



“ People often say that motivation doesn't last. Well, neither does bathing – ”  
that's why we recommend it daily – *Zig Ziglar*

**Mr Draghi's comments of 'whatever it takes' indicate Europe is finally ready to move beyond the preamble of solving the Eurozone crisis. This afternoon's ECB rate meeting is eagerly awaited. My gut feeling is the deposit rate could be lowered to negative territory and the sovereign bond purchases restarted alongside more verbal assurances of strong action. Spain is on precipice. As late as early July, the Spanish government was telling everyone, "Spain doesn't need a sovereign bailout". It is now almost certain they can't do without one. Spanish debt cost is spiraling at the short end too. With the country's ratings under review, a downgrade now could cut Spain's access to the bond market altogether. For me, this is the inflexion point in the Euro crisis and could be the reason for the recent bold comments from the ECB. The US Fed's QE3 is likely to come at its September meeting. US Q2 earnings have not been bad but revenue expectations have lagged. However, the fall in consumption and income have bottomed and real spending is turning into a shallow uptrend. US Q2 GDP growth of 1.5% though small, keeps recession at bay. Slow growth with incredibly loose monetary policy bodes well for Equities. Large-cap US stocks are still the place to be, in the Industrial and Energy sectors in particular. Euro weakness will stay and GBP's rehabilitation continues, at least until the UK gets downgraded..**

#### **The Eurozone has more issues than Vogue, but it has super Mario**

When you hear a statement like "We will do whatever it takes" it can be mean two things - either a sign of determination or evidence of cluelessness. Since the speaker in this case is ECB President Mario Draghi (or super Mario as he has come to be known), it's more the former than the latter.

Speaking in London last week, Mr Draghi said that the ECB would do "whatever it takes to preserve the Euro" and concluded "believe me, it will be enough." Is this an indication that Europe is finally ready to move beyond the preamble of solving the Eurozone crisis? For the yields on Italian and Spanish sovereign bonds to descend from their unsustainable levels, the ECB has to buy the bonds, rather than just continue to buy time - the modus operandi for the last few months.

This afternoon's ECB rate meeting gives Draghi an opportunity to walk the talk. His options are: cut the base rate from the current 0.75% to 0.50%; reduce the deposit rate it pays from 0% to -0.25% and force banks to take the capital they have deposited at the ECB and start lending; further extend the eligibility criteria for securities to be accepted as collateral in order to receive ECB funding; reactivate Securities Markets Programme (SMP) and buy Italian and Spanish bonds; and the biggest of all - a plan for outright large scale QE (quantitative easing). The likelihood of the last option being announced is very small given the determined opposition of Germany's

Bundesbank to any plan that directly finances government's deficits.

Fixing the problems in the Eurozone remains a marathon, not a sprint. I expect Draghi to tone down heightened expectations today but also give enough support to keep the bears away. Granting the European Stability Mechanism a banking license is not on the horizon and a Reuters article Wednesday indicated that ECB insiders believe that "bold action is probably at least five weeks away". My gut feeling is the deposit rate could be lowered to negative territory and the SMP restarted alongside more verbal assurance of strong actions. Will it be enough to bring Spanish yields down? Perhaps, for couple of weeks, but the market will quickly look ahead to concrete measures that live up to Draghi's 'whatever it takes' comment.

To say the Euro is 'irreversible' is probably a step too far, too soon, unless of course one believes the Euro can be transformed into a "proper" currency with a single state and a single fiscal policy. Does anyone in Europe really want such a union? Even the German public generally sympathetic to the cause thus far, is turning. A recent poll in a popular German mass circulation weekly Bild am Sonntag showed 51% of Germans believed Europe's top economy would be better off outside the seventeen-country Eurozone. 29% said it would be worse off. The survey also showed that 71% of Germans wanted Greece to leave the Euro if it did not live up to its austerity promises. These numbers are very different from last year

when Germans overwhelmingly were in favour of keeping the Euro. If German Chancellor Angela Merkel were therefore forced to put the Euro to a referendum, Germany could – wait for it - vote to leave the Eurozone.

