



Big-government liberals don't like people with a sense of independence - because independent people don't need big government.

- Neal Boortz



Summary:

In the rescue of two of its troubled banks - Banca Popolare di Vicenza and Veneto Banca, Italy decided to abandon the new European bail-in rules and instead "bail-out" these banks, at a cost to the Italian taxpayer of €17 billion. So much for new rules ensuring taxpayers are never going to bail-out failing banks again! The European Union (EU) has once again failed to rein in bankrupt banks. Investors are watching and many are not impressed. The EU is no longer a bureaucracy, it has become an adhococracy that uses ad hoc rules which it makes up as it goes along. In the UK and the US, Labour leader Jeremy Corbyn and US Senator Bernie Sanders are suddenly the role models of the youth who are overcome with pangs of socialism. History suggests that every single truly socialist country has been an economic failure. Socialist nations make their people poorer, undermine democracy and endanger individual freedom. The poor in socialist countries have always done worse than they would have done under a capitalist economy. This lesson is sadly lost on the modern day youth in the western world. Frustration in the youth of today is understandable. People whose life hasn't matched their expectations, often become alienated and angry. They were promised a better future and it looks anything but that.

Wildcat Banking

Between 1816 and 1863 in the United States, banks were chartered under state laws and no federal oversight existed. This led to US banking degenerating into so-called "wildcat banking." Banks of very dubious soundness would be set up in remote and inaccessible places "where only the wildcats thrive." Bank notes would then be printed, transported to nearby population centres, and circulated at par. These bank locations were sometimes the only places where the bank's notes could be redeemed, thereby creating a formidable obstacle for their redemption by note holders and providing an unfair advantage to unscrupulous bankers. These and other similar abuses made banking frequently little more than a legal swindle. Banking has undoubtedly changed since then, and bank branches may no more be purposefully set-up in remote "wildcat" neighbourhoods, but greed and naivety still get people swindled, no matter which part of the world they live in. In Italy retail clients have been the victim of "wildcat banking" and indeed their own greed and naivety, and they have paid the price. Retail investors were sold risky bonds in Italian banks without a proper explanation of the risk and some bought them due to the attractive yield on offer.

In 2014, the European Union (EU) adopted the Bank Recovery and Resolution Directive (BRRD) that set a framework for a common approach within the EU for the recovery and resolution of banks and investment firms. The BRRD is a key component of the EU's efforts to end the "too big to fail" problem. As part of the BRRD, in January 2016 the EU bail-in rules came into effect. The rules state that no bank can be "bailed-out" with public money until creditors accounting for at least 8% of the lender's liabilities have paid up. Italy has numerous troubled banks and in November last year, Italy decided to apply the "bail-in" rules in rescuing four banks. This led to almost 130,000 shareholders and holders of Euros 790 million (US\$864 million) of junior debt, see their investments wiped out. The problem was that many of the subordinated bondholders, who had to be bailed-in, were ordinary savers who had been sold these investments without an explanation of the risk. One bond holder committed suicide. It was the first time since the 1930s that bondholders had suffered losses in a banking crisis in Italy. "Bail-in" rules were also applied to banks rescued in Cyprus, Portugal and Spain.

"Bail-ins" therefore seemed the way forward and the proper template to clean up the European banks of their loan books on the way to eventually achieving a European Banking Union (EBU) in the near future. All that changed however last Sunday when something quite extraordinary happened.

In the rescue of the two troubled banks - Banca Popolare di Vicenza and Veneto Banca, Italy decided to abandon the bail-in rules and instead "bail-out" the banks, at a cost to the Italian taxpayer of €17 billion. So much for the new EBU rules ensuring taxpayers are never going to bail out failing banks again!

The EU "pragmatically" interpreted the BRRD (or rather largely ignored it) and allowed Italy to go ahead with the bail-outs. Even the subordinated retail investors are being fully compensated. The EU has once again failed to rein in bankrupt banks. Everyone is watching and many are not impressed. The EU is no longer a bureaucracy, it has now become an adhococracy that uses ad hoc rules which it makes up as it goes along.

