



“ Even if you're on the right track, you'll get run over if you just sit there. ”
- Will Rogers

The Q4 US GDP growth brought us not three cheers but two. The ECB's 3-year financing facility has given risk assets wings and we have seen a spectacular rally over the last two months. The trend is your friend...until it bends. The test for this rally will be the end of the second ECB financing facility on February 29, with no provision for a third allocation penciled in. The Greek PSI (public sector involvement) deal has so far proven to be more elusive than the artist Banksy. For me, a political discord in Europe is the single biggest risk this year. I am cautious in the short-term and constructive in the medium term. If the new macro data fail to confirm the good numbers we have recently had (especially in the US), a pull back is possible. However with the Fed hinting of QE (Quantitative Easing) and the ECB more supportive in Europe; equity markets will continue to find a safety net for a rally to restart should there be a pullback.

What a start!

The trend is your friend...until it bends. The trend has certainly been a friend so far this year, continuing the festive cheer from December.

Unlike his predecessor at the ECB, Mr. Draghi has been more pro-active and decisive and has wasted no time in getting a handle on the problems facing the European banking sector and hence the entire Eurozone. He has cut interest rates twice and has put in place a 3-year funding facility which offers banks three-year loans at 1% against a wider than usual range of collateral. This was the real game-changer in terms of market sentiment.

The ECB lent €500bn in a first allocation in December and market expects to see a demand of up to €1 trillion in the second allocation on February 29. By cutting interest rates and allowing banks to borrow for three years instead of one, the ECB has effectively plowed money into the European banking system and eased fears of a financial meltdown.

This has given risk assets wings and the result has been a spectacular rally, as financial stress and the risk of a systemic panic in global financial markets has receded. In fact, the S&P 500 was up 4.56% in January and has had its best January performance since 1997 - and its best month since March 2010.

This good start to the year does not mean that the European crisis is over by any stretch. The test for this rally will be the end of the second ECB financing facility on February 29, with no provision for a third allocation penciled in. In this Leap year though, I hope European policy makers will make the extra day count!

No longer a haircut, but a scalping

The Greek PSI (public sector involvement) deal has so far proven to be more elusive than the artist Banksy. We have heard and read about the deal being agreed (several times now) but have yet to see anything concrete emerge.

The haircut on Greek debt has increased from 21% back in July, to 50% in October and potentially 70% today. Critics may say it's no longer a "haircut" but a "scalping," but there is no alternative. Without a large debt reduction and fiscal transfer, Greece will most certainly be forced to hard default. This is the default in the Eurozone that I referred to in the December newsletter (and thank you all for your feedback that I should have been more specific).

Benjamin Franklin said, "In this world nothing can be said to be certain, except death and taxes." You can now safely add "sovereign defaults" to that list.

The best-case scenario is for Greece to get debt relief in return for implementing structural reforms. A hard default by Greece may sound a fearful thing, but in reality it can be managed. Inter-bank markets may freeze temporarily until there is clarity as to which banks will survive, but given that the ECB can extend emergency life support; a liquidity crisis can be averted. One has to remember any crisis will get contained if the ECB prints money. If Germany objects, they will be faced with a choice of a catastrophic failure or agreeing to ECB printing money. In the end, I firmly believe that they would choose the latter.

US GDP: Hip, Hip but no Hooray

The Q4 US GDP growth brought us not three cheers but two. It came in at 2.8%, below the 3% consensus expectation.

The US Fed also indicated that its zero interest rate policy has at least until 2014 to run; inflation is expected to undershoot the 2% target, and with risk to growth still to the downside there is fresh ground for additional intervention by the Fed.

The US recession came to end in Q2 2009. In the slowest recovery on record since the Second World War, ten straight quarters of growth have delivered half the average growth seen in past recoveries following a recession. The average cumulative growth at end of ten quarters of recovery, for past recessions, is 22%.

Another disappointment in the latest GDP numbers is that inventory accumulation made up 1.9% of the 2.8% growth rate i.e. The US was producing more goods but consumers were not buying. This stockpiling will likely be a drag on Q1 2012 growth data.

