



## Market Viewpoints

Manish Singh

September 2015

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**“How do you tell a Communist? Well, it’s someone who reads Marx and Lenin. And how do you tell an anti-Communist? It’s someone who understands Marx and Lenin.”**

**- Ronald Reagan**

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The US Federal Reserve estimates the “natural” rate of unemployment stands between 4.9% and 5.2%. The current rate of US unemployment is 5.1%. Monetary theory therefore dictates that interest rates must be raised. However, the Fed is in no rush to do this and forecasts the unemployment rate for 2016 to drop below this “natural” rate. It is therefore quite clear that monetary policy will be governed by concerns about financial stability and not by fears of inflation; as has been the case for the past few decades. Fed Chair Janet Yellen is truly biased in favour of “lower for longer”. I find it hard to believe interest rates will go up this year. My guess is you will see the first rate rise in the US in Q1’16. Additional Renminbi (RMB) devaluation is coming. However, crucially, as the last few weeks have shown, the People’s Bank of China has the capacity to keep the RMB stable. The Chinese government aims to stabilise GDP growth at “around +7%” by carefully increasing fiscal support via infrastructure investment. There is room given its relatively small share of overall fixed asset investment of 17.5% compared to the historic share of approximately 25%. Around 15% of China’s population are rural migrants living for at least six months in urban areas. By gradually being recognised as urban residents, they will become more likely to buy a property, send their children to school and become part of the Chinese urban consumption economy. Urbanisation and the growth of the middle class with spending power are ultimately the key to China’s transition to a consumption-driven economy. China’s fifth Plenum starts in two weeks time. Decisions made and political agreements forged there, should remove a key obstacle to business and government investment. I expect China’s data to reflect a positive turnaround by the end of this year and to firm up further in Q1’16.

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### **What’s the worry? What’s the hurry?**

The unemployment rate in the US stands at 5.1% and the GDP in Q2 grew at an impressive +3.7%, yet, Federal Reserve Chair Janet Yellen chose not to raise interest rates at the September Federal Open market committee (FOMC) meeting. Many market observers were understandably dismayed by the Fed’s actions and words.

Marianne Faithfull’s song “What’s the Hurry” may amusingly offer some understanding. Faithfull asked, “What’s the panic, where’s the static? That seems to be the key. The Fed doesn’t see an inflation problem and therefore is in no rush to raise rates. It’s fair to say those forecasting a September hike (myself included) were not as much forecasting, as prescribing, what a “data dependent” Fed should do.

From the FOMC statement and the press conference that followed, it’s clear that the Fed, at present, is entirely unconcerned about the risks of higher inflation and is eager to push unemployment below what most economists regard as its “natural” rate. The “natural” rate in the case of the Fed is the “non-accelerating inflation rate of unemployment” (NAIRU). Monetarism, the body of economic theory pioneered by Milton Friedman that has dominated a generation of policy and academic thinking since the 1970s, would suggest that, if monetary policy is used to try to push unemployment below NAIRU, inflation will accelerate without limit and destroy jobs. The Fed’s latest model estimates NAIRU to be at 4.9-5.2%. The current rate of US unemployment stands at 5.1%. Monetary theory therefore dictates that interest rates must be raised. However the Fed is in no rush to do this and forecasts the unemployment rate for 2016 to drop to 4.5 – 5% i.e. below NAIRU. NAIRU is dead, long live NAIRU!

It seems either the Fed has buried “monetarism” or the Fed no longer believes in any version of a natural rate of unemployment. Either way, it is quite clear that monetary policy will be governed by concerns about financial stability and not by inflation, as has been the case for the past few decades. Yellen’s Fed is truly biased in favour of “lower for longer.”

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Yellen would, however, still like us to believe that the Fed will raise rates later this year. She said; "It will likely be appropriate to raise the target range of the federal-funds rate sometime later this year." I suspect she will keep talking up tightening and building up confidence in the recovery and the economy. What else is a central banker to do? Build confidence in the economy. When the time comes, she will back off again, until such time as she has inflation staring her in the face. Therefore, I find it hard to believe rates will go up this year. My guess is you will see the first rate rise in the US in Q1'16.

### **China: command and control (or lack of it)**

The Fed's focus on "non-US" developments when it kept rates on hold in September, underscored the far-reaching implications of the concerns over China. No one can deny that China has slowed down on both a structural and cyclical basis. The two important questions to keep in mind. Is the degree of slowdown (and fallout from the currency devaluation) priced into the markets? What is China doing to contain the fallout from the slowdown?

