CROSSBRIDGE
CAPITAL

Market Viewpoints

Manish Singh
June 2014

“Success is getting what you want. Happiness is liking what you get” – H.Jackson Brown, Jr.

Mario Draghi’s “whatever it takes” pledge in July 2012 came at a time of extreme market dislocation and it completely changed the market’s expectations. Last week, in another unprecedented move, the European Central Bank (ECB) cut the overnight deposit rate to below zero and announced a new round of liquidity inducing measures. The ECB has a tough job to change expectations for future growth and inflation and this is where the challenge lies. For now, Draghi has done enough to buy time and keep deflationists at bay without announcing an overt Quantitative Easing (QE) program. In the US, house prices have risen, the Standard & Poor’s (SPX) 500 index has tripled from its 2009 lows and the US has recouped all of the 8.7 million jobs it lost during the last recession. Yet, the GDP growth rate is not back to its pre-crisis level. The rally in equities is not over, but we are seeing early signs that the US corporate profit margin cycle has begun to turn down. Separately, it’s almost time for the Football World Cup and I pick Argentina to win.

"Changing Lanes”

Just when ECB President Mario Draghi’s assurances were beginning to look empty, he went ahead and restored the market’s faith in his promises. With the 25th anniversary of the student uprising in Tiananmen Square on everyone’s minds and the iconic image of the lone “tank man” temporarily stopping the advance of tanks in Beijing flashing all over the media; Draghi rolled into the ECB press conference all guns blazing to prevent the Eurozone from falling into deflation. Europe’s would be “tank man” - the Bundesbank - having acquiesced in the weeks leading up to this meeting, offered no resistance. In an unprecedented move, the ECB cut the overnight deposit rate to below zero.

Let’s look at the package unveiled by the ECB

- **Interest rates**: A cut in the refinancing rate from +0.25% to +0.15%; and a cut in the overnight deposit rate from 0.0% to -0.10% to pressure banks into lending instead of depositing excess cash at the ECB
- **Liquidity:** Draghi announced the end of sterilization of the Secondary Market Purchase (SMP) bond holdings. This is likely to release €160bn of liquidity. More liquidity will come from the ECB decision to continue conducting the Main Refinancing Operations (MRO) as fixed rate tender with full allotment until the end of December 2016. The MRO is the ECB’s principal means to provide weekly liquidity to the banking system in the Eurozone
- **Credit easing**: the alphabet soup of monetary policy just got another acronym, Targeted Longer Term Refinancing Operations (TLTRO). The ECB will conduct two successive TLTRO in September and December 2014, adding a combined €400 billion liquidity to boost bank lending to companies. Those banks that tap the TLTRO facility but fail to lend will have to pay back the cash early
- **Asset purchases:** No asset purchase measures were announced but the door is open to conduct a Small & Medium Enterprise (SME) loan or Asset Backed Securities (ABS) purchases at a later stage

As if all these measures were not enough (and they may not be), Draghi added – “We aren’t finished here” i.e. the ECB is willing to do more.

Draghi’s “whatever it takes” pledge in July 2012 came at time of extreme market dislocation and it changed investor expectations. When the ECB announced a 3 year LTRO in 2011, banks rushed in and borrowed nearly €1trillion. Back then, getting liquidity was difficult except for the strongest banks, now, even Greek banks are able to raise equity. The ECB has a tough job to change expectations for future growth and inflation and this is where the challenge lies. How far will these new measures succeed in kick-starting the credit delivered to the businesses that need it most, and boost inflation as well as GDP growth? Only time will tell.

For now, Draghi has done enough to buy time and keep deflationists at bay without announcing as overt QE program. In reality, Italian and Spanish banks using LTRO money from the ECB to buy their nation's sovereign bond is effectively QE in disguise. The result has been a collapse in the yield of sovereign bonds in the Eurozone. If you look at the 5 year bond yield, Italy is now more creditworthy than the US!