The news out of Greece is not any better. There is certainly some truth to rumors of the IMF losing patience with Greece and having (re)-done the math they now believe giving more money to Greece is unwise. So, come September, we could have the first exit from the Euro. Could this be what prompted Draghi's recent comments?

### Spain on the precipice

As late as early July, the Spanish government was telling everyone – “Spain doesn't need a sovereign bailout”. It is now almost certain they can't do without one. Spanish bond yields are at stratospheric levels. The short-term 2-year has more than doubled from 2.5% in April to 6.5% in July. The 10-year yield reached 7.75% earlier this month. With Spanish GDP growth still negative (-0.3% for Q1 and -0.4% for Q2 12) and debt costs spiraling at the short end too, the specter of another ratings downgrade of Spain looms and would make the situation even worse.

Moody's placed Spain's Baa3 rating under review for possible further downgrade on 13 June with a maximum review period of 3 months (ending 13 September). The review for downgrade will focus on the outcome of the ongoing audits of the Spanish banking system, and the conditionality of the EFSF/ESM loan agreement. A downgrade could easily take the country below investment grade and Spain could lose access to the bond market altogether. For me, this is the inflexion point in the Euro crisis and it could be reached as early as this month.

President Hollande's 75% tax rate comes into force this month in France. The taxes may have pushed more French professionals to the 21st arrondissement of Paris (aka London) but French government bonds have done extremely well. The 10-year yield has dropped a full percent from 3% at the time of the French elections to 2% today. Perhaps buoyed by this fact, Hollande seems to be looking for more tax ideas to impose. Here is one idea should he be reading this column - levy a tax on speaking French outside of France. He will be able rein in all escaped francophones living abroad into his tax net once again.

Two dates to bear in mind

- 31 August, Ben Bernanke Speaks in Jackson Hole, Wyoming. This will be a key event as we wrap up August. QE3 will most likely be announced at the 13 September FOMC meeting but the US Central Bank

Governor could use his Jackson Hole speech to lay the groundwork as he did for QE2 in 2010.

- 12 September – German ESM Ruling: The German Constitutional Court is to rule on the complaints lodged against the ESM and the fiscal compact. The chances of the ESM being vetoed are low due to the wider ramifications for the Eurozone.

### Equities

The macro economic data in July has been mixed.

The advance estimate of 2Q12 US real GDP came in at 1.5% annualized growth. Housing provided a boost, the growth is clearly slowing but a recession is not on the horizon. Other economic numbers – manufacturing, inflation, consumer confidence have all been mixed. The jobs report has been worse than expected but signs of improvement in housing and lower oil prices should allow the economy to continue to grow at a moderate pace.

Slow growth accompanied by incredibly loose monetary policy makes a friendly combination for Equities. Therefore, a growth of 1.5% is not to be frowned upon, small though it may be.

We are more than half way into the US Q2 earnings season, nearly 70% of the companies have beaten EPS (earnings per share) expectations (albeit lowered ones) but only 40% have beaten revenue expectations (a number lower than the average of 60% we saw in 2011). The numbers for European stocks are 55% and 62% respectively. Easy money and depressed expectations will lead to better Q3 earnings for stocks.

We have the key US Non Farm Jobs report this Friday. The unemployment rate (end of June) stands at 8.2% with Q2 job creation averaging 75,000 jobs, a third of the average 225,000 jobs we saw in Q1 this year. Another confirmation of slowness in jobs growth this Friday will most likely get the Fed to press the QE3 button at its 13 September FOMC meeting.

China could slow down further and the Eurozone could disappoint, but we have to get used to those risks as they won't go away anytime soon. Fundamentally, the case for investing in Equities is building up - the Fed is getting closer to more QE, as the MPC in the UK is getting closer to cutting rates (and perhaps more QE) and as the ECB will do 'whatever it takes'.

Over last twelve months, defensive sectors have performed best - Telecom Services +18.5%, Consumer Staples +15%, Utilities and Health Care +12.7%. In the same period S&P 500 index is up +5.4%. The cyclical

sectors have underperformed: Materials -8.9%, Energy -8.8%, Financials -1.3%, and Industrials +2.5%.

