Market Viewpoints

Manish Singh

May 2014

“Always be a first-rate version of yourself, instead of a second-rate version of somebody else."
- Judy Garland

The first estimate of Q1 US GDP came in at a paltry +0.1%, a full 1% below expectations. Despite this disappointment, other data in the US have been very encouraging - consumer spending has climbed higher, core capital goods orders have improved, and the manufacturing index indicated a pickup in production. The April US Jobs report released last Friday showed the largest outperformance relative to expectations since November 2013 and an unemployment rate at 6.3%, is at its lowest level since September 2008. M&A activity is clearly accelerating and is providing equity markets a much-needed tailwind. US multinational companies have accumulated $1.95 trillion outside the US and repatriating that cash to the US incurs a tax penalty of 35%. It is therefore an incentive for companies to spend money on overseas acquisitions, even at a bid premium, and gain control of a competitor rather than take a tax hit and get nothing in return. It is May and “Sell in May” headlines are back. This May I wouldn’t despair. Keep your longs, as I see very limited downside.

On your marks, get set, No!

Last Friday, there was an air of excited anticipation - now that the cold weather had receded, the April Jobs report in the US (also known as Non-farm payrolls or NFP) would show strength. It would send the S&P500 index (SPX) soaring, and make it break out of the tight range of 1840-1880 that it had traded in for the past six weeks. Market watchers were not disappointed. While the consensus called for an increase of 218,000 jobs, the actual reading was 70,000 higher (and the previous two months data was also higher when revised). Even the most optimistic Wall Street economists did not forecast such strength in the labour market. This was the largest beat relative to expectations since November 2013. Also, strikingly the unemployment rate dropped to 6.3%, its lowest level since September 2008 and already within the band that the US Federal Reserve (Fed) had forecast for year-end. It looked like it was off to the races for equities, but not so fast.

The fly in the soup was labour force participation (the share of adults in the labour force) which fell to its lowest level since February 1974, as 804,000 people left the labour force. In addition, the first estimate of US GDP growth for Q1 reported on the same day, came in at paltry +0.1%, a rounding error one might say, and a full 1% below economists’ expectations. As a result, the SPX, instead of racing ahead, registered another false start and kept its sideways trend intact.

Since the US recovery started in Q2 2009, the GDP growth momentum has struggled each year, although the SPX kept going higher. In 2010, there was the European crisis, in 2011 the US debt downgrade/Greek exit, in 2012 gridlock in Washington and in 2013 the fiscal tightening/government shutdown all took their toll on a fragile US economy. This year, it’s the severe winter weather. GDP growth just can’t seem to cut a break. However, with the harsh Q1 winter weather in our rear-view mirror, I believe Q2 will help regain the lost momentum.

As an aside, but still related to the economy, the bestselling book on Amazon right now is 577-page *' Capital in the Twenty-first Century'* by French economist Thomas Piketty. Translated from French, it is broadly regarded as the intellectual heir to Marx’s “Das Kapital”. In it, Piketty painstakingly documents the evolution of income and wealth over the past 300 years, particularly in Europe and the US. The book is so popular, that it has sold out on Amazon, a rare occurence, as Amazon is regarded as having the best logistics and inventory management system in the world.

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Maypole Dancing or despair

Maypole Dancing is a traditional May dance when people used to cut down tall young trees, stick them in the ground in the village square and dance around them in celebration of the start of the weather that would allow the planting season to begin. The Wall Street equivalent is – cut down long positions, don't dance but take the cash and go away. Of course I am referring to the old adage of "sell in May and go away". So it is May and "Sell in May" headlines are back. It has worked historically as well as in 2010, 2011 and 2012, but not last year. What about 2014?

The narrative for the bear case is as follows:

- US Wage Growth is minuscule and will impede the recovery
- The Eurozone is trapped in a deflationary spiral and the European Central Bank (ECB) isn't helping
- The Fed is tightening and stocks are expensive
- The geopolitical landscape is worsening
- Abenomics isn't working in Japan
- China will implode
- Valuations are too high

Let's look at each point individually

- It is true that wage growth is tepid, but jobs growth is rising and jobless claims are falling. Wage growth can only follow and get better
- Deflationary concerns in Eurozone abound, but the ECB is certainly more amenable than ever to follow unconventional policies
- Fed tightening is the biggest exaggeration of all. Interest rates rises may start by Q3 2015 but the Fed balance sheet is not going to shrink anytime soon. The Fed will not risk a relapse into recession
- Yes, geopolitics are a lot more uncertain, but it's also true that the market is not unfamiliar with such uncertainty. The previous big concern, the Syrian civil war (a proxy US-Russia battle) has been raging unresolved for over two years now. What are the options for the US and Russia - either they compromise or risk war. The choice is obvious. Peace will be maintained in an environment where both sides believe the other will go to war if compelled. U.S. exports to Russia account for just 0.7% of its total exports
- The Bank of Japan (BoJ) Governor Haruhiko Kuroda has become hawkish of late, but let's not forget that the BOJ is already in a very accommodative stance. It wants to see the impact on the Japanese economy of the April consumption tax increase, and this will take few months before the BOJ takes any more action
- Since 2008, every bearish analyst calling for a market correction has used China as a reason. The growth in China is certainly slowing but the government there is doing a great job of registering +7.5% growth even as it's clamping down on excess credit. As promised, President Xi Jinping is cracking down on both "tigers" and "flies" – powerful leaders and lowly bureaucrats – in his campaign against corruption. Structural reform has started and will gain momentum
- Despite the 1Q GDP growth disappointment, in the US the manufacturing and jobs data restore credibility to earnings growth. The current P/E of the SPX of 15.6 is not high by any means, and increased Capital Spending should aid sales growth. The SPX is headed over 2000 in the next 12 months

