



Market Viewpoints

Manish Singh

September 2013

Do what is right and fair. The Lord accepts that more than sacrifices

-- *Proverb*

The nervousness in the market is not about overvaluation or excess flow into equities. Valuations are not expensive and the flow is on the side of equities. The real concern is regarding the uncertainty and the magnitude of the US Central Bank's tapering announcement (expected later this month) and what diminished Central Bank support will do to asset prices. Will it lead to another big bond sell-off, sending interest rates spiking? This has the ability to disrupt the equity market and send the S&P 500 Index (SPX) towards the 1500 level. I expect the US jobs report this Friday to beat market expectations and the Fed to embark on a moderate \$20 billion of tapering. Therefore, we will see the SPX reach 1600 post the tapering announcement, and perhaps lower if the Syria conflict gets messy. In my view, a bond sell-off coupled with the SPX hitting 1500 seems extremely unlikely. The Eurozone is out of recession and data out this week indicate a return to economic growth that is broad-based and not just Germany-specific. China has not entered a slowdown as was anticipated. The problem in Emerging Markets (EM) could get worse, but a re-run of 1997 is unlikely given changed domestic structures – no USD currency pegs, more local currency debt and high FX reserves.

A September to Remember?

Every September, planet Earth tapers off its vertical axis and moves further from the sun, announcing the transition from summer into autumn in the Northern Hemisphere. While there is little doubt about Earth's September tapering, the US Federal Reserve's tapering of its \$85 billion per month Quantitative Easing (QE) program is at the top of every investor's mind. This Friday's unemployment number in the US is clearly a key release, as it will offer Fed policymakers the final major labour market report before they decide the fate of QE. The Romans believed that the month of September was looked after by the god Vulcan and associated the month with fires, volcanic eruptions and earthquakes. Will it be a September to Remember? Let's hope things don't go that far.

To be fair, in reality, things are good if not very good. Revised Q2 US GDP data suggest that the US economy is gaining momentum. After bottoming in Q4 of last year, growth picked up to +2.5% in Q2 of this year. This opens the door for tapering by the Fed in September. The Federal Open Market Committee (FOMC) is currently projecting +2.3% to +2.6% growth for this year, so we will either see a robust Q4 GDP number or a lowering of the forecast when the FOMC meets in two weeks' time.

At the June FOMC press conference, Fed Chairman Ben Bernanke said:

*"If the **incoming data are broadly consistent with this forecast**, the Committee currently anticipates that it would be **appropriate to moderate the monthly pace of purchases later this year**. And if the subsequent data remain broadly aligned with our current expectations for the economy, we would continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around midyear."*

I expect the jobs report to beat market expectations (expectation +180K) and the Fed to embark on moderate \$20 billion of tapering.

Over the last two years, the S&P 500 Index (SPX) has rallied nearly +50% and although we have had four corrections of over -5%, none have been greater than -10%. Since its August peak, the SPX has pulled back -4.5% while Gold has rallied.



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The nervousness in the market is not about overvaluation or excess flow into equities. As Bank of America Merrill Lynch notes – “\$980 billion poured into bond funds and \$388 billion pulled from stock funds since 2000, it is impossible to argue the world is significantly overweight equities and underweight bonds.” The real concern is on the uncertainty and the magnitude of the Fed’s announcement and what diminished Central Bank support will do to asset prices. Will it lead to another big bond sell-off sending interest rates spiking? This has the ability to disrupt the market and send the SPX towards the 1500 level. A saving grace could be that that valuations are not expensive.

Emerging Markets = Submerging Markets? Not exactly

The anatomy of an Emerging Market (EM) crisis is nearly always the same.

1. An economic boom sets in post-reform (India) or natural resource boom (Brazil, Indonesia)
2. The private sector grows and companies find it easy to borrow USD abroad at lower interest rates than borrowing in the domestic market
3. Stories about how “things have changed”, “dawn of new era” let policymakers believe this is going to last forever and they lose track and commitment to carry out more reforms
4. Debts pile up as the world is all too eager to lend. The resulting capital flows into the country - from borrowing and foreign investors flocking to the local stock market - keep the currency strong
5. Strong exchange rates encourage imports and discourage exports. This develops into a current account deficit (meaning the country buys more goods and services than it sells)
6. This scenario is sustainable as long as the capital flows continue. These continue so long as growth continues. Since nothing continues forever, not the growth and definitely not the fickle private capital flow (be it EM or even Eurozone sovereign debt)
7. A shift in sentiment reverses the flows and a crisis sets in

As the growth in EMs has slowed, and the prospects for the developed markets have improved, the US Treasury yield has almost doubled in the past three months. The capital flows from EMs have reversed and USD has strengthened. This has hurt the EMs who rely heavily on foreign investment – namely: India, Indonesia, Brazil and South Africa.

Will we see a 1997-like crisis?

The problem could get worse, but a re-run of 1997 is unlikely, given changed structures in the EMs. The pace and scale of the collapse in FX and equity markets in 1997 was much more rapid due to structural reasons which do not exist today.

