



Market Viewpoints

Manish Singh

October 2013

If you put the federal government in charge of the Sahara Desert, in 5 years there'd be a shortage of sand" - Milton Friedman

The September US Central Bank's "tapering" decision took almost everyone by surprise. The S&P 500 index rallied to a new high of 1730 however, since then, with the help from the US Congress, US equities have rediscovered gravity and pulled back. It is also evident that the Fed will err on the side of caution and would like to see signs of inflation picking up before dialling down monetary policy. Over the past month, several key hazards seem to have been resolved. The US Fed has kept its monetary policy supportive, current Fed Vice-Chairman Janet Yellen is back as the favourite to replace Bernanke, elections in Germany have passed and returned a more pro-Euro mandate and a potential US/Syrian conflict seems to be heading towards a global diplomatic solution. There was a time not so long ago, when the world looked to the US for both political and economic leadership. Not anymore. The current malarkey in Washington is about nothing more than egos that must be protected and soothed. In leading to the US government shutdown, neither side budged an inch in the negotiations and both sides eventually embraced a shutdown. It may be a "zero-sum" game for the politicians, but if played for too long, it could have negative implications for the economy. European equities continue to outperform and Italy's political situation is looking more upbeat. I still recommend being long Europe, Japan and US equities. Any dip in equities caused by the US debt-ceiling stalemate, should be seen as a buying opportunity. I do not see the S&P 500 Index going below 1600. I remain positive that at the end of the year, the S&P 500 index will hit my target of 1744.

Who let the doves out?

The September US Central Bank decision took almost everyone by surprise. Chairman Ben Bernanke had built up a hawkish expectation and some degree of "tapering" was seen as a done deal. However, when the statement was released, it sounded more like dove-speak. The Fed decided to keep its \$85 billion per month bond-buying program unchanged. Market participants, such as me, who were primed for a start to tapering, were left asking the question – who let the doves out?

The US 10 year bond yield fell precipitously from 2.9% to 2.67% within minutes of the announcement and continued lower to the 2.58% level in the week that followed, as the S&P 500 Index rallied. However, since then, with the help from the US Congress, US equities have rediscovered gravity and pulled back. I am bullish however equities and, as we enter Q4, the delay in tapering is just that, a delay. The Fed will most likely start tapering before the end of the year.

It was indeed a little puzzling why Bernanke did not take advantage of the market's preparedness to accommodate the start of tapering. Like one market participant commented: "In every cycle, the Fed is late. The Fed is never a leading indicator. It's always a lagging indicator and it looks like the Fed is going to be a lagging indicator in this cycle too."

If you were to analyse Bernanke's speeches, you will notice that inflation, or the lack of it, has always been his main concern. The US Consumer prices Index (CPI) overall rose +1.5% in the year to August, well below the 2% target and Bernanke's favourite inflation indicator, the core Personal Consumption Expenditure (PCE) fell to +0.8% in Q2 of 2013 from an upwardly-revised +1.4% in Q1. These weak numbers that followed the Fed announcement, underscored the US Fed action. I believe the Fed will err on the side of caution and would like to see signs of inflation picking up before dialling down monetary policy.

Bernanke also re-emphasized that the asset purchase program is dependent on economic data, so the market will stay quite focused on every release. To temper expectations, Bernanke said the Fed would continue to try communicating



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clearly on the bond-buying program and try not to disturb markets. He described it as "tools that are less familiar, harder to quantify and harder to communicate than the Federal Funds rate."

The Washington malarkey

Frank Capra's 1939 movie, *Mr Smith Goes to Washington*, depicts an honest and stalwart Senator Jefferson Smith (Jimmy Stewart) standing up against a crooked political machine. Sadly, there are no Mr Smiths in Washington anymore. There was a time not so long ago, when the world looked to the US for both political and economic leadership. Not anymore.

The Washington malarkey is about nothing more than egos that must be protected and soothed. A bad idea, once embraced, must be pursued to its logical conclusion, never mind the destructive consequences. People who oppose you are not just opponents, they are the enemy.

No wonder this week then that "Sorry, we're CLOSED" signs have come to hang in front of US national parks, museums and some federal government offices. If you are visiting the US and wish to see the Museum of Natural history, you are best advised to rent a copy of *The night at the Museum* and accept Ben Stiller as your guide.

A "working congress" is now an oxymoron and perhaps a more ridiculous one than "jumbo shrimp." Debt-ceiling standoffs, filibusters, dead-end legislation and posturing: on the floor, on the radio and on the news, are a way of life in Washington. In leading to the shutdown, neither side budged an inch in the negotiations and both sides eventually embraced a shutdown. It may be a "zero-sum" game for the politicians but if played for too long, it could have negative implications for the economy.

The last time the US government was shut down was in 1995, during the Clinton administration, when the economy was booming. The unemployment rate stood at 5.6% and most economic forecasts indicated further growth. Today, the economy is fragile, unemployment stands at 7.3% and the recovery is yet to be secured.

Back then, one party controlled both houses of Congress. Today, Congress is divided, with the Democrats controlling the Senate and the Republicans controlling the House.

Back then, House Speaker Newt Gingrich and President Bill Clinton were ready to negotiate and met at least five days a week before and after the shutdown to hammer out a deal. Today, President Obama and Speaker John Boehner spoke Monday night as the clock ticked down to the shutdown. The call lasted nearly 10 minutes. It was their first conversation in 10 days.

The Clinton-Gingrich deadlock was resolved when the Senate Majority Leader Bob Dole, broke ranks and declared, "Enough is enough". What or who breaks the current deadlock is unclear as is the economic damage it brings. Estimates suggest that a shutdown for a few dates would likely have zero net impact upon growth; a two-week shutdown could shave 0.5%, off GDP; while a one-month shutdown could cut 1-2% from Q4 growth.