Over last six months, we have seen cyclical stocks take the lead many a time but only to give it away each time as the 'risk off' trade kicked in. Cyclical sectors are still my favorite. The decline in US consumption and income has bottomed and real spending is turning into a shallow uptrend. Large-cap US stocks is the place to be. Industrial (XLI US) and Energy (XLE US) sectors have not performed well. If any sectors benefit most from the next rally, it will be these.

Financials will be volatile and present a trading opportunity but not an investment opportunity. The overhang of the LIBOR investigation is not helping.

Depending on the outcome of the ECB announcements today, a case for large-cap European stocks is building up too.

In Emerging Markets (EM) - India (structural weakness, policy deadlock) and Russia (Oil weakness) look vulnerable. Brazil (underperformed EM by as much as 10% YTD) and China (supported by PBoC's easing policy) look good to go long.

### Currencies

So long as the European sovereign funding crisis remains, the Eurozone economy will underperform and odds of EUR/USD weakness stays. There is little appetite to short the Euro at the current levels in the face of ECB's determination to act. I think it's more likely to hover in the 1.20 region. In fact, in response to the ECB actions there is every chance the Euro may strengthen temporarily but the long-term case is one of downtrend. In terms of charts, the next support for the Euro is 1.18, and if it breaches that it could go all the way to 1.08.

I don't anticipate a US recession and therefore have positive views on both the US-linked currencies, CAD and MXN. I am still bearish on INR as the lack of policy response is getting worse, so much so that India experienced one of its worst power failures this Tuesday that left more than half the country (that's 700 million people) in the dark for over three hours. This doesn't bode well for investor sentiment or local production.

I still prefer the GBP to the EUR and Moody's decision to leave UK's AAA rating intact will provide some support for Sterling (although due to the misguided policy of the Chancellor I expect the UK to lose its triple A crown before year end). Sterling has been in slow rehabilitation for no other reason except that it is not the Euro. A range of 0.80

to 0.75 is where I see EUR/GBP.

As Europe slows down further I would be wary of Scandinavian safe haven currencies SEK and NOK. The economies there cannot sustain permanently strong currencies for long without hurting the local economy and raising a cry for currency weakening.

### Commodities

Among commodities the softs - Corn and Soybean prices have set new record highs as forecasts of the US Midwest drought stretched into August. I expect this to continue through August.

In metals, just as my preference is for cyclical stocks so is my positive view on Copper. I continue to believe in Gold for all the reasons I have mentioned in previous newsletters. Nothing so far takes away from a long Gold trade. It will likely be range-bound for now until catalysts (such as QE3, high tolerance for inflation, targeting of nominal growth etc.) return.

Crude oil prices rose in July primarily on increased geopolitical risk (notably a terrorist attack on an Israeli tour bus in Bulgaria that stoked Mideast tensions) and increased anticipation of monetary easing both in Europe and US. However, total oil product demand according the US DOE's (Department of Energy) latest weekly data indicates only a slight rebound. The case for Oil is tied to the case for cyclical stocks, which are - appropriate policy response and growth. Oil should remain range bound (90-110). A QE3-like response will lift all risk boats and Oil should benefit from that.

### Bonds

Draghi's comments will have European sovereign bond investors buoyed and short sellers worried. In fact, if Draghi's comments were to be implemented, a long case for peripheral bonds can be made. The mere appearance of a massive ECB bazooka could send Spanish 10y yields hurtling down towards 6%.

The German Bund is a different matter. Increased participation in shoring up peripheral bonds is an expense to Germany, and Bunds will sell off.

In other recommendations - Long Investment grade bonds in USD and Emerging Market corporates. Long US high yield but not European high yield. No financial bonds. I prefer UK Gilts to German Bunds and better still look to build Short Bund exposure. US Treasuries can still rally from current levels.

And finally...

This newsletter would be incomplete without a mention of the Olympics.

