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Market Viewpoints

October 2011

Manish Singh

> It's not whether you're right or wrong that's important, but how much money you make when you're right and how much you lose when you're wrong.
>
> *George Soros*
>
> October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February.
>
> *Mark Twain*

The Bond market is still pricing in a recession ahead and when bonds and equities disagree, the bond market usually wins. The Fed dissenters and the Republican Congressmen kept the Bernanke Fed from expanding its balance sheet. 'Operation twist' may not be too much of a help. If conditions worsen; expect the Fed to carry out another round of QE. In the near term, Europe leveraging up the EFSF and a good start to Q3 earnings season has the potential to deliver a short term rally in equities, but it's not one to participate in without insurance. Dollar strength has wiped some glitter from Gold, but the case for Gold remains solid.

Should I stay or should I go?

In the recently published World Economic Outlook (WEO), the IMF cut the growth expectations in the advanced economies by a third, from 2.2% to 1.6% in 2011 and from 2.6% to 1.9% in 2012. The Fed dissenters and the Republican Congressmen kept the Bernanke Fed from expanding its balance sheet with another round of Quantitative Easing (QE). The tone of the Fed's statement was more negative than anticipated. *'Significant downside risks'* to economic growth got everyone refocused on that one thing –growth, and S&P 500 fell by -5.9% by the close of next day. Since Ben Bernanke was made Chairman of the Fed in February 2006, this marked the worst reaction to a Fed meeting under his tenure.

The swings in the markets ever since the big slide began in early August have recently become almost commonplace. If the last twenty trading sessions in the S&P 500 were to be broken into 5 parts, the moves were -7.35%, +5.64%, -5.5%, +7.38%, -8.66%, +7.33%. Needless to say, the main driver of stock prices has been headlines.

In the immortal words of English punk rock band The Clash entitled – *'Should I stay or should I go .... this indecision is bugging me'* . The song captures the current mood of investors perfectly. Any news or rumour of big action in the Eurozone, anticipation of QE or any other form of stimulus has the investors 'staying', no sooner it is denied or priced in, and investors decide to 'go'.

My advice is - stay, but buy protection.

The Bond market is still pricing in a recession ahead and when bonds and equities disagree, the bond market usually wins. Europe leveraging up the EFSF and a good start to Q3 earnings season has the potential to deliver a short term rally but it's not one to participate in without insurance.

When the rally ensues, volatility will fall and it will be good time to buy some protection to safeguard your existing or new Longs. Not one month protection but six month protection either at-the-money or out –of- the- money or better still some combination of the two. Eurozone troubles, ill health of financials, US political deadlock and policy errors are going to stay with us for months if not years to come. While I do not expect the bottom to fall out of the market, a sharp down leg/legs is very much a possibility. The protection is to take care of such a scenario and also to lock in some returns by taking profit on existing puts in a down leg and putting on new positions in an up-leg.

To QE or not to QE

In the September 21st FOMC announcement the Fed's balance sheet was adjusted but not expanded. They unveiled a nine month $400bn 'operation twist' – selling short dated Treasurys currently held on its books and using the proceeds to buy long duration (10yr+) Treasurys. How useful will this effort be? For months now, borrowing costs have been low and there are no signs of economic activity picking up.

What we need is more stimuli - both fiscal from government spending, and monetary via QE (Quantitative Easing). Critics of QE fail to realise that QE is nothing but creation of credit. Creation of credit is central to growth. You only have to look at credit availability problems that plague a typical emerging market where promising business never take off as it's starved of credit. Good ideas get nipped in bud as banks don't extend credit.

It's easy to understand why credit drives economic growth. When credit is expanding - consumers can borrow and spend more and businesses can borrow and invest more. Increasing consumption and investment creates jobs and expands income and profits, as income rise, the price of assets such as stocks and property increase. Rising asset prices give the owners of assets more wealth (i.e. collateral) against which they can borrow still more. A happy upward spiral of prosperity….so long as it continues. Eventually, however, every credit-induced growth will come to an end when one or more participant becomes incapable of repaying the debt or interest on its debt and the spiral ruptures. The housing sector was the trigger this time. Therefore, the Fed and other central banks are following an easy monetary policy to keep the cost of servicing debt low and find a way out. It's a fact that *Credit growth drives economic growth until it doesn't.* Expansion of credit is not bad so long as the cost of credit is kept at a level that prevents its misuse. Sadly this was ignored in last decade and now we have this mess to deal with which will take years to unwind.

In the meantime any austerity plan which doesn't incorporate near term sustained and appropriate stimulus, availability of credit to restart growth is bound to pile more misery and delay a full recovery.

Eurozone: a 'fiscal transfer' without a 'fiscal union' is merely crisis postponed

Europe's problem is easy to comprehend – you would not hesitate to share your home baked cake with your neighbour but would you be as eager to share your bank balance and credit line with them? Would you like your neighbour to get a house loan guaranteed on your bank balance? No, for you will fear the scenario where you end up with the house loan and your neighbour ends up with the house.

If you are of a progressive persuasion (like the founders of the Euro) and would like to share your balance sheet with your neighbour, I am guessing you would like your neighbour to disclose all their earnings and expenses before you sign on the loan document, you would like to have some control on their spending habits in return for extending your balance sheet to them i.e. endeavour to form a 'fiscal union'. Europe is at this point, either there is a 'fiscal union' or the Eurozone's present arrangement cannot be sustained.