Mind the Gap

The Eurozone unemployment rate is at 10.4%, the highest since the Euro was created. The unemployment rate in Spain, Greece and Portugal is at record high of 22.9%, 19.2% and 13.6% respectively. On the other hand, Germany has a record low unemployment rate of 6.7%, the lowest level since German unification in 1991.

This vast gap in unemployment levels is a clear indication of the lost competitiveness of the peripheral Eurozone over the core, Germany. Labor reform and wage deflation is required to regain competitiveness, but for nations already saddled with debt and high interest bills – and with more austerity to come - this is easier said than done.

A forced austerity, as some have proposed, would give rise to another kind of risk - political risk - with the threat to renegotiate Eurozone agreements in case of changes in government. This would undo most of the progress made so far.

For me, a political discord in Europe is the single biggest risk this year. Germany understands this, and this is why we will all witness the surreal picture of Angela Merkel

campaigning for Nicholas Sarkozy in France. He is running in a tight presidential race against Socialist candidate François Hollande, who has pledged to renegotiate the European treaty if he wins. Mrs. Merkel to the rescue!

Asset Class views

Equities: Last year the risk was skewed to the downside, now the risk appears more balanced. However, while liquidity provisions and cheap equity valuations are appealing, the GDP growth i.e. growth in personal consumption expenditure is the straw that will ultimately stir Mr. Market's drink.

As for my outlook: I am cautious in the short-term and constructive medium term. If the new macro data fail to confirm the good numbers we have recently had (especially in the US), a pull back is possible. However with the Fed hinting of QE and the ECB more supportive in Europe; equity markets will continue to find a safety net for a rally to restart should there be a pullback.

I am bullish on equities, but do think that the rally may have gone too far and too quickly. However, it's noteworthy that the two sectors that have been primary driver of markets this year are technology and consumer discretionary - both have bullish implications for the future.

My equity bias continues to be toward US stocks, with sector preference for Materials, Financials, Technology and Industrials i.e. cyclicals. European equities are cheap and do have potential to provide catch up gains given their underperformance last year. However, I would still advise to stay away from European financials, if you are thinking of a long term play. European financials are more of a tactical trade, with one eye firmly on the exit.

Beyond Europe, the political leadership and Central bank of China continue to navigate safely – avoiding a hard landing for now - in this year of leadership transition (The HSCEI index is up 43% since October). With interest rates still high and inflation receding, headroom for aggressive rate cuts remains.

The rally to date notwithstanding, I expect Q1 to be challenging for emerging markets. Emerging markets rely mostly on exports and they will feel the drag from a Eurozone which is already in a recession and below expectation growth rates in the US.

Bonds: The FOMC (federal open market committee) now projects a continuation of exceptionally low fed fund rates until late 2014 (versus mid 2013 previously) The Fed's assessment of economic conditions has been downgraded despite the recent positive momentum in economic data. This is the Fed's way of reminding us that monetary support will not be prematurely withdrawn until the economy is on a sound(er) footing. It is likely QE3 will be not the last QE measure we see from the Fed. I don't see any risk of a US treasury sell-off yet as the biggest buyer in town - the Fed - is likely to visit again. However, in bonds, my preference is for US investment grade corporates and emerging market sovereigns.

Gold: Regular readers of this newsletter will know I have been a Gold bull for all of last year, and my ex colleagues at Soc Gen will know I have been a Gold bull since I first recommended it at \$1100. Nothing has changed. Gold is up more than 13% year-to-date and it has more to go. The recent Fed measures hint at inflation targeting i.e. if the real growth was to be negative, higher inflation will be tolerated to achieve a positive nominal growth. The Fed's dual mandate of price stability and full employment means inflationary concerns will be damned to bring about nominal growth. No wonder China continues to buy gold hand over fist!

Oil: All of the above inflation arguments also apply to Oil and commodities in general. While lower GDP growth is a drag on crude prices, anticipated inflationary push is the support.

Currencies: I maintain my view of Euro weakness into Q1 and perhaps Q2 as well. A start of QE3 may put downward pressure on the USD, but problems in Europe are immense and a weak Euro helps the Eurozone.

Best wishes



Manish Singh, CFA

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