Earlier this month the People's Bank of China (PBoC), the Chinese central bank, loosened its reserve requirement ratio (RRR) rules. Under the old rule, which had been in place since 1998, banks had to meet their RRR on a daily basis. The new rule, effective September 15, gives banks more leeway. They can report RRR that is up to 100 basis points lower than the rate set by the PBoC, as long as their daily average in the assessed period meets the central bank's requirements. This rule change can release up to 1.3 trillion Yuan (USD\$200 billion), or 1% of total banking deposit, on some days, if needed.

Additional Renminbi (RMB) devaluation is coming. However, crucially, as the last few weeks have shown, the PBoC has the capacity to keep the RMB stable. The PBoC holds USD\$3.6trn in reserves and USD\$4.4trn of net foreign assets at the end of July. China's trade surplus has averaged USD\$45bn/month so far this year, a record high. If RMB speculation were to gain ground, China would likely use macro prudential measures to counter this – i.e. raise the cost of currency speculation, request State Owned Enterprises (SOEs) to settle export receipts sooner, strengthen capital controls and open parts of the domestic financial markets to foreign investors.

Significant fiscal stimulus in China only started in May of this year and we have seen improving data on the housing front. Effects of policy stimulus generally come with a lag of one or two quarters. Meanwhile, the August Caixin manufacturing PMI dropped to 47.1 and caused anxiety. However, it's worth noting that the Caixin PMI is based largely on enterprises in the manufacturing industry. It doesn't cover LGFVs (local government financing vehicles) who benefit directly from fiscal stimulus and it also doesn't cover property developers whose financial conditions have improved recently.

The Chinese government aims to stabilise GDP growth at "around +7%" by carefully increasing fiscal support via infrastructure investment. There is room given its relatively small share of overall fixed asset investment of 17.5% compared with the historic share of around 25%.

Then there is urbanisation. The new model of China's urbanisation, as championed by Premier Li Keqiang, places stress on improving living standards and shifting to a consumption-based growth model. This can be seen in the 2014-2020 Urbanisation Strategy where the emphasis is on easing the path for rural migrants to become urban residents through "hukou" reform. Around 15% of China's population are rural migrants living for at least six months in urban areas. By gradually recognising these migrants as urban residents, they will become more likely to buy a property, send their children to school and become part of the Chinese urban consumption economy. Urbanisation and the growth of the middle class with spending power are ultimately the key to China's transition to a consumption-driven economy.

China's fifth Plenum starts in two weeks time and there's a sense that the fighting between the top leadership has diminished. This reduction of perceived political risk, together with less inter-departmental bickering post-Plenum, would remove a key obstacle to business and government investment. I expect China's data to reflect a positive turnaround by the end of this year and to firm up further in Q1'16.

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### Where to invest?

October will be difficult to navigate as per usual. It's a month known for volatility and negative events. Worryingly, as has become evident over the last few weeks, stocks are no longer responding to expansions of central bank accommodation. The Fed didn't raise rates and equities sold off; the ECB continues to hint at a large scale asset purchase program, and the perceived odds of expanded BOJ action are rising, but equities have done nothing but experience heightened volatility. Has the ability of central banks to influence stock sentiment peaked? Or are we in for a violent two-way move in the S&P500 (SPX) index in the range of 1800 to 2000 for the rest of the year? I think it's the latter. With the likelihood that the SPX is nearer the top end of the range by year-end. A turnaround in stocks could start with the Q3 earnings season, which will gather steam from mid October.

European equities are suffering from the overhang of automakers (particularly the DAX index) due to the scandal at Volkswagen. However, if you were to compare the conditions in the Eurozone now to what they were twelve months ago:

- EUR/US is down over 20%
- Commodities have collapsed and the Eurozone is a net importer of commodities
- Interest rates have collapsed as ECB QE continues
- Monetary policy is simulative and will continue to be for all of 2016 at least
- Fiscal policy is no longer a drag as "austerity" clamour has been silenced, and
- Bank lending data is turning up after a long retrenchment

In such a circumstances why would you not be overweight Eurozone equities? Further, the "new orders" component of Eurozone manufacturing just hit a 5 month high. The P/E multiples have de-rated sharply and the entire rally we saw in first half of the year has dissipated. I expect Eurozone equities to catch a bid as the earnings season begins.