Not all wealth is created equal

The effect of wealth (or the "wealth effect"), the extent to which rising wealth leads to consumption and growth is an issue of great interest in the economic research world. As stock prices rise and house prices recover, the theory goes, wealth accumulates, consumer confidence increases and so does consumer spending and the use of credit. Well, that's the theory at least.

- The US added 217,000 jobs in the month of May, the fourth straight month of gains above 200,000. With 8.8 million more people working now than at the trough in February 2010, the US finally recouped the 8.7 million jobs lost during the last recession
- At the bottom of the credit crisis in March 2009, the S&P 500 Index reached a nadir of 666. Today, it's nearly three times that level, leading to huge wealth creation
- According to a report by the Federal Reserve, the net worth of U.S. households and non-profit organizations—the total value of homes, stocks and other assets minus debts and other liabilities—now stands at $81.8 trillion, the highest on record

Yet rising stock markets and rebounding home prices aren't resulting in increased consumption and GDP growth as they did before. Why not?

- Not all wealth is created equal and therefore its impact on consumption and spending is variable
- Many of the gains are going to affluent people who tend to save
- While the US has recouped the jobs lost in the recession, the working age population has since then increased by 10.6 million, while 12.8 million Americans have dropped out of the labour force
- Another gauge of America's wealth, U.S. net worth as a share of disposable income, remains marginally below levels seen in 2007
- The total U.S. household debt is now at 108% of disposable income, down from a peak burden of roughly 135% in 2007

In a consumer survey by The Royal Bank of Canada (RBC), when asked about what would embolden the respondent to increase spending, nearly half of respondents noted wage increases while about 20% said a better job backdrop. Therefore, 65% of consumers think employment dynamics are what matter most. Contrary to popular belief it seems, the "wealth effect" due to rising stock markets and surging housing prices will NOT necessarily spur demand and consumption. It is no surprise therefore, that central banks are worried about falling inflation due to reduced consumption and tepid wage growth in key sectors of the economy.

Where to invest

In my May newsletter, referring to the old adage of "Sell in May and go away" I recommended – "This May I wouldn't despair. Keep your longs, as I see very limited downside" and what a May it has been! The Standard &Poor's 500 (SPX) Index notched more than half of its January - May returns just in the month of May, and it continues to do well. So where do we go from here?

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The tripling of the SPX from its 2009 lows has come on the back of weak growth, weak consumption and falling inflation. The important point to note here is that the rally in the stock market is liquidity driven, which has seen volatility slump. With central banks controlling this liquidity, bond yields have collapsed. We haven't yet seen the rally induced by robust GDP growth and inflation. This may well be the next stage of the market rally. However, if there were to be a pit stop for this rally it would come in the form of a decline in US corporate earnings. Some early warning signs have started appearing and need close monitoring. US corporate profits from current production, complied by the Bureau of Economic Analysis, fell -9.8% in Q1 2014. This is the first decline since 2011. Therefore, if consumption, GDP growth and inflation do not pick up, I believe we could see a market correction towards the end of 2014 or Q1 2015.

Until then, equities are still the asset class to be invested in. Despite tepid growth, the US economy is holding on well and although the Federal Reserve has started to taper its QE program, it is still running a loose money policy. The increase in Initial Public Offerings (IPO) and M&A activities should provide support for equities. In my December 2013 newsletter, I set my SPX year-end target for 2014 in the range of 1956-2000. I will stick to this and as the year-end draws closer, will move my allocation from cyclical to defensive sectors, should GDP growth not improve.

