



“ **Central bankers always try to avoid their last big mistake. So every time there's the threat of a contraction in the economy, they'll over stimulate the economy, by printing too much money. The result will be a rising roller coaster of inflation, with each high and low being higher than the preceding one. – Milton Friedman** ”

The two doses of LTRO that Europe got were just the vitamin and not meant to be penicillin. The growth prospect in Southern Europe looks dire and austerity targets ambitious. The first quarter rally in the S&P 500 has been the best in over a decade but will the market continue to bloom this spring? The US Jobs report out on Good Friday and the Q2 earnings season starting 10th April will provide us with the answer. I am cautiously optimistic for Q2 earnings and therefore think the market could rally all of April. Two factors have been key influences - good macro data from the US and a reward (albeit delayed) for last year's US corporate earnings. It is attractive to be a contrarian but one can only be a contrarian at the ends; in the middle, one is a trend follower. We still seem to be in a good data trend from one economy that still matters more than others - the US.

Spring is in the air?

Spring is here. Each year around this time, the seeds push up through the soil and the trees begin flowering. Will the markets continue to bloom or wilt? I have a feeling the spring flowering of the market is still on, at least for another month.

Spain has been in the news lately and I was thinking Spain must arguably house the most enviable (and the least enviable) jobs in Europe today.

The least enviable job, I am thinking of Spain's Prime Minister Mr. Mariano Rajoy – he faces 50% unemployment in under-25s and 23.6% unemployment nationwide; he has to carry out wide-ranging Labour market reform, financial sector reform and commit to cutting the budget deficit to 5.3% of GDP in 2012 from 8.5% in 2011 – that's a whopping 3.2% cut in the midst of a recession.

The most enviable job, I am obviously thinking of Victor Valdes, the Barcelona goalkeeper, who spends more time celebrating a goal than doing his job of saving one.

The S&P 500 has been off to the races in Q1, with a gain of nearly 12% and the largest gain in Q1 for well over a decade. The reasons are plain - good data in the US, liquidity and a 'firewall' provision in Europe to prevent a disorderly event.

Could this rally continue? Is there more headroom?

The US Jobs report out on Good Friday will provide us with the answer. It will not be wrong to say that the recent rally in the S&P is a delayed reward for last year's earnings. As you may recall, US earnings grew by 12% in 2011, but the S&P 500 finished flat. The ISM manufacturing data for March came in at 53.4; a reading above

50 indicates an expansion in the US economy. If I carry out a simple regression (as one does) of ISM data versus year-on-year growth in the S&P 500, I arrive at an S&P value of 1454 corresponding to the latest ISM data. This makes me think there is still some headroom before the market hits fair value. The current forward P/E of the S&P is 13, well below the 10-year average of 14.5.

A good Q2 earnings season (starting on 10th April with Alcoa) could be an additional boost to the US equities market. I am cautiously optimistic for the Q2 earnings season.

As we progress into the year, politics become more important: French elections, Greek election and the all-important US elections. In the US the approval rating of the US Congress has fallen to nearly 10%, roughly the same percentage of Americans who believe Elvis is still alive...

As for the UK, Chancellor Osborne is not happy with OECD's projection of the UK falling back into a recession. He has reason to be upset after having presented what I think was a very good budget – raise tax collection, reduce spending, reduce corporation tax, and incentivize corporates to create jobs.

However through no fault of his own Osborne ended up becoming a victim of 'pastygate' – his proposal to tax the hot pasties but not the cold ones. It made some people wonder if you buy a cold pasty and microwave it at home, would HMRC accuse you of exploiting a tax loophole?

As I have indicated for the past three months, the risk to the market remains to the upside, even though the crisis in Europe is far from resolved. The reason – it is attractive to be a contrarian but one can only be a contrarian at the ends; in the middle, one is a trend follower.

EU Austerity: You've got Fail

Europe has printed enough debt, loaned it to each other and now has a false sense of wealth; a reduction in living standards is a stark reality waiting to be acknowledged. As someone once said - "the romance finishes when the finance starts".

Germany went through its own austerity in the late 90's and for that, Germany - had to break the EU deficits targets, freeze wages for a few years, and as luck would have it, the capital goods boom in emerging markets at the time (particularly China) meant Germany shipped a lot of industrial goods and machinery. It is hard to see how Southern Europe can replicate this achievement and meet the austere Debt/GDP targets.

The data out this week indicated a stable unemployment rate of 6.7% in Germany, in sharp contrast to the 23.6% seen in Spain. The unemployment rate among Spain's under-25s rose to 50.5%. How long is it before a full scale social unrest is at hand? We know the psychology of a society: In the end it really doesn't matter how the problem arose in the first place. One group of people will not tolerate long-term austerity - severe enough to keep half of their youth unemployed - in order to ensure the continued prosperity of another group.

