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CAPITAL

Market Viewpoints

Manish Singh
June 2013

There is nothing noble in being superior to your fellow man; true nobility is being superior to your former self. --

-- *Ernest Hemingway*

The two big macro themes that have concerned the markets recently haven't changed – the Fed's *Tapering* and *Abenomics*. US Treasuries saw a 50bps rise in yields during May yet the SPX had a positive month. The Fed Chairman Ben Bernanke must certainly be pleased so far by the market reaction to the talk of tapering. What we saw in the markets in May was "volatility" and not "weakness". Selling in May, didn't pay. In my May newsletter, I suggested - don't be a grizzly bear (sell the equities and go short the market) but be a teddy bear (stay invested and buy some out-of-the-money Puts). I still have the same advice for the month of June. The deterioration in German retail sales and the rise in the number of unemployed in Germany have focused the minds that the malaise in Europe could be heading to the core and there is expectation of further European Central Bank (ECB) actions. Rising home prices, declining initial jobless claims and better job creation numbers are boosting US consumer confidence. This bodes well for the US equity markets. Despite the recent correction, the medium to long-term case of Yen weakness and Nikkei strength remains. I would advise against investing in commodities at this time, unless the macro picture for China and the global economy gets clearer. Gold bears will continue to win and so will Copper bears.

Delayed Spring; delayed correction?

It's not just Spring that is delayed this year, it seems that the "Sell in May" memo got delayed too. When it finally did arrive in the US during the last trading hour of May, the Dow Jones Industrial Average promptly slid 200 points (although it is still up +1.9% for May and +15.7% YTD) and the S&P (SPX) dropped -1.4% (still up +2.36% for May; +14.8% YTD). The Japanese version of the same memo did reach Tokyo in time and the Nikkei (NKY) had a volatile month, giving up all the +13% gain it made in May and finishing the month flat (the NKY is still up +32.5% for the year however).

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The two big macro themes that have concerned the market haven't changed – ***Tapering*** and ***Abenomics***.

- *Tapering* refers to the gradual winding down of the US Federal Reserve's $85 billion per month Quantitative Easing (QE) program
- *Abenomics* refers to the suite of measures introduced by Japanese Prime Minister Shinzo Abe to revive the sluggish economy with "three arrows" : A massive fiscal stimulus, more aggressive monetary easing from the Bank of Japan (BoJ) and structural reforms to boost Japan's competitiveness

The talk of Fed tapering and US dollar strength led to some sharp sell-offs in Emerging Market (EM) bonds and EM currencies last week. It doesn't help that economic growth in EM countries has been disappointing with India leading the list. The current Indian administration is still beset with a lack of leadership and direction resulting in decision paralysis that has stalled much-needed reforms: pension, insurance, tax simplification and the approval of various infrastructure projects. India's GDP growth rate hit a decade low of +5% from the lofty heights of +9% during the good years. Besides India, other disappointments included, China (+7.7% vs +7.9%), Russia (+1.6% vs +2.1%) and Brazil (+1.9% vs +1.4%).

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The deterioration in German retail sales (-0.4% drop in April following -0.1% drop in March) and the rise in the number of unemployed in Germany have focused the minds that the malaise in Europe could be heading to the core. There are great expectations for potential European Central Bank (ECB) actions– negative deposit rates, restarting of securitsation and loans to businesses, or more non-standard measures, however, it seems unlikely we will get any of these this Thursday when the ECB meets. Lacking any supportive announcement from the ECB, if the European manufacturing indices were to deteriorate further, a summer swoon may follow. US Treasuries saw a 50bps rise in yields during May yet the SPX had a positive month. The Fed Chairman Ben Bernanke must certainly be pleased so far by the market reaction despite the talk of tapering.

In this talk of tapering and rate rises, it is worth taking note of what happened in February 1994. Back then, the Fed surprised the market with a rate hike and over the ensuing twelve months, yields rose dramatically.

- The Federal Funds Rate (FFR) rose from 3% in February 1994 to 6% in February 1995
- Equity markets fell immediately following the rate hike; the SPX fell over -9% in next two months. The Eurostoxx 50 Index (SX5E) fell over -13% during the same period
- Markets continued to fluctuate, with a new trend setting-in only in December 1994 as the rate hike cycle neared its conclusion. In the following 26 months the SPX rose over +80% and the SX5E rose over +60% during the same period

Could we now see a repeat of 1994? I don't believe so.

- The rate hikes in 1994 were a surprise; this is not the case today. It is just the *when* and by *how much* that remain unanswered
- In 1994, the rise in the FFR was large and swift: 3% in 12 months. This time around, when the rate hikes begin, the move will not be so rapid, albeit from a much lower base
- In 1994, equity market valuations were stretched: The P/E on the SPX was greater that 16x the forward earnings (pricing in the anticipation of strong growth). Today, the SPX trades at a forward P/E of 14.8x (pricing in moderate growth)

September 18, 2013

Forty years ago, on September 18, 1973, future US President Jimmy Carter filed a report with the National Investigations Committee on Aerial Phenomena (NICAP), claiming he had spotted an Unidentified Flying Object (UFO).