There is an old saying – *"To return to the root is to find the meaning, but to pursue appearances is to miss the source".* The response coming from Europe to date has been directed to dealing with – The Euro currency in crisis, Italian and Spanish debt costs spiralling, and risks of ratings downgrade all appearances and not the source of the problem. Focus now needs to be directed to the source of the problem, namely the fiscal imbalance in the Eurozone and the link between sovereign indebtedness and distressed balance sheets of European banks.

When the problems with the Eurozone were first raised we got the '*shrugs*' and the '*mañana*' from EU leaders and when it pleased them a hurriedly worked out solution (often over weekend) with each solution claiming to be decisive one, but which was unable to placate the market for more than a few days. More of the same will be very costly and could take Europe to the brink and solutions are enforced by the market. We do not want this disorderliness.

It's encouraging that after initial denials, European leaders now acknowledge that banks will have to be recapitalised. The EFSF size is expected to be increased too. The leveraged EFSF will be able to provide increased funding to the periphery nations who have to implement an austerity budget and take care of the primary deficits in their books. In addition, the EFSF will likely recapitalize the banks by swapping their sovereign debt for a SPV issued AAA debt.

Will the plan work? Well in the short term yes, German and French bank will get recapitalised and Germany will also be able to implement austerity in the peripheral nations. The question is - what will the Greeks make of it, when they realise that the French and the Germans are getting a bank bailout and they are getting more austerity. Not a happy situation but I don't think Greece can afford to leave the Euro, with a primary deficit of 3%, it's not in their interest.

A leveraged EFSF is bullish near term for most risk assets as the overhang of Europe recedes. However it doesn't address the source of the problem -'fiscal disparities among Eurozone members'. This will therefore be a crisis postponed. The EU policymakers will just hope it gives them enough time to find a better and permanent fix for the source of the problem.

Gold: has the shine gone?

A combination of - margin hikes by CME (Chicago Mercantile Exchange) and Shanghai Gold exchange, receding inflation fears and the strength of Dollar have contributed to the 13% fall in Gold price from its peak. Is that the end of Gold trade? Absolutely not. Gold at this elevated level has always been about ‘store of value’ and not just an inflation hedge trade.

Unlike equities or bonds, Gold’s value doesn’t depend on solvency of any institutional body be it government or other. This will prove very important in the years ahead as sovereigns address the ‘astronomical debt’ issue. Well ,perhaps, we should stop using the word ‘astronomical’ when referring to sovereign debt, as the number of stars in our galaxy only run only into hundreds of billions whereas we are now talking about trillions of dollar debts and bailouts!

Questions that still need answers to support long Gold trade

- Unsustainability of the Eurozone in its current form, a fiscal union is desirable but is it achievable?
- Is Germany going to play ball and sign up to the large guarantees it’s been asked to in order to support the Eurozone. If yes, for how long?
- Should the strength of US Dollar be taken for granted? What happens when the faith in USD is tested?
- How is the mushrooming sovereign debt going to be dealt with? Inflate it away and debase the currency?

Short term fluctuations that we see now will shake out momentum traders and keep the investors; and hikes in margin requirements will shake out the leveraged speculators. The case for Gold as ‘store of value’ has not changed.

Signs to look for to indicate a return of ‘risk on’ scenario

- GDP growth figures start stabilising, especially in the US, or
- a robust and long lasting solution to the Eurozone which must include a provision to deal with fiscal imbalance in the Eurozone,
- another round of QE in the US, or
- most equity strategists turning bearish and lowering their year-end S&P targets drastically,

While the signs of improvement in the market conditions are not difficult to spot, timing the trade is still an art more than science. An interesting statistic from analysts at Societe Generale – *“small errors in timing can be very costly: EuroSTOXX 50 data suggests that buying eight weeks too early requires an average 55 weeks to recoup the losses; six weeks too late and you will miss the first 75% of the rally”*

One way to mitigate the timing is by using Options. However, be mindful of the volatility. If volatility is high, it’s expensive to buy it outright – therefore a Call Spread (buying a lower strike call and selling a higher strike call) or selling a PUT to finance a Call should be considered.

Best wishes

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Key dates for the calendar

October 4
Meeting of EU finance ministers in Luxembourg

October 6
ECB meeting in Berlin. This will be Jean-Claude Trichet's last rate setting meeting as ECB President.

October 11
Q3 US earning season starts with Alcoa (AA) reporting earnings at market close.

October 14-15
G20 finance ministers meeting in Paris. G20 annual summit in Cannes on Nov 3 - Nov 4

October 17-18
Summit of EU heads of state and Government in Brussels

November 1
Trichet retires and Mario Draghi takes over as the ECB President, rate setting meeting on Nov 3

November 2
FOMC decision. Bernanke will be holding press conference after this event.

November 16
BAC (Bank of America) court case regarding its $8.5bn mortgage repurchase settlement.

United Kingdom

9 South Street
London W1K 2XA
United Kingdom

Singapore

One Temasek Avenue
23-05 Millenia Tower
Singapore 039192

Visit our website:

crossbridgecapital.com

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United Kingdom

9 South Street
London W1K 2XA
United Kingdom

Singapore

One Temasek Avenue
23-05 Millenia Tower
Singapore 039192

Visit our website:

crossbridgecapital.com

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