CROSSBRIDGE CAPITAL

Market Viewpoints

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Facts do not cease to exist because they are ignored.

- Aldous Huxley

While bond yields have risen recently, to me, this looks like another episode of "taper tantrum," where bond prices are recalibrating to prepare for a (perceived) less aggressive monetary policy. In the developed markets, low growth and subdued inflation outcome/expectations mean monetary accommodation is set to continue. Bond yields will remain low until such time as the global economy is back to its normal growth rate. If that takes another decade, then so be it. At least in the Eurozone and Japan, I see bond yields remaining low for the foreseeable future. These markets will not be broken by central banks. In many respects, the central banks "own" these markets. If anything breaks the market, it will be the upheaval that only politics can cause - the US election, the Austrian election, and the Italian constitution referendum amongst others. One aspect of monetary policy accommodation which hasn't worked, is the negative interest rates policy (NIRP). Lower rates have a depressing effect on household incomes, through reduced interest on savings and pensions. To my mind, NIRP will, in due course, be seen as a major policy error and the BOJ specifically, has painted itself into a corner. With respect to the FOMC meeting this week, I believe it will be a very close call and should we get an interest rate hike, it will not spook the market and financial stocks should rally post hike.

Rising Yields

One of the biggest themes in capital markets over the past few days has been the sharp increase in bond yields. Yields on sovereign debt, from the US to Germany to Japan, have risen in secondary markets amid concerns that central banks will stop expanding their balance sheets and in some cases even consider shrinking them.

The yields on government bonds began to rise last week, when the European Central Bank (ECB) surprised some market participants by not announcing fresh rounds of stimulus or committing to an extension of its Quantitative easing (QE) program beyond March 2017. The ECB's decision added to concerns emanating from Japan where bond prices had been falling for weeks, as investors speculated that the Bank of Japan (BOJ) could encourage long-term yields to rise in an effort to help banks and insurers that are challenged by negative interest rates.

Rising yields could have a profound effect on the fiscal positions of governments, particularly in Europe. Société Générale recently estimated that around 40% of the reductions in budget deficits by Eurozone governments between 2012 and 2015 were due to cheaper borrowing costs. The UK's total interest payments were -35% lower last year than in 2013, even though the country's debt pile had expanded by +8%, official figures show.

While yields may rise further, be careful, bet against central banks at your peril. To me this looks like another episode of "taper tantrum," where bond prices are recalibrating to a (perceived) less aggressive monetary policy, resulting in higher term premiums . As soon as this gets priced in, bond yields will stop rising. In the developed markets, low growth and subdued inflation outcome/expectations are set to continue. In such cases, bond yields cannot remain elevated. Although the 10-year Treasury yield has been climbing from a record-low close of 1.37% set in July, yesterday's close at 1.69% was still well below 2.27%, where it settled at the end of 2015. If anything, I would bet that the US 10y bond yield is more likely to go to 1% than to 3% over the next 12 months.

Monetary accommodation is set to continue. Bond yields will remain low until such time as the global economy is back to its normal growth rate. If that takes another decade, then so be it. At least in the Eurozone and Japan, I see bond yields remaining low for the foreseeable future. These markets will not be broken by central banks. In many respect the central banks "own" these markets. If anything breaks the market, it will be the upheaval that only politics can cause– the US election, the Austrian election, and the Italian constitution referendum amongst others.

One aspect of monetary policy accommodation which hasn't worked, is the negative interest rates policy (NIRP). We are at near zero interest rates in the US and the UK and at negative interest rates in the Eurozone, Japan, Switzerland, Denmark and Sweden. Not only have very low or negative interest rates failed to stimulate demand, they have arguably reduced demand as people save more and spend less. To my mind, NIRP will in due course be seen as a major policy error and the BOJ specifically, has painted itself into a corner.

Lower rates have a depressing effect on household incomes, through reduced interest on savings and pensions. If consumers don't spend, corporates or governments have to step in to fill that spending gap to keep the demand at trend level. However, corporates make investment decisions not on the basis of overnight interest rates but on their expectations of future growth and demand for their produce. This leaves only the Government to fill the spending gap and in this respect the fiscal response has been woefully inadequate.

Will the Fed raise rates this week?

Back-to-back policy decisions in Japan and in the US this Wednesday mean central banks will dominate this week. Until last week, I was expecting both an interest rate cut and an increase in the size of bond purchase from the BOJ. However, recent comments by Governor Haruhiko Kuroda and other BOJ officials, have tempered my expectations.

It seems the broad message will likely be that the BoJ still believes in NIRP and that it has ample room for further easing but it will hold fire this time on taking rates further into negative territory. However, I do expect the BOJ to increase the size of its bond-buying program from the current rate of 80trn Yen per annum.

On the other hand, the US Federal Reserve rate decision on Thursday this week will be a close call. The rate setting, Federal Open Market Committee (FOMC) members look divided on the issue of whether to raise rates now or wait longer.

FOMC members who previously expressed caution, most prominently Boston Fed President Eric Rosengren, now appear ready to vote for a rate hike based on their assessment of the economy. Fed Chair Janet Yellen's recent Jackson Hole speech did not cite any new risks. Fed Vice Chair, Stanley Fischer when asked if the US economy could withstand further USD strength, said that the greatest issue facing the economy is declining productivity, not the stronger dollar. He also noted that the US remains at or near full employment despite substantial USD appreciation since 2015.