Japan's Government Pension Investment Fund (GPIF) is the world's largest public pension fund with assets totalling Y128.6 trillion ($1.26trillion). GPIF is under pressure to buy assets that offer higher returns, as Prime Minister Shinzo Abe and the Bank of Japan (BOJ) spur inflation which risks eroding the value of local bonds. GPIF's current allocation is – 55% in local JPY bonds, 17% in domestic equities, 15% in foreign stocks and 11% in overseas debt. Professor Yasuhiro Yonezawa, chairman of the Investment Committee of the GPIF said he would not be surprised if the domestic equity portion in the guidelines rises to 20% from the current 17%. It is also anticipated that the local bond allocation could fall to 40%. This would be bullish for Japanese equities and bearish for the Yen, given the magnitude of the anticipated flow.

The ECB's easing package is likely to favor European peripheral bonds as well as equities. I remain bullish on Europe and Emerging Markets (EEM US, VWO US), becoming more bullish on Japan (DXJ US), and moderately bullish on US equities.

- My sector preferences in the US are Financials (XLF), Technology (XLK), Industrials (XLI) and Healthcare (XLV).
- Some of the other stocks I hold/like to hold in our discretionary portfolio: Amazon (AMZN), Google (GOOG), Citigroup (C), JP Morgan (JPM), Bank of America (BAC), Pfizer (PFE), Schlumberger (SLB), Boeing (BA), Freeport McMoran (FCX), P&G (PG), Glencore (GLEN LN), Nestle (NESN VX), UBS (UBSN VX), Philip Morris (PM), Barclays (BARC LN), Pepsi (PEP), Roche (ROG VX), Volkswagen (VOW GY), Cognisant (CTSH), Standard Chartered (STAN LN), Gilead Sciences (GILD), Vinci (DG FP), Sanpaolo Intesa (ISP IM), EUFN (ishare European financials) Anheuser Busch (ABI BB), Chipotle (CMG), Starbucks (SBUX) and Conagra Foods (CAG)

One final point about China. If land prices are a predictor of a bursting property bubble, here is a comparative statistic to bear in mind - Tokyo's total land value in 1990, prior to the property bust there, was equal to 63.3% of US GDP. When the Hong Kong property bubble burst in 1997, land values there reached 66.3% of US GDP. In 2012, the total land value in Beijing was 61.6% of US GDP i.e. inching closer to the ominous level. Of course China is not an open economy like the Japan of 1990 or Hong Kong in 1997. It is a controlled economy and has trillions of spare cash to cushion the downside risk of such an occurrence. The targeted Reserve Rate Requirement cuts announced by China indicate it is ready to embark on another round of easing, should GDP growth fall short of its +7.5% target.

Currencies

The new round of ECB easing is EUR/USD negative, however the currency could slowly inch back and test 1.37 given the ECB will not take any additional action until they see how the economy reacts to the recently announced measures. Given the first round of TLTRO allotment is not until September, the paucity of new action/announcements from the ECB over next three months, will keep EUR/USD in the 1.3470/1.3750 range.

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The UK trade deficit hit a 5-year high due to declining exports outside of the European Union. The weakness in exports highlights the UK's vulnerability to a strong GBP and explains why the Bank of England (BoE) will not rush to raise rates. GBP/USD is likely to trade a 1.6600/1.6850 range.

The USD/JPY is primed for a move up to 105 on the back of changes to the asset allocation of Japan's GPIF portfolio. Last year, the changes were announced in June, therefore it is quite likely we will get an announcement before the end of Q3. I expect USD/JPY to trade in the 105-108 range come the end of 2014.

And Finally….

It's almost time, and the "are we there yet" conversations can finally end. After so much talk about delays and protests in Brazil, the Football World Cup kicks off Thursday with the hosts Brazil playing Croatia in Sao Paulo. I predict an Argentina v Brazil Final with Argentina to win. My other predictions are as follows:

- Netherlands to go out at the Group Stage level with Chile qualifying from Group B
- Greece to qualify ahead of Ivory Coast from Group C
- Belgium to beat Portugal in the Round of 16
- Colombia to beat England in the Round of 16
- France to beat Germany in the Quarter-Final but lose to Brazil in the Semi-Final
- Golden Boot: Lionel Messi

Best wishes,

Manish Singh

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