This September 18, at the conclusion of the Fed meeting, will Bernanke file a report with the markets that he has spotted sure signs of recovery (elusive and hard to come by as they have proven to be) and call for tapering?

It is fair to assume that an important announcement such as this would be accompanied by a Bernanke press conference. The schedules of next post-meeting press conferences are June 19, September 18 and December 18. June clearly is too early and December perhaps too late. Therefore, the September 18 FOMC meeting and press conference become an important date for the calendar.

Where to invest

The Bull Run on the SPX took the index 100 points over the prior cycle high (1562 in October 2007) and at its current level is still 70 points higher. The S&P is up over +140% since the March 2009 lows. While it took courage to go long equities in the bear market of 2009, it will take patience to make positive returns from here.

The US macro data continue to look better and this keeps me positive on equities:

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- US Q1 GDP was revised modestly lower to +2.4% QoQ from +2.5%. However, final sales were revised higher to +1.8% from +1.5%, and personal consumption was revised +0.2% higher to +3.4%
- The University of Michigan consumer sentiment for May came in at 84.5. This was higher than the 83.7 in the preliminary report and an even greater improvement from April, when the index stood at 76.4. This indicates that the consumers are feeling more positive and expect their situation to improve over the next six months
- The Chicago Purchasing Managers Index surged to 58.7 in May. This is the strongest level for fifteen months
- The labor differential – a measure of "jobs plentiful" minus "jobs hard to get" – narrowed to -25.3 from -27.2. This suggests that May could be another good month for job growth. Non-farm payroll numbers are due out this Friday
- One-year-ahead inflation expectations were unchanged at +3.1%. Five-year-ahead inflation expectations are at +2.9%. Overall, inflation expectations remain well anchored

Rising home prices, declining initial jobless claims and better job creation numbers are boosting US consumer confidence and giving families a sense of stability. This bodes well for the equity markets.

My favored allocation is still overweight equities (55-60% of a portfolio) – with the US and Japan as the key overweights and I recommend investors start building positions in European equities in anticipation of a better second half to the year, following more actions from the ECB.

One of my favorite themes for this month will be investing in equity indices, particularly European equity index using a *lookback* feature – where the entry level is determined based on the lowest point the index reaches in the *lookback* period, typically the first 6 months of the life of the product.

The defensive (Telecoms, Utilities, Healthcare) could do well through the summer volatility but they are an expensive play and you will be rewarded by the cyclical sectors through year-end. Financials (P/E 13.1x), Technology (P/E 13.9x) and Energy (P/E 12.9x) in particular are the only sectors with less than a 15 P/E. Improving fortunes of the economy will bring more investors to the Technology and Financial sectors as dividends increase.

My equity overweight sectors are Financials (XLF) and Technology (XLK) and I also like Healthcare (XLV), Industrials (XLI) and Energy (XLE).

Some of the stocks I like:

Technology: AAPL, ORCL, SYMC, GOOG, SAP, IBM, LNKD
Financials: C, JPM, CS, UBS, BARC, OZM
Industrials: GD, UTX, HON, DHR
Energy: MPC, HAL, SLB, BHI

Currencies and Commodities

EUR/USD: The deterioration in German retail sales indicates the problems in Europe could be heading to the core. The consumer sentiment in Europe is suffering due to high unemployment and sluggish growth. Bank of Italy Governor Ignazio Visco's recent comments on the potential for another rate cut are also keeping the Euro lower. Earlier this month, Visco, also a member of the ECB Governing Council, said that the ECB was "technically prepared" to introduce negative deposit rates. The bar is high for negative deposit rates but a further decline in the manufacturing indices due out this week, will seal the deal for more stimulus. Expect the Euro to remain weak until the Eurozone is out of recession and sustainable growth sets in.

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GBP/USD: The Bank of England (BoE) will likely leave monetary policy unchanged when it meets this week. UK mortgage approvals are rising, albeit at a very slow pace. Consumer credit rose £0.5 billion in April, down from £0.6 billion in March. The consumer confidence number bounced higher (-22 v -27) and this prompted the British Chambers of Commerce to forecast higher growth for the UK over the next three years. They however did warn that “this does not change the fact that economic growth is still too weak and the pace of recovery will remain unduly slow for a while yet.” Given the renewed strength in the USD and the likelihood of looser monetary policy under incoming BoE Governor Mark Carney, I expect GBP to remain weak.

USD/JPY: The currency pair has seen rapid USD strength to 103.5 , settling back to 100.5 levels. Japanese domestic investors are selling foreign assets instead of selling JPY and buying the foreign assets. This is keeping JPY supported. The Bank of Japan (BoJ) would rather tolerate temporary JPY strength than deal with a full-blown crisis should JPY weaken too rapidly and risk spooking the Japanese bond market further. This means that USD/JPY may be range bound in the short term. I however still believe that the three arrows of Abenomics will land on target and over the medium to long-term case of JPY weakness remains.

Gold and Copper: China is unlikely to have a hard landing but a “managed” landing is in progress. Gold bears will continue to win and so will Copper bears. With no noticeable rise in real inflation in the US and disinflation in Europe, the case for Gold is weak. With China tightening lending and aiming to monitor debt in the economy, I would advise against investing in commodities at this time, unless the macro picture for China and the global economy gets clearer.

Best wishes,

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