On the other hand the very influential Fed Governor Lael Brainard's, in a speech last week. advocated against a rate hike. She said – in the presence of uncertainty and the absence of accelerating inflationary pressures, it would be unwise for policy to foreclose on the possibility of making further gains in the labor market. Brainard is a former Treasury Department Undersecretary and is close to Democratic Presidential nominee Hillary Clinton. She is seen as a possible pick for Treasury Secretary in a future Clinton administration.

I believe that the FOMC may not have enough votes in favour of raising rates this Thursday. I would attribute it to the forthcoming US elections, which will definitely weigh on the minds of members. With Republican nominee Donald Trump rising in the polls, implications of his victory will not be lost on the committee. Trump wants to renegotiate the North American Free Trade Agreement (NAFTA), with a possibility of even scrapping it, and restrict immigration from Mexico and elsewhere. Such moves would hurt US corporations. Imposing stiff tariffs on China and Mexico could push the US into a recession and cause 5 million US jobs, according to a study by the Peterson Institute of International Economics. The National Federation of Independent Business, which represents small businesses, said in August that a record 39% of survey respondents cited the political climate as the most important reason not to expand operations.

I believe it will be a very close call and should we get a rate rise, it will not spook the market and financial stocks should rally post hike. During the last rate hike cycle during 2004-2006, the Fed raised rates 17 times in 25bps increments. This may be ambitious this cycle, but it's important to bear in mind, which sectors did well then. The list below shows the cumulative total return performance of the top five sectors for the holding period January 2004 through December 31, 2006:

- Energy +115%
- Utilities +76%
- Telecom services +55%
- Financials +41%
- Materials +40%

Where to invest?

During the last ten days, equity volatility has picked up quite dramatically on the back of the sell-off in the bond market. The VIX index (a measure of US equity market volatility) shot up from 11.7 to 20.4 and has settled at over 16. However, concerns about an end to easy money are greatly exaggerated. The move higher in market volatility was triggered by a misunderstanding of the ECB's intentions, which some have interpreted as an ECB taper tantrum. The ECB has merely delayed easing and not abandoned it.

Volatility-induced selling has probably another week or so to go, largely on deleveagring by volatility-targeting funds that need to sell holdings on any rise in realized volatility. According to an estimate by JP Morgan, volatility-targeting funds have grown dramatically in recent years and now have some $1 trillion in Asset Under Management (AUM). Record tight trading ranges in equities during August, and a one directional (higher) move in bond prices forced these funds into very large notional exposures by last week.

Fundamentally nothing has changed. Central banks still have the back of the market, The ECB will do more QE and the GDP growth and inflation expectations in the developed world are still muted. As I have mentioned in last three monthly newsletters, you are unlikely to see any sustainable and meaningful rally in the S&P 500 Index (SPX) until after the US election. The S&P 500 index has hovered close to the 2150 mark since mid-July and traded in a tight 1-2% range. A rally in the SPX post the US elections is largely dependent on the expectation that the new administration, be it Trump or Clinton, will have little choice but to come up with fiscal measures to accelerate US growth. I continue to advocate, any sell-off in equities is an opportunity to buy and add on to the good stocks that you already hold in your portfolio. It's better to buy the dip than to chase the rally.

In terms of equity positioning, US equities and the US dollar are my favorite. The US is ahead in the rate cycle and while the Eurozone has a mountain of issues that plague its growth, the economic conditions in the US are getting better. We received another indication of it last week in the US Census release of the 2015 Survey of Annual Social and Economic Supplements (ASEC) which was resoundingly positive:

- Median incomes rose from $53,718 to $56,516 using 2015 dollars. That's the largest arithmetic increase in the history of ASEC dating back to 1967 and also the largest YoY percentage change at +5.2%
- The spiking income growth is being driven most by the low end of the income distribution. The lower two deciles of incomes rose by the most -up +7.9% for the bottom 10% and +6.3% for the second-lowest decile. That compares with just +2.87% real income growth for the top decile of income
- The number of people in poverty fell by 3.5 million between 2014 and 2015. Young people (with their high propensity to consume) and minorities are seeing some of the most impressive growth, especially Hispanics where median incomes rose +6.13% YoY
- This is a profoundly positive outcome for the economy after years of negative median income growth and rising income inequality

Emerging Markets (EM) will experience volatility every time Fed rate rise expectations build up. However the USD is unlikely to strengthen much vis-à-vis the EM currencies because there is hardly anyone who believes the Fed will get on a clockwork-like rate rise cycle anytime soon. Therefore an index neutral allocation to EM equities is advisable.

In the US, among the sectors, I like Technology (XLK), Healthcare (XLH), Consumer (XLV) and Financials (XLF). Some of the stocks I hold/recommend holding: Starbucks (SBUX US), JP Morgan (JPM US), Bank of America (BAC US), Gilead Sciences (GILD US), Allergen (AGN UN), Biogen (BIIB), Amgen (AMGN), General Electric (GE), General Dynamics (GD US), Apple (AAPL US), Google (GOOG US), Amazon (AMZN US), Schlumberger (SLB US), Pepsi (PEP US), McDonalds (MCD US), Daimler (DAI GY), Airbus (AIR FP), Roche (ROG VX), Rio Tinto (RIO LN), Halliburton (HAL US), Walgreen Boots (WBA US), CVS Healthcare (CVS US), Home Depot (HD UN), CBS Corp (CBS US), Alibaba (BABA US), Pfizer (PFE US), Michael Kors (KORS US), BNP Paribas (BNP FP), UBS (UBSN VX), Salesforce (CRMUS), Estee Lauder (EL US).

Best wishes,

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