscal response. In the past, fiscal stimulus has been an important component of a recovery post a recession. This time around, austerity has been the buzzword.

The Oil Sheikh-up

The Oil market has witnessed one of the biggest (if not the biggest) shake-ups in history. It is quite unlike the previous slumps of 1985-86, 1997-98, 2000-01and 2008-09 when the Organisation of Petroleum Exporting Countries (OPEC) or let's say, Saudi Arabia, had greater control in restoring prices to pre-slump levels by cutting production.

So what's different this time around? US shale.

Shale's impact on the oil market has been so disruptive as its cost base has emerged in the middle of the Oil price curve. The breakeven price for shale oil ranges from as low as $30 per barrel to $60 or above. The shale revolution of horizontal drilling and hydraulic fracturing techniques is not new. The first horizontal well was drilled in 1929. The problem has always been its relatively high cost. Shale oil drilling techniques were used extensively in North Dakota in the early 1990s but could not be made to work commercially (Oil price was then in the $20 range), leading to their abandonment by the end of the decade.

However, a quadrupling of oil prices between 2002 and 2012 - coupled with significant technological improvements - created conditions for a second shale revolution, and this time it did not stall. The result has been an extraordinary renaissance in US oil production. In December last year, the production of US petroleum products - 14.83 million barrels per day (bpd) - exceeded Saudi Arabia's output by 3.3 million bpd, leading some to nickname the US as "Saudi America."

Quite simply, Saudi Arabia is not the "swing producer" it once was and therefore cannot be sure of cutting production and sending oil prices back up. Lower for longer is the new regime for oil, barring a geo-political conflict that disrupts supply. Cutting production to keep prices artificially high would only sacrifice Saudi Arabia's market share and allow shale production to continue expanding. Instead, Saudi Arabia is determined to let prices decline enough to begin curbing investment in new shale wells and formations.

Saudi policymakers perhaps also remember the bitter lessons from the early 1980s, when Saudi Arabia cut its production and exports to prop up prices in the face of falling demand and rising supplies from non-OPEC producers including the North Sea. In 1983 and 1984, for example, the Saudis found themselves producing only about 3.5 million barrels per day, despite their (then) production capacity of almost three times that level. They lost market share and revenue and it didn't do much for the oil price. Saudi policymakers today are determined not to make the same mistake again.

U.S. consumption of petroleum products declined by more than 2 million bpd (almost 12%) between 2005 and 2013, even though the country's population increased by more than 20 million over the same period and real economic output grew by 10%. High prices were essentially the key catalyst for the US shale boom which resulted in one of the fastest increases in oil production in history during 2013-14.

Oil prices must ultimately drop to a point at which the market rebalances – which means eliminating some of the production as well as slowing or reversing the reduction in demand. There are signs the adjustment is well under way.

European (dis)Union and Brexit

Ever since the fall of Rome in 476 AD, a school of European thinking has longed for the re-creation of an overarching political structure for Europe, using the Roman Empire as a model. First in 800AD - more than three centuries after the fall of Rome - Charlemagne, the king of the Franks, had himself crowned in Rome by the Pope. His empire stretched from the Pyrenees to the Danube and from Hamburg to Sicily. Charlemagne's empire fell apart fairly swiftly after his death in 814AD but his ideas continued to inspire those who sought to unify Europe. Napoleon invoked Charlemagne at his imperial coronation in 1804 and more than a century later Hitler's loyalists ignominiously gave the Roman salute and their cry *“Heil Hitler!”* was modelled on *“Hail Caesar!”*. The Charlemagne connection doesn’t end there; the European Union (EU) has been run from the Charlemagne building in Brussels.

European unity is facing a testing time again. This time from the UK with a *Brexit* referendum on June 23 that could see the United Kingdom vote to leave the EU and cause damage to European solidarity. The notion that unity and peace in Europe are two sides of the same coin is an article of faith for modern pro-Europeans. Whatever one may think of the whole *Brexit* issue, it is clearly a possibility. One cannot ignore the uncertainty which will come in its wake prior to and indeed post the referendum, if the UK did vote to leave the EU. The plain fact is that there is no precedent of a nation leaving the EU. We therefore have no template for how economic relations might be post-*Brexit*.

Having said that, given the trade reliance it’s inconceivable that the EU would be spoiling for a fight with the UK if it were to leave.

- According to year-end 2014 figures, the UK exported £230 billion (44.8% of total UK exports) of goods and services to other EU member states and Goods and services imports from the EU were worth £290 billion (52.8% of the total imports). The UK therefore had a trade deficit of £60 billion with the EU. Of that deficit, £27 billion (nearly 45%) is with Germany, £12bn with Spain, £9bn with Belgium, £6bn with France and £5bn with Italy
- The EU as a bloc is by far the UK’s largest trading partner. Exports to the US were £88.0 billion and exports to China £18.7 billion in 2014

The EU started as an economic area, breaking down trade barriers. Few leaders in EU or the UK would want to go back to the time of trade barriers. Besides the EU is in no position to pick a trade war with the UK. It will be mutually destructive and therefore unlikely. On a macro level, the Eurozone has not grown measurably at all since 2008. Levels of unemployment remain stubbornly high at 10.4%, leading to extensive youth emigration from distressed southern and Eastern European countries.

My best possible guess is that come *Brexit*, we will see a period of uncertainty lasting 12 to 18 months during which the whole EU-UK relations are renegotiated and preferential EU-UK trade deals covering goods and services sectors are put in place. This will restore most if not all of status quo as existed pre-*Brexit*. Guaranteeing seamless access to EU markets for UK businesses will be more difficult, not least because the UK has a deficit with the EU in goods, but a surplus in services.

