CROSSBRIDGE CAPITAL

Market Viewpoints

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> **There is nothing new on Wall Street or in stock speculation. What has happened in the past will happen again, and again, and again. This is because human nature does not change, and it is human emotion, solidly build into human nature, that always gets in the way of human intelligence. Of this I am sure.**
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> - Jesse Livermore

When the S&P 500 index (SPX) fell -10.5% by early February, it might have seemed a tall order to believe that we would be looking at a positive finish for the quarter. This is exactly what has happened as the central banks of the world have renewed their focus on monetary easing, with the biggest single impact coming from the US Federal Reserve. Last week, Fed Chair Janet Yellen provided a "Spring bounce," by sounding more dovish than anticipated. Yellen's comments appear to have ended the bull run in the USD and given a boost to risk assets. The Fed has undershot its inflation target for so long that it's not unimaginable that it would be willing to accept some inflation overshoot (when there is one) to make up for the loss. This means that the interest rate risk is only to the downside. Inflationary pressures will likely remain elusive, and if they do come, then the Fed will most likely tolerate them rather than hike interest rates too quickly to quash them. Did last month's G-20 meeting in Shanghai come up with a secret currency accord? A "Shanghai Accord" to weaken the US dollar, help the global economy and give China room to rebalance its economy? If the second largest economy of the world, China, is going to make a transition to a more flexible FX regime, and the emerging markets of India and China are to be a pocket of strong GDP growth that the world desperately needs, then both a contingency plan and global coordination are key. Therefore, if there was a tacit deal at the G-20 last month to keep the US dollar from strengthening further, it is certainly comforting. A weak USD will also be a help to Emerging Markets as a whole. The US economy has plenty of steam left in it and should continue its expansion for at least another eighteen months, if not longer. We were always unlikely to see a US recession this year, and the Fed's decision to stay dovish has pushed this likelihood back further.

When Spring came

Spring is upon us. In *A Moveable Feast* by Ernest Hemingway, a memoir about his time as a struggling writer in Paris, he wrote, "... when Spring came, even a false Spring, there were no problems except where to be happiest." How one wishes those words were true for the market this Spring - no problems, just buoyant stocks and assets to choose from.

When the S&P 500 index (SPX) fell -10.5% by early February, it might have seemed a tall order to believe we would be looking at a positive finish for the quarter. However, this is exactly what has happened. The SPX has rallied over 200 points since its mid-February lows. So, can the bounce last?

Yes, and the simple reason is that the central banks of the world have renewed their focus on monetary easing, with the biggest single impact coming from the US Federal Reserve (Fed). Last week, Fed Chair Janet Yellen provided a"Spring bounce" by sounding more dovish than anticipated. Yellen's comments appear to have ended the bull run in the USD and given a boost to risk assets. In the press conference that followed the Federal Open Market Committee (FOMC) decision last week, Yellen highlighted that the stability of longer-term inflation expectations cannot be taken for granted. In terms of the labour market, she noted improvements but said that slack remains, as evidenced by a lack of sustained wage growth. She also highlighted concerns about the international environment. The Fed now expects only two rate hikes this year (as opposed to four in their previous projections.) The FOMC is now in line with my own forecast made in December 2015. The Fed has projected four additional +0.25% rate increases next year but, in my view, they will be lucky to pull off two increases.

In that same newsletter, I also said that we would not likely see a new high in the SPX in 2016. I will now take that back. (He giveth and he taketh away). The SPX is very likely to see a new high this year, although the equity market will continue to be volatile. Rallies will be sold as they reach technical levels only to be bought back again as dovishness and the support of central banks persists.

Last week, not only did the Fed signal that the path to higher rates will be very gradual, but that the higher rate itself will be lower. The median estimate of the long-run Federal Funds rate is now at +3.25%. It was at +3.5% in December 2015 and +4% two years ago. You could say that the markets had reached the same conclusion long before the Fed. This is why 10-year Treasury yields have stayed below +2.5% for nearly two years now. Fed officials are finally coming around to the market's way of thinking.

On Friday, Former Fed Chair Ben Bernanke posted a new entry to his blog; "What tools does the Fed have left?" and went on to say that the Fed is not out of ammunition. That said, there are signs that monetary policy in the US and other industrial countries is reaching its limits, which makes it even more important that the collective response to a slowdown involves other policies, particularly fiscal ones. A fiscal response will be key and has been missed for some time now. Having easy monetary policy in place will not deliver the GDP growth in as much as merely having a fitness App on your iPhone doesn't guarantee you will lose weight. Politicians have to "run" with the fiscal policy to bring back growth. Particularly in Europe, where there is a demand problem. Demand problems need a fiscal response.

Shanghai Accord?

Currency accords have become a thing of the past, or so we think. The last significant such accord was thirty years ago. The 1985 Plaza Accord between the G-5 nations of France, West Germany, Japan, the United States and Britain, allowed the US dollar to weaken significantly through joint intervention in the currency markets and it spurred the US economy to climb out of a long recession.