On current growth projections, Italy's economy is not expected to return to its pre-crisis (2007) level until the mid-2020s, implying nearly two lost decades of growth. The second round effect of a stagnant or shrinking economy, is that Italy's banks are saddled with nonperforming loans (NPLs) and the NPL ratio has risen to 18% of loans. The corresponding NPL ratio for banks in Spain, France and Germany is 6.5 %, 4% and 2% respectively. That is not all. Italy's public debt was around 100% of GDP at the time of the global financial crisis. It now stands at almost 132% of GDP, the second highest in the Eurozone, after Greece. High NPLs have adversely affected the banks' profitability, as margins (already among the lowest in Europe) are squeezed further. It also limits their ability to extend credit to the economy thereby hurting an already reeling economy further. More pain lies ahead. An IMF report published in July last year says that retail investors own about one third of the €600bn of bank bonds in Italy. They also own half of an estimated €60bn of subordinated bank bonds. There is always a cost for continuing with bad practises. Why would the retail investors not load up on more low-quality bank debt when they know that the government doesn't have the stomach to bail them in? If sustainable growth doesn't return to Italy, debts will sour. More bail-outs are on their way and European banking union will die a very quick death.

Pangs of Socialism

So, UK Prime Minister Theresa May called an election and she didn't achieve her initial objectives. Labour leader Jeremy Corbyn didn't win either, but you wouldn't know that if you listened to him and his acolytes. Such is the halo around Corbyn that you would think he is the current occupant of No 10 Downing Street, running the country on weekdays and espousing his socialist views at Glastonbury on the weekend. This past Sunday, Corbyn ranted against "austerity" to the Glastonbury faithful, who had paid over £300 a head to listen to likes of Katy Perry and Radiohead.

Corbyn and US Senator Bernie Sanders are suddenly the role models of the youth who are overcome with pangs of socialism. History suggests that every single truly socialist country has been an economic failure – North Korea, Venezuela, USSR, Cuba, Yugoslavia...and the list goes on. China, once an utter failure under Chairman Mao's authoritarian socialism, has since gained success by adopting capitalist policies. India, my home country, started making rapid progress only after it had cast aside the shackles of the socialist policies of the previous decades. Socialist nations make their people poorer, undermine democracy and endanger individual freedom. The poor in socialist countries have always done worse than they would have done under a capitalist economy. This lesson is sadly lost on the modern day youth in the western world. Capitalism, of course, has its flaws and it should be addressed via strict regulations, but, whatever the question is, socialism is not the answer.

Frustration in the youth of today is understandable. People whose life hasn't matched their expectations often become alienated and angry. They were promised a better future and it looks anything but that. Successive generations are destined to be poorer than the previous ones. Why this frustration? A few decades ago, a small number of young people went to university and then on to a decent job and career. The rest chose apprenticeship and didn't see university education as a must have. Both sets led a life full of values and fulfilment and the country had all the skill it needed and the proper allocation of resources. Then some bright spark (Prime Minister Tony Blair in this country) set out to achieve a goal of 50% of UK's young adults progressing to higher education by 2010. The goal being for them to get better, high-skilled jobs, earn more money, pay more tax and boost the economy. The number of Brits going to university soared. In the UK today over 50% of 25-34 year olds go to university. Compare that to Germany where the corresponding number is 29%. And which country do you think has the better educated and more high-skilled workforce? Germany of course. Research for the Chartered Institute of Personnel and Development (CIPD) shows that 58.8% of UK graduates have ended up in non-graduate jobs. Think of the precious three years wasted at university studying for the degree, the earnings foregone, the expenses incurred. Go to university they said and the world will be your oyster. Only in this case for many, the oyster doesn't come with a pearl but with the debt papers of a student loan.

The expansion of the universities system has created more jobs for left-wing academics than for students graduating from them. Apprenticeship has floundered and university education has been promoted to the detriment of useful and highly needed skills in the workforce. Government guarantees of student loans have made the situation worse and led to a huge and unsustainable increase in college fees particularly in the US. University was never meant to be for everybody. It was always supposed to be for the more academic students who pass the strict entry criteria. Imagine if we said 50% of those who can limber up and run 100 metres, should be allowed to compete at the Olympics? University places should be limited to 30-35% of the young or a proportion as deemed fit to meet the skills demand and the skills gap. University education should not sell a dream and serve a harsh reality three years later.

You would think policymakers would learn but very few do. Populist Corbyn has another bright idea - abolish tuition fees at university. Why do we constantly have the need to forget lessons in favour of "new ideas"?

Where to invest?