Japanese earnings are a standout among major developed markets. Japanese earnings are rising partly because the companies have done a tremendous job cutting costs when the Yen went all the way up to 75 per USD. According to Credit Lyonnais Securities Asia, Japanese companies, on average, can break even at approximately 92 Yen per USD. The Yen is currently trading at 120 per USD, which means additional savings. The third arrow of Abenomics is the Return on Equity (ROE) revolution. The truth is, corporate governance at Japanese companies was so poor, it does not take much to improve ROE. [I spoke about this topic on Bloomberg recently](#). Over 30% of Japanese companies still have returns on equity that are less than 5% (as compared to the US where ROE is greater than 15%). Japan's new corporate governance code now holds companies accountable if their returns on equity are below 5%. The dollar hedged Japan ETF (DXJ) is a favourite of mine for long Japan trade. Bouts of Yen appreciation has not allowed DXJ to rally, however as we head into October and the case for BOJ stimulus builds up, buying DXJ should be a good trade.

In the US, the most recent set of data indicate the new home sales rose +5.7% to its strongest level since early 2008. Jobless claims ticked higher but the increase was marginal. The only dark cloud was orders for durable goods, which fell -2%. While this report raises the risk of weaker growth in the third quarter, durable goods orders can be volatile month to month and manufacturing activity has not been a major cause of concern for the Fed. Yellen wants us to believe the rates are going higher by the end of this year, nonetheless the fact that Fed Fund futures is only pricing in a 38% chance of a rate increase in December and a 47% chance in January indicates there is significant misalignment between market and Fed's expectations. As I have indicated above, I don't see rates rising this year.

My equity position is equal weight on US, and overweight on Europe and Japan. I still advocate an underweight in Emerging Markets (EM), with overweight on Indian equity (INDY US, INP US). The Reserve bank of India (RBI) cut interest rates by 50 bps Tuesday, a bold and welcome move and one that should help the Indian economy a great deal. A rate cut alone, by no means, is panacea; fiscal measures and reforms must follow. So far, Prime Minister Narendra Modi's reform agenda is still on track and looking to accelerate. Over the weekend, in a highly publicised trip to the US, Modi made a great pitch for the use of technology to drive his reforms and development agenda and opened door to Silicon Valley companies and investors to help him achieve this. He stressed the need and his goal to de-regulate the

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Indian economy from bureaucratic controls and aims to grow India's GDP from current \$2trillion to \$5trillion during his term in office. Modi rightly champions the use of technology and India has a lot of catching up to do. In 2014, 18% of Indians used the Internet, compared with more than 80% in the U.S. and Europe.

Some of the stocks I hold/recommend holding – Disney (DIS US), Starbucks (SBUX US), Citi (C US), JP Morgan (JPM US), Bank of America (BAC US), Gilead Sciences (GILD US), Allergan (AGN), Apple (AAPL US), Google (GOOG US), Amazon (AMZN US), Facebook (FB US), Anheuser Busch (ABI BB), Pepsi (PEP US), UBS (UBSN VX), Richemont (CFR VX), Volkswagen (VOW GY), Airbus (AIR FP), United Technologies (UTX), Barclays (BARC), Societe Generale (GLE FP), Roche (ROG VX), Novartis (NOVN VX), Vinci (DG FP), Rio Tinto (RIO LN), Alcoa (AA US), Freeport-McMoran (FCX), Michael Kors (KORS US), Halliburton (HAL US), Caterpillar (CAT US), Intel (INTC US), NXP Semiconductors (NXPI), Walgreen Boots (WBA US), Home Depot (HD UN), Intesa Sanpaolo (ISP), Inditex (ITX)

**EUR/USD:** the FOMC disappointment in September saw the US Dollar sell off and the EUR/USD climb higher to nearly 1.15. Last Thursday, Yellen breathed new life into the USD by laying out her strongest case yet for raising interest rates this year. The EUR/USD is now trading at 1.12. Yellen said there would likely be an initial increase in the federal funds rate this year but "if the economy surprises us, our judgments about monetary policy will change." There are a lot of question marks surrounding what will make the Fed move. This Friday's jobs report could answer some of these. If job growth is strong, investors will immediately start pricing in an October tightening and USD will rally. I see no clear trend in EUR/USD over Q4 and it will likely be range bound between 1.10 and 1.15 with the Euro leg buoyed by Fed holding back and the USD leg buoyed by additional stimulus expectations from the ECB.

Best wishes,

Manish Singh, CFA