The truth is if the UK and the EU put as much effort into reforming the EU as it would have to in order to make *Brexit* amenable, the UK and the EU would both be far better off. However the best outcome rarely is the most likely outcome as history has taught us. The latest *YouGov* poll on *Brexit* puts LEAVE on 38%, REMAIN on 37%, with 25% undecided. Both sides have all to play for.

Where to invest

While choppy markets require a strong stomach, they also historically hold attractive returns. After falling for most of the year, stocks have staged a good rebound in the past week. It’s encouraging to see some of the most beaten-up stocks - Energy and Mining as well as Financials, rebound by as much as +15% since the Standard & Poor’s 500 index (SPX) hit a multiyear low on February 11. This augurs well for stocks overall, however, we may not be back in a secular uptrend yet and the recent market calm and rising prices may be short-lived.

Incoming economic data continue to tell a story of a two-tiered US economy. On the one hand, the consumer and housing sectors continue to expand at a solid pace and the labor market moves closer to “full employment.” On the other hand, data on the industrial sector point to contraction.

The current US economic expansion is almost seven years old. This may seem like a long time and we therefore hear murmurs of looming recession. However, one must not forget, this expansion is the worst ever in terms of per annum (p.a.) GDP growth. During 1910-30, when the US experienced one of its worst depressions, GDP grew at a +2.6% p.a. pace. During 2009-15, US real GDP has grown at a paltry +2.1% p.a. largely due to absence of any meaningful fiscal response. In the past, fiscal stimulus has been an important component of a recovery post a recession. This time around, austerity has been the buzzword. Of course, a high debt/GDP ratio didn’t make the case for stimulus any easier.

A US fiscal response is key to coming out of this "stagnant/low growth" trend. Unfortunately, a policy vacuum prevails on the fiscal front until the election is over. There is little discussion about increasing taxes and/or spending. Everyone remembers President Ronald Reagan’s 1981 tax cuts. His admirers are less likely to tout the tax hikes he accepted as the 1981 recession and his own tax cuts began to unravel his long-term fiscal picture - a large tax increase on business in 1982, higher payroll taxes enacted in 1983 and higher energy taxes in 1984. A decade later President George Bush Sr similarly raised taxes on higher-income people in 1991 and President Bill Clinton doubled down and raised them again in 1993, in response to a serious recession and worsening fiscal outlook. If the Democrats win the White House, be prepared for higher taxes and a higher deficit to boost economic growth. In fact, a Republican President will be pushed to do so as well.

The greatest risk to the US economy continues to be the US Federal Reserve (Fed) tightening monetary policy too far, too fast. I don't believe they will, and, as I have said in the past - the Fed will be lucky to get two rate hikes in this year.

Recent stock market weakness has helped the index of Leading Economic Indicators (LEI) register a negative print for the second month in a row. A third negative reading in a row would indicate the onset of recession. So concern is apparent among economists. Yet, one should bear in mind that the LEI has predicted eleven of the last seven recessions! The decline of the Index for consecutive months has generally been a condition for a recession, but not necessarily a confirmation of one.

There are a few good reasons why US recessionary fears are overdone.

- Since 1960, the median increase in the unemployment rate in the year before a recession is +0.4%. The past year has seen a drop of -0.8%
- *GDPNow*, the Federal Reserve Bank of Atlanta's real-time estimation of U.S. gross domestic product based on current data, is currently predicting +2.8% growth for the first quarter
- The employment numbers clearly show the US economy is growing, with gains in manufacturing employment, increases in hourly earnings and hours worked, and an uptick in participation
- The consumer continues to show strength that is evidenced by strong retail sales numbers

The U.S. economy has plenty of steam and should continue its expansion for at least another 18-24 months. In fact I will go as far as to say - be prepared to be surprised by inflation in Q3/Q4 this year, when more slack has been removed from the US jobs market and money saved from "low energy" prices is finally spent. When you make an unexpected saving (as is the case from low energy prices over last 12-15 months) you don't go and spend it unless you feel secure about your job and wages. Jobs and wages in the US are getting better and it will beget the savings that consumers have pocketed from low energy prices.

Whatever the reason, as an investor, it is best to focus on the medium term and not just short-term market volatility. The market will continue to be volatile but we have an European Central Bank (ECB) easing, perhaps a further easing from the Bank of Japan (BOJ) and the Fed staying on hold at its March meeting. The SPX, at 1850, is a buy and we have seen that level tested in August last year and twice this year.

Some of the stocks I hold/recommend holding - Starbucks (SBUX US), Citi (C US), JP Morgan (JPM US), Bank of America (BAC US), Gilead Sciences (GILD US), Allergen (AGN UN), General Electric (GE), General Dynamics (GD US), Apple (AAPL US), Google (GOOG US), Amazon (AMZN US), Schlumberger (SLB US), Anheuser Busch (ABI BB), Pepsi (PEP US), UBS (UBSN VX), Richemont (CFR VX), Daimler (DAI GY), Airbus (AIR FP), Roche (ROG VX), Rio Tinto (RIO LN), Halliburton (HAL US), Walgreen Boots (WBA US), Home Depot (HD UN), CBS Corp (CBS US), Alibaba (BABA US), Pfizer (PFE US), Michael Kors (KORS US), Salesforce (CRM US).

Best wishes,

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