Disinflation is still a concern. The latest figures from the New York Federal Reserve and the University of Michigan show long-term consumer inflation expectations at record lows. US consumers' expectations of inflation one year from now fell as did projected inflation three years from now. This complicates the US Federal Reserve's (Fed) case for raising short-term interest rates. Fed officials have long expected inflationary pressures to continue to rise back to their official 2% annual increase target arguing that the recent weakness is temporary. However, softening inflation expectations, complicate that view since the expectations of future inflation exert a powerful influence on price levels now. The decline in expectations could herald softer inflation readings in the future.

Despite some concerns, the equity market has continued to drift higher. It has now been more than a year since the S&P 500 (SPX) last saw a correction of at least 5%. That's the longest streak since 1996. The SPX has notched 24 all-time closing highs this year. The worst sell-off on the closing basis this year was a -2.8% decline over 44 a day period from March 1 through April 13. Remember the days back in 2007 and 2008 when -2.8% declines were common in a single day?

The yield curve continues to flatten while the Fed raises short-term rates. The Fed Funds Target Rate (FDTR) is now 100 basis points higher than it was before the current hiking cycle began, but the 10-year Treasury yield is 5 basis points lower over the same period. Continuing Quantitative Easing (QE) by foreign central banks in Europe, Japan and the UK could be distorting the term structure of US interest rates. While a flatter yield curve doesn't bode well for equities in the longer term, for now, so long as the yield curve is still upwardly sloping, a less steep yield curve is not necessarily a sign of recession.

Reasonable US growth and falling labour market slack should allow the Fed's tightening cycle to continue. I still expect we could get two more hikes this year and perhaps balance sheet reductions before year end.

While I am risk positive and still recommend to keep your equity longs, I sometimes do worry that the market's apparent "certainty" regarding the future path of interest rates could be giving many a false sense of calm. The market might not be giving sufficient attention to the unlikely risk of the Fed tightening quickly.

Euro area GDP has accelerated and should grow +2% in 2017. The economy is staging a cyclical recovery in corporate earnings and asset quality. The growth is sufficiently strong to steadily nudge the European Central Bank (ECB) in a more hawkish direction and this Tuesday we saw signs of that. ECB President, Mario Draghi, hinted that the ECB might start winding down its stimulus in response to accelerating growth in Europe. "Political winds are becoming tailwinds," Draghi said. "There is newfound confidence in the reform process, and newfound support for European cohesion, which could help unleash pent-up demand and investment." The ECB is currently buying bonds at the rate of €60 billion per month. Expect it to go to €40bn monthly purchase rate at the start of 2018 and €20bn thereafter, before a complete wind down. An extension of QE beyond the middle of next year is very unlikely. The central bank is soon expected to start running short of bonds to buy, particularly German debt, due to self-imposed constraints in the design of QE.

European equities continue to be a good long position for reasons mentioned above. I continue to hold US equities with sector bias to Industrials (XLI), Technology (XLK) and Financials (XLF). Continue to hold Emerging Market (EM) equities as US dollar strength seems to be less of a concern. And as I mentioned last month, as we head into a slowdown in momentum at the equity index level, it will pay to hold single stocks over Index funds or ETFs, both in the US and Europe.

In terms of stocks I like: JP Morgan (JPM US), Bank of America (BAC US), Citi (C US), Allergan (AGN UN), Celgene (CELG UW), General Dynamics (GD US), United Rentals (URI), Northrop (NOC US), BAE Systems (BA LN), Boeing (BA UN), Apple (AAPL UN), Google (GOOG US), Microsoft (MSFT US), Amazon (AMZN UW), Home Depot (HD UN), CBS Corp (CBS US),

Alibaba (BABA US), Pfizer (PFE US), Publicis Groupe (PUB FP), BNP Paribas (BNP FP), UBS (UBSN VX), Salesforce (CRM US), Estee Lauder (EL US), Johnson & Johnson (JNJ), Walgreen Boots (WBA US), Glencore (GLEN UN), Rio Tinto (RIO LN), Pioneer Natural Resources (PXD), Blackrock (BLK), United Health (UNH), Comcast Corporation (CMCSA), Eiffage (FGR FP), VISA (VUS), Baidu (BIDU US).

Best wishes,

Manish Singh

Manish Singh, CFA

United Kingdom

9 South Street
London W1K 2XA
United Kingdom

Singapore

One Temasek Avenue
23-05 Millenia Tower
Singapore 039192

Monaco

Le Park Palace,
Bloc A, 8ème Etage
5, Impasse de la Fontaine
98000 Monaco

Visit our website:

crossbridgecapital.com