1. Local currency debt is far more common now, so currency falls have less impact
2. Current account deficits are in better shape to start with. In 1997, the Asian countries had current account deficits of over 5% of GDP; this time around the number is closer to 3%
3. The level of FX reserves is on average twice as large as in 1997 and would cover deficits for longer
4. Though the respective central banks have intervened in the FX market, they are more willing to accept a weakening of their currency and an adjustment of the current account deficit rather than spend valuable FX reserves to defend the currency. This is a very sensible approach that bodes well for these countries

However in this EM sell - off, China has fared better than anticipated, in large part because of restrictions imposed on capital flows that have sheltered the Yuan. China's GDP grew +7.6% in the first half of the year, the slowest pace in years, but China has not entered a slowdown as was anticipated. Additionally, China's official manufacturing Index, released Sunday, hit a 16-month high of 51 (back above the expansion level of 50). These numbers, added to a series of better-than-expected data for China's economy in July, have confounded pessimists, who expected growth to slow in the second half of this year.

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The Eurozone is out of recession and numbers out Monday indicate a return to economic growth that is broader-based and not just Germany-specific. According to a survey of purchasing managers at manufacturing companies in the Eurozone, factory-activity growth has resumed in Spain after more than two years of decline and the activity in crisis-hit Greece shrank at the slowest rate in more than three years. It also picked up in Italy and Ireland, as well as in Germany, the Netherlands and Austria. The activity in France decreased marginally.

It's been a good year for US equities so far with the SPX up +14.5%. Healthcare (XLV, +23%), Consumer Discretionary (XLY, +21.5%), Financials (XLF, +18%) and Industrials (XLI, +16.8%) are the outperformers. Technology (XLK, +8.8%), Materials (XLB, +7.7%) and Utilities (XLU, +6.8%) are the laggards. Energy (XLE, +14.2%) and Consumer Staples (XLP, 13.2%) are hugging close to the index.

It is likely we will see the SPX reach 1600 post the tapering announcement and perhaps lower if the Syria conflict gets messy. This will make US equities attractive with a view that I still see the SPX over the 1700 level (my target 1744) by year end, given the improving macro backdrop.

European stocks have done well recently, outpacing US stocks last month; a move anticipated and highlighted in my last two newsletters. European stocks will continue to do well as the European Central Bank (ECB) gets more supportive post the German elections later in September. Angela Merkel and her new coalition partners are unlikely to change their view on support to peripheral nations, especially now that they seem to be recovering. Better European growth and global momentum should translate into higher earnings and upside for European equities.

EMs are likely to head lower as the de-risking continues with rising US yields reversing the capital flows. This is a blessing in disguise, exerting pressure on the countries affected to carry out structural reforms. Thankfully, with no peg to USD this time around, the weakness in their currency is an automatic adjustment to their current account balance, as imports become more expensive. However, the high cost of capital will bear on growth and therefore the earnings of EM stocks.

Therefore, my equity recommendation is still to be long US, Japanese and European equities, and to wait on going long EM equities until after tapering and its effects have played out.

My sector biases are as follows

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

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

Some of the stocks I like: SAP, Volkswagen, Roche, Lloyds, Credit Suisse, ARM Holdings, Glencore-Xstrata, Ford, Schlumberger, General Dynamics, United Technologies, Wells Fargo, Blackrock, GE, Google, Apple, and Amazon

Commodities and Currencies

In the short run, the USD currency pairs – EUR/USD, JPY/USD, GBP/USD and AUD/USD will be driven by the tapering decision more than anything else. The questions are - how much will the Fed taper, which assets (US Treasury or Mortgage Backed Securities (MBS)) will the Fed taper and will this reduction be the beginning of a series of moves that will be carried out over the short term or the long term. The answer to each of these questions is crucial to how USD reacts. The market expects some degree of tapering therefore 'no tapering' will be seen as a disappointment and USD will plunge. Only a small reduction in Treasury purchases, could keep the dollar flat to slightly weak. However, if the Fed thinks it is time to be aggressive and reduces asset purchases of both Treasuries and MBS in a meaningful way, this will cause a sharp rise in U.S. yields, sending USD soaring. With my expectation of mild tapering, I expect USD to strengthen marginally.

On balance, I am bearish EUR/USD anticipating rising US yields and easing from the ECB post the German elections. USD/JPY is likely to stay below 100 for some time; GBP/USD is to be range bound 1.52-1.57.

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Commodities have recently lost favour as fears of slowdown in China grew. However, the modest rebound in Chinese growth now under way is getting commodities back into play. The fear of a one-way path to economic stagnation in China has eased and the increased geopolitical risk in the Middle East has obvious implications both for Oil and Gold. I see Brent holding on to \$100-110 mark with a marginal upside push as the Syria conflict stays in the headlines. However, any large spike (if any, barring one driven by Iran's involvement) will be quickly sold off within a short time, as the market often likes to "sell on the news". Syria is not a major contributor to world oil supply nor does it control any supply routes.

On Gold, my recommendation stays the same: Build long positions when Gold trades in the \$1180-1280 range, but do not expect Gold to stay above \$1400 for too long. We saw a \$140 rally in Gold over the last four weeks due to various factors – short covering, physical buying, worsening geopolitics in the Middle East and a pause in Gold ETF liquidation. However, Gold seems challenged to stay above the key \$1400 mark. I think over the next few weeks, physical demand will slow and the focus will return to the US economy and monetary policy. Tapering by the Fed is bearish for Gold. I see Gold in the sub \$1200 region, where it will become a long-term buy again.

Best wishes,

Manish Singh, CFA



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