If there were an Olympics for financial markets, the Eurozone would be a hot contender for the Gold medal in the dressage event. They have been dressing up and parading ever since the last Olympics in 2008 when the Euro crisis first came to the fore.

The beach volleyball gold medal would go to US Dollar. Who cares about the reality (large debt) as long as you can look good and attract an audience?

Kayaking Gold would go to Greece – for the past three years Greece has navigated the most extreme of rapids and despite being loaded with vast amounts of debt, has still managed to remain afloat.

Top honors in the High Jump would be keenly contested and Spain would inch past Italy in the finals to take the Gold. The Greeks, Portuguese and Irish - with bond yields above 10%, -are ineligible for this contest.

Boxing Gold would go to Germany. I dare not think how one-sided this contest would be.

Weight lifting Gold would go to the UK. The Bank of England with £325bn of QE has already lifted 35% of the total Gilt supply and is going to lift more in the next round. The US's QE of \$1.7trillion amounts to only 11% of its Treasury debt supply. Let's hope many of Team GB's athletes do as well in the next few weeks.

Best wishes,



Manish Singh, CFA

## Important Information

This document is provided to you for your information and discussion only. It is not a solicitation or an offer to buy or sell any security or other financial instrument. Any information including facts, opinions or quotations, may be condensed or summarised and is expressed as of the date of writing. The information may change without notice and Crossbridge Capital (UK) Limited, Crossbridge Capital Merchant Banking LLP and Crossbridge Capital LLP (together "Crossbridge Capital") are under no obligation to ensure that such updates are brought to your attention.

The price and value of investments mentioned and any income that might accrue could fall or rise or fluctuate. Past performance is not a guide to future performance. If an investment is denominated in a currency other than your base currency, changes in the rate of exchange may have an adverse effect on value, price or income. This document and any related recommendations or strategies may not be suitable for you; you should ensure that you fully understand the potential risks and rewards and independently determine that it is suitable for you given your objectives, experience, financial resources and any other relevant circumstances. You should consult with such advisor(s) as you consider necessary to assist you in making these determinations. Nothing in this document constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to your individual circumstances, or otherwise constitutes a personal recommendation to you.

Crossbridge Capital does not advise on the tax consequences of investments and you are advised to contact a tax advisor should you have any questions in this regard. The levels and basis of taxation are dependent on individual circumstances and are subject to change.

This document may relate to investments or services of an entity/ person outside the UK, or to other matters which are not regulated by the FSA, or in respect of which the protections of the FSA for retail clients and/or the UK Financial Services Compensation Scheme may not be available. Further details as to where this may be the case are available on request in respect of this document. This document has been prepared from sources Crossbridge Capital believes to be reliable but we do not guarantee its accuracy or completeness and do not accept liability for any loss arising from its use. Crossbridge Capital reserves the right to remedy any errors that may be present in this document.

Crossbridge Capital its affiliates and/or their employees may have a position or holding, or other material interest or effect transactions in any securities mentioned or options thereon, or other investments related thereto and from time to time may add to or dispose of such investments. Crossbridge Capital may be providing, or have provided within the previous 12 months, significant advice or investment services in relation to the investment concerned or a related investment to any company or issuer mentioned. Some investments referred to in this document will be offered by a single entity or an associate of Crossbridge Capital or Crossbridge Capital may be the only market maker in such investments.

This document is intended only for the person to whom it is issued by Crossbridge Capital. It may not be reproduced either in whole, or in part, without our written permission. The distribution of this document and the offer and sale of the investment in certain jurisdictions may be forbidden or restricted by law or regulation.

Crossbridge Capital LLP and Crossbridge Capital Merchant Banking LLP are authorised and regulated by the Financial Services Authority for the conduct of investment business in the United Kingdom. The registered addresses of Crossbridge Capital (UK) Limited, Crossbridge Capital LLP and Crossbridge Capital Merchant Banking LLP are 9 South Street London W1K 2XA respectively. If you have any questions regarding the document, please contact your RM.

### 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](http://crossbridgecapital.com)

 [@CrossbridgeViews](https://twitter.com/CrossbridgeViews)