According to US Treasury Secretary Jack Lew, the US government will reach its debt limit no later than October 17 and the US will effectively default on its loans for the first time ever, if the debt ceiling is not increased by that date. The US government has been shut down 17 times before, but it has never defaulted on its debt. Let's hope this record remains intact this time around.

Failure to extend the debt ceiling would require the US government to balance its budget immediately i.e. cut its spending by about 20% or 4% of GDP. Such a hurried response will no doubt bring about a debt default and a downgrade. This is not an outcome priced in by the market and not an outcome that anyone would desire. At the time of the last debt limit debacle in 2011, equity markets dropped -19%, including a one-day decline of -6.7%, in response to the downgrading of the US credit rating by S&P. In fact, the market sell-off occurred despite an agreement having been reached - which in the eyes of credit agencies, didn't go far enough.

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Over the past month, several key hazards seem to have been resolved. The US Fed has kept its monetary policy supportive, current Fed Vice-Chairman Janet Yellen is back as the favourite to replace Bernanke, elections in Germany have passed and returned a more pro-Euro mandate and a potential US/Syrian conflict seems to be heading towards a global diplomatic solution.

The recent economic data in the US is looking up. The manufacturing index rose to 56.2 in August, reaching its highest level since April 2011. The ADP private payroll report showed U.S. private sector employment increasing. Personal income increased in August, in line with expectations. The increase was the largest since February. Second quarter GDP growth in the US remained at +2.5% in the final revision.

However, there is something even more important happening in the background. Energy is changing the US and reshaping not just US but the world too. The Wall Street Journal reports that the US is poised to overtake Russia as the world's single largest producer of oil and natural gas this year, a startling shift that is reshaping energy markets and eroding the clout of traditional petroleum-rich nations. US imports of natural gas and crude oil have fallen -32% and -15%, respectively in the past five years, narrowing the US trade deficit. Shale-rock formations of oil and natural gas have fuelled a comeback for the US that was unimaginable only a decade ago. Russia produced an average of 10.8 million barrels of oil and related fuels a day in the first half of this year. That was about 900,000 barrels a day more than the U.S.—but down from a gap of three million barrels a day a few years ago, according to the International Energy Agency.

Europe continues to outperform. The rationale underpinning this - underweight investor positioning, more attractive valuations than in the US (12.8 forward P/E compared to 14.5 in the US), steadily improving growth, and earnings estimates ticking higher. Italy's political situation is looking better and the European Central Bank (ECB) is ready with another round of long-term refinancing operations (LTRO) - a process by which the ECB provides financing to Eurozone banks. European stocks will continue to perform better than their US peers in Q4.

After decades of policy inaction, Japan is the real policy reformer among developed nations and the Nikkei Index continues to creep higher. The news out of Japan has been slow for most of the summer but Prime Minister Shinzo Abe has kept his promise for reform on track by announcing the consumption tax would be increased from 5% to 8% in April 2014. This levy is expected to raise 8 trillion Yen of which 5 trillion will be recycled back into the economy in the form a new stimulus package - public works spending and tax breaks.

My equity recommendation is still to be long Europe, Japan and US and, any dip due to the US debt-ceiling stalemate, should be seen as a buying opportunity. I do not see the S&P 500 Index going below 1600. I remain positive that at the end of the year the S&P 500 index will hit my target of 1744.

My sector picks are as follows

US: Industrials (XLI), Technology (XLK) and Financials (XLF), Energy (XLE)

Technology, Financials and Energy all trade at sub 14 P/E (of the three Energy is at sub 13) when the broader index is trading at 15.8.

Europe: Financials, Media, Healthcare, Consumer Discretionary, Information Technology

Some of the stocks I like: EADS, SAP, Volkswagen, Total, LVMH, Vinci, Allianz, Roche, Credit Suisse, BMW, and Siemens

Gilead Sciences, Schlumberger, Anadarko, Occidental Petroleum, CBS, General Dynamics, Citi, JP Morgan, United Technologies, Wells Fargo, Blackrock, GE, Google, Apple, and Amazon

Commodities and Currencies

There has been a marked decline in volatility in the FX market. The Deutsche Bank CVIX index is down -25% in over last three months with half of that decline coming in September.



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A relatively benign move in the currency market has continued as Italian PM Enrico Letta appears to have been able to split Silvio Berlusconi's party and to remain in office. The ECB has already mentioned the possibility of another round of LTRO but its timing is not fixed. The mention of LTRO alone is not enough to send the EUR weaker but a focus back on an interest rate cut will send the EUR down. In case the ECB downplays the strength of EUR (highly unlikely), the EUR could hit 1.36. On balance, I would be short EUR/USD, and Long GBP/EUR.

While the US Shutdown is weighing on the equities market, the selloff in USD has been much more muted. Part of the reason for this is that no one expects this shutdown to be prolonged or that both Republicans and Democrats will lead the country to the point of catastrophe. Expect the USD strength to renew as soon as a deal is reached in D.C. I would prefer to be long USD/JPY as well as USD versus Emerging Market currencies.

The downside risk to Gold remains. Tapering is delayed and not cancelled and signs are that inflation is undershooting. As I have said before, Gold is to be traded and is not a trend play anymore. \$1200 to \$1400 is the range unless we see a change in the inflation picture, which takes the Gold over the \$1400 level. Brent is also in a range trade, between \$100-\$110, with no immediate catalyst in sight. If anything, the risk to Brent is to the downside.

Best wishes,

Manish Singh, CFA



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