Did last month's G-20 meeting in Shanghai come up with a secret currency accord? A "Shanghai Accord" to weaken the US dollar, help the global economy and give China room to rebalance its economy? There are good reasons to believe that there was a tacit deal. Since that G-20 meeting central bankers have made some unexpected moves, taking markets by surprise. First, China has managed to convince the market, to a large extent, that devaluation of the Renminbi is not a policy of theirs - a move that stopped further weakness in CNY/USD. Second, the European Central Bank (ECB) said it was done with lowering rates for now - a move that has driven the EUR/USD higher. The Bank of Japan (BOJ) at its most recent policy meeting stayed put and did not take the opportunity to weaken the Japanese Yen (JPY) further, despite a bad Q4 GDP number. And finally last week, the Fed struck a surprisingly dovish tone and indicated that it would significantly slow the pace of rate hikes this year, ignoring the recent set of better than average US economic data. The net result of all these actions is the weakening of the US dollar against the RMB, EUR and JPY, all major trading partners of the US and the world. If a deal were struck, this would be a welcome move and truly very reassuring. It's good to know the world is not left to its own devices.

The dollar index (DXY) jumped almost +10% last year and, in December, it reached its highest level in more than a decade. There should be no doubt that preventing an overshoot of US dollar strength is in the interests of the US and the world. The financial community was increasingly beginning to ask difficult questions: What happens if China devalues CNY by X% versus the USD? How big should the one off devaluation be? Does that mean US equities go down by 3x or 5x or more; What about oil and other commodity prices? Does the Hong Kong dollar (HKD) peg survive? How about the Saudi Arabia Riyal (SAR) peg, would that survive? These are all searching questions with no easy answers.

The point is, that if the second largest economy of the world, China, is going to make a transition to a more flexible FX regime, and the emerging markets of India and China are to be a pocket of strong GDP growth that the world desperately needs both a contingency plan and global coordination is key. Therefore, if there was a tacit deal at the G-20 last month to keep the US dollar from strengthening further, it is most certainly comforting.

Where to invest

The big macro events have come and gone and most were risk positive. At China's National People's Congress (NPC) the officials calmed worries regarding the country's growth and indicated that weakness in CNY was overdone.The ECB announced a large expansion of its Quantitative Easing (QE) program and the FOMC 's decision was more dovish than anticipated. Meanwhile it seems that oil producing countries and Russia continue to move forward with their production freeze plan, lifting energy prices in the process i.e. reducing the risk of disinflation/deflation which has been a concern for sometime now. Global growth, although downgraded, has proven resilient to any signs of US or global recession. The market has thus responded from its mid-February lows. With the Fed decision now out of the way, the market's upside squeeze into quarter end continues.

The US has undershot its inflation target (+2% inflation over the medium term) for so long that it's not unimaginable that the Fed is willing to accept some inflation overshoot to make up for the loss. For instance, over the past decade the core Personal Consumption Expenditures Index (PCE) - the Fed's favourite measure of inflation - has missed the Fed target by +0.35% per year, meaning a "cumulative miss" of +4.2% inflation relative to their target. Therefore, if the Fed were to "make up for the miss" they would have to let core PCE run at +3% (i.e. +1% above their target) for about 4 years. This means that interest rate rise risk is only to the downside. Inflationary pressures will likely remain elusive and, if they do come, the Fed will most likely tolerate them, rather than hike too quickly to quash them.

Therefore equity longs are still a Hold. The fundamentals have not changed much, but the over-bearishness of January and February has dissipated. A 25bps increase in interest rates every six months does not really affect the economy in any meaningful way. Stronger capital controls from China, a dovish Fed, and lower US dollar makes China's job easier i.e. China factor will not bear on the market as much as it did last few months. A weak USD will also be a help to the Emerging Markets as a whole. The US economy has plenty of steam and should continue its expansion for at least another eighteen months, if not more. We were always unlikely to see a US recession this year, and Fed's decision to stay a dove has pushed this likelihood back further.

As an investor, it is best to focus on the medium term and not just short-term market volatility. As I have said in the past, the SPX, at 1850, is a buy and we have seen that level tested in August last year and twice this year. It's likely the new high in SPX doesn't last, but a move back down to 1800 also looks unlikely over the next quarter.

Of course, while I draw a risk neutral/positive scenario here, risk and uncertainty still abound as they always are, ranging from a British vote (*Brexit*) on whether to leave the European Union (EU), to a fractious presidential election in the US and to Emerging Markets still battered by low commodity prices and a (still) relatively strong US dollar. With central banks at zero rate and negative interest rate policies not finding favour, monetary policy in the developed world has been stretched to its limits.

Oversold Energy (XLE US) and Mining stocks (XLB US) have seen a good rally and we're likely to see more positive moves in these two sectors. There are a combination of factors at work; thoroughly depleted long positioning, regaining of confidence in China's ability to manage its own economy, a weak USD outlook, as well as capital investment cuts and steps to curb oversupply. On the back of an Energy and Mining stock recovery, the Industrial sector (XLI US) should perform well as well. With the SPX index closer to the 2100 level than 1900, it will be prudent to consider income strategies over directional only trade strategies.

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, 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), Lloyds (LLOY LN), BNP Paribas (BNP FP), UBS (UBSN VX), Intesa Sanpaolo (ISP IM).

Best wishes,

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