Mergers and Acquisition (M&A) activity is accelerating and provides equities a much-needed tailwind. The bulk of the action so far has been in healthcare, but other sectors will also come into play. The Pfizer-AstraZeneca deal has sparked a discussion around US corporate tax policy with the Obama administration now focused on ways to curb tax-motivated reincorporation in other countries by U.S. businesses. US multinational companies have accumulated $1.95 trillion outside the U.S. (GE's $110 billion leads U.S. companies, followed by Microsoft's $76.4 billion, Pfizer's $69 billion, Merck & Co.'s $57.1 billion and Apple's $54.4 billion). Repatriating cash to US incurs a harsh tax penalty of 35%. It therefore provides companies with an incentive to spend money on overseas acquisitions, even at a bid premium, and gain control of a competitor rather than take a tax hit and get nothing in return. If the US were to reform its tax rate and make it attractive for companies to repatriate offshore cash holdings, US companies would spend that money in the US. Either way, this money will be spent and boost equity prices

This May I wouldn't despair. Keep your longs, as I see very limited downside.

Where to invest

Despite the disappointing first reading of Q1 US GDP, other data have been very encouraging - consumer spending has climbed higher, core capital goods orders have improved and the ISM manufacturing index indicated a pickup in production. Also, there have been only six quarters in the past 15 years where the US GDP growth number missed estimates by a percentage point or more. If history is any guide, when all the revisions are tabulated over the next few months, that +0.1% reading may end up being higher. For the six prior quarters with big misses, the original reading has been revised up by an average of +0.8% since the initial report.

There is some concern of "momentum" fading with Biotech, Internet and Software stocks. However, one ought to bear in mind that "momentum" doesn't mean "growth". The SPX is flat over last six weeks even as Tech and Biotech stocks are down 10-20%. The selloff is therefore more a "profit taking", or "rotation" than an "exit" from the market. The momentum stock sell-off began on March 6 and hasn't stopped despite a bounce in April. Amazon (AMZN) is down over -25% since its high. For anyone concerned over this sell-off, I have only one piece of advice – when well-run companies get sold off, you should buy more of them. I will be adding to my Amazon (AMZN US), Gilead Sciences (GILD US) and Salesforce (CRM US) positions and this week I also invested in Twitter (TWTR) for the first time. The recent sell-off has put TWTR in the "attractive" bucket.

The ECB Quantitive Easing (QE) rhetoric continues even though the prospect of immediate action has faded. At the April meeting ECB President Mario Draghi said - *"we are resolute in our determination to maintain a high degree of monetary accommodation and to act swiftly if required. Hence, we do not exclude further monetary policy easing and we firmly reiterate that we continue to expect the key ECB interest rates to remain at present or lower levels for an extended period of time".*Eurozone inflation in April ticked up a notch to +0.8% and has taken some pressure off the ECB to act. GDP is on track to grow +1.5% this year in the Eurozone. This is a big improvement over the -0.4% of last year. Spain's 10-year bond yield fell below 3% for the first time since 2005 last week and Italian 10-year bond yields are at a record low of 3.01%. Outside the Eurozone, the UK is experiencing a robust recovery and GDP will expand by over +3.2% this year according to the OECD (The Organisation for Economic Co-operation and Development).The rally in Emerging Markets (EM) continues and with elections concluding in India next week, EM equities will get a check. Should the elections bring in a new government and a promise of reform, this will add to the bullish sentiment in EMs.

The case for equities remains positive. I stay bullish on Europe and Emerging Markets (EEM US, VWO US), cautious on Japan (DXJ US), and moderately bullish on US equities.

- My sector preferences in the US are Financials (XLF), Technology (XLK), Consumer Discretionary (XLY) and Energy (XLE) and Healthcare (XLV).
- Some of the other stocks I hold/like to hold in our discretionary portfolio: Apple (AAPL), Salesforce (CRM), Twitter (TWTR), Citigroup (C), JP Morgan (JPM), Pfizer (PFE), Schlumberger (SLB), Boeing (BA)Freeport McMoran (FCX), P&G (PG), Rio Tinto (RIO LN), Glencore (GLEN LN), Nestle (NESN VX), UBS (UBSN VX), BNP Paribas (BNP FP), Philip Morris (PM), Barclays (BARC LN), Pepsi (PEP), Roche (ROG VX), Volkswagen (VOW GY), Cognisant (CTSH), Petrobras (PBR), Gazprom (OGZPY US), Standard Chartered (STAN LN), Gilead Sciences (GILD), Vinci (DG FP), Inditex (ITX SM), Sanpaolo Intesa (ISP IM), Anheuser Busch (ABI BB), Chipotle (CMG), Starbucks (SBUX) and Conagra Foods (CAG)

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Currencies

Despite a good US Jobs report, the USD index is still closer to the lower end of its year-to-date range, while FX volatility continues to fall towards all-time lows. FX volatility is at record lows for this phase of the Fed cycle. For instance, over the last year alone, the 3 month volatility for EUR/USD is down by -25% and that of USD/JPY is down astonishing -43%, even as geopolitical risks have risen. In Thursday's ECB press conference, Draghi hinted at possible easing at the June meeting. This sent the EUR/USD sharply lower to 1.3850 but I suspect the market will find it hard to believe such statements. Therefore, I expect EUR/USD to head to 1.40 again and trade in a 1.3750-1.40 range until data deteriorates further in the Eurozone, forcing the ECB into an easing mode. I do anticipate that EUR/USD will head to 1.35 or lower in Q3, as US data improves.

GBP/USD is likely to stay in the 1.68-70 range for the time being, given the strength of the UK data and OECD comments about solid growth in the UK.

Best wishes,

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