It is also a fact that there can be no wealth without competitiveness. The reason you are where you are is because you competed to be there. The uncompetitive South of Europe, locked in the high exchange rate of the Euro can never compete with a productive Germany. And to make matters worse, Germany gets more productive with every passing year as Southern Europe gets poorer and more unproductive. Southern Europe has a trade balance deficit because they do not have enough to export; and the imports are paid for with debt and not by exporting more, so the hole keeps getting deeper.

The cure to debt deflation of course is inflation. If Germany accepts to keep the Euro together, it will have to pay the price of inflation and as a result a reduction in its real wealth. Inflation will allow the Southern Europeans to inflate their debt and reset.

European monetary union is vastly different from the US monetary union. The success of the US monetary system is based on centralized government expenditure - on healthcare, the military, infrastructure, welfare payments, to name but a few. Poorer US States are supported by fiscal transfers from the wealthier ones so New Yorkers can continue to work and Californians can continue to innovate, without the prospect of natives from poorer states revolting.

Can Europe achieve this? Will we ever see centralised defence spending and manufacturing plants spread over Europe and not just in Germany and France? Can you imagine Germany agreeing to pool resources to make welfare payments to their poor southern neighbours? As long as the structure of the Eurozone continues to result in assets flowing North and debts and unemployment piling up in the South, there will be no end to the Eurozone troubles - short of ending the Euro.

Now for some asset class specific views:

Equities:

My equity bias continues to favour the US over Europe and I have a lack of affinity for Emerging Markets until we see a strong policy response or a sustainable manufacturing reading as reflected by PMI data. Recent Chinese PMI was good but there is a strong seasonality to February and March PMI readings, and therefore it may be premature to get over excited.

My sector biases for the US continue to be cyclical sectors: Financials, Technology, Energy and Industrials. In energy, I prefer the Oil servicers (Occidental, Halliburton) over the Oil Majors (Exxon, Chevron)

The ECB's LTRO was the vitamin not the penicillin; therefore I would stay away from European financials except a select few with good retail/wealth management operations.

The wide difference we now see between US and European growth is down to a rebound in business investment. In the US, firms have a wider range of financing options. In Europe, companies have fallen victim to credit rationing by their banks. The lending caution of banks in Europe is understandable, given the huge debt level and no growth.

High unemployment and tight credit all point to further contraction in Europe. Of course, a policy change of high tolerance to inflation could change all that and asset prices, specifically equities, could rally, but we are not there yet and neither is there a hint of such a regime change on inflation.

Growth in Japan is projected to rebound strongly in the first quarter to 3.4%, before easing to 1.4% in the second quarter according to the OECD. As mentioned in my last newsletter, Japanese equities continue to be a good buy.

So much for economic optimism, but earnings have to come in too. Therefore the Q2 earnings season starting on April 10th is one to look out for. Financials start reporting from April 13th with JP Morgan and Wells Fargo.

Bonds:

There is a growing chatter of a bond bubble. Is there one? Well, there will be one at some stage given the historically low level of yields, but in the near term: No. For buy-to-hold bond investors, who know how much they are going to get at maturity, don't get out of your bonds.

Bond yields are not set to change gear; the crisis has not yet been resolved. A wholesale move away from bonds to equities will not start until the 'rate rise' expectation gains ground. We are far from there.

While I am not inclined to hold Emerging Markets (EM) equities, EM bonds, both sovereign and corporate, are a good buy, specifically bonds of BRIC nations as well as Poland and South Africa. When it comes to high yields bonds, I like only the US names.

Commodities:

I have a bullish outlook for precious metals, with very bullish view on Gold. Oil should be flat to bullish; I am bearish to very bearish for Natural gas and base metals.

Long Oil is not just a play on concerns with Iran and the oil embargo. Reports suggest that crude oil stocks stands at 5-year lows due to persistent supply problems. Add to that the fact that US growth is back and the bearish case for Oil (even with Brent at \$124) stands on weak ground. Oil at \$130 over the summer is easily a possibility.

Currencies:

As I highlighted in my last newsletter with the short AUD call, commodity currencies are overvalued. AUD is down more than 5% in the month of March. AUDUSD parity is my near term target. However, as long as concerns about China persist, short AUD will be in play even if parity is breached.

A widening economic data gap between the US and Europe points to the fact the EUR weakness is here to stay. The LTRO impact will fade and in the absence of growth and reconfirmation of the same, the EUR risks breaking to the downside.

Best wishes,



Manish Singh, CFA

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