



Market Viewpoints

Manish Singh

May 2013

Art is the only way to run away without leaving home

-- Twyla Tharp

We saw broad-based weakness in the momentum of US economic indicators during the month of April. The housing data was the lone bright spot. The US Federal Reserve left its asset purchase and interest rate policies unchanged. Yet, officials did alter their statement to say that they are prepared to increase or reduce the pace of asset purchases as conditions warrant. This has helped the equity markets rally even as the macro data has been showing signs of weakness. The European Central Banks (ECB) signaled its intent to tackle the problem of lacklustre lending to small business. If the European Investment Bank (EIB) steps in to provide credit guarantees, securitize these loans and transform them into high quality assets that the ECB would readily accept as collateral, it could be a game changer in Europe and positive for European equities. I still prefer US and Japanese equities though and would look to buy some protection on the S&P 500. My FX views are Short EUR/USD, Short GBP/USD and Long USD/JPY.

The Great Gatsby market

In the F. Scott Fitzgerald Classic *The Great Gatsby*, there is an intriguing exchange between Nick Carraway and Jay Gatsby that takes place near the end of Chapter Six:

"I wouldn't ask too much of her," Carraway says, *"You can't repeat the past."* To which Gatsby retorts, *"Can't repeat the past? Why of course you can!"*

The S&P 500 index has had better luck than Gatsby in repeating the past. Last month, the Index reached its previous October 2007 high and it has just kept on going, scaling the 1600 level last week.

We saw broad-based weakness in the momentum of US economic indicators during the month of April. The housing data was the lone bright spot that helped soften the blow from the slowdown in manufacturing. The manufacturing data in Europe and China were also weak as were retail sales in Europe. The Reserve Bank of Australia (RBA) cut rates this week. The signal it is sending is quite bearish vis-à-vis China and Industrial metals. The inflation indicators, the world over, are tracking low (but not in Rome apparently- where a British tourist was reportedly charged £54 for four gelatos). The US Federal Reserve left its asset purchase and interest rate policies unchanged last week. Yet, officials did alter their statement to say that they are prepared to increase or reduce the pace of asset purchases as conditions warrant. This has helped the equity markets rally even, as the macro indicators shows signs of weakness.

The European Central Banks (ECB) signalled its intent to tackle the problem of lackluster SME (small and medium enterprise) lending. In the US, the capital markets are the main intermediary in the loan/bond market. In Europe, 80% of this intermediation is conducted through the banking system and the troubled balance sheets of most European banks means that SME lending has been hit. One way the ECB has proposed to get lending moving again, is for the European Investment Bank (EIB) to provide credit guarantees, securitize the SME loans and transform them into high quality assets that the ECB would readily accept as collateral. If the EIB steps in, it could be a game changer in Europe. It would promote responsible securitization, get credit and loans moving and give the ECB better control over risk in European financial markets. This would be positive for the European economy as a whole and indeed European equities. Additionally, any EIB involvement in this process would hardly impact the profitability of European banks, given the moribund state of their securitization business.



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The 1Q Earnings Per Share (EPS) for the S&P 500 Index should finalize at \$26.5-\$26.75. The 1Q result makes a full year 2013 EPS of \$110 credible, which is a 5% year-on-year growth. A Price-to-Earnings (P/E) of 14.5 to 15 gives the S&P a year-end target price of 1595-1650.

As we enter May, the "sell in May and go away" adage is being bounced around. Since sitting on cash hardly pays and bonds are in overvalued territory, if you do choose to "sell in May" then "don't go away" but stick around to get back in soon.

The Fed, the ECB and all other central banks are still in a monetary easing mode. There are less and less reasons to be bearish and the valuations are not stretched either. However, if you still feel like being bearish, 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).

The fifth film adaptation of the 1920's classic *The Great Gatsby* hits cinema screens this summer. The novel, its characters' insouciance and the 1929 market crash are often talked about in the same breath. Let's hope no such market crash follows this film adaptation. Following the dot com crash in 2000, it took more than 13 years for the S&P 500 to move up 100 points (an increase of less than +7%) from 1500 to 1600. Equity bulls will most certainly hope it doesn't take another 13 years to bank the next 100 index points.

Turn around when possible

In 2010, economists Carmen Reinhart and Kenneth Rogoff (RR) of Harvard University released a paper – "*Growth in a time of debt*" The paper concluded that economic growth stagnates in a country once its government debt-to-GDP ratio exceeded 90%. Austerity backers on both sides of the Atlantic, having made up their mind that spending cuts are the only way to prosperity, latched on to the RR paper and quoted from it regularly. The paper became central to their policies and speeches. Last month, this edifice suffered an ignominious dismantling and rebuke when Thomas Herndon, a 28-year-old graduate student, found basic spreadsheet and data errors in the RR paper when he replicated it for his class assignment.

Herndon, Ash and Pollin of the University of Massachusetts at Amherst also found that spreadsheet coding errors, the selective exclusion of available data, and unconventional weighting of summary statistics led to serious errors in the paper that inaccurately represented the relationship between public debt and GDP growth among 20 advanced economies in the post-war period. **They found that when properly calculated, the average real GDP growth rate for countries carrying a public-debt-to-GDP ratio of over 90 percent was actually +2.2%, not -0.1% as initially published in the paper.** Contrary to RR, average GDP growth in countries with public debt/GDP ratios of over 90 percent is not dramatically different from when debt/GDP ratios are lower.

Apparently the RR paper was never "peer reviewed." Call it Math-in-a-time-of-Excel; but RR's erroneous conclusion and now its rebuttal have significant impact for policies and the future growth trajectory of the world economy. Structural reforms and responsible budget management are still needed but the rigor and "self-flagellation" initially espoused can now ease, as budget deficits and debts are balanced over the medium term, and not the short term as initially proposed.

The UK is the poster child of austerity policies and Chancellor Osborne - having taken the wrong road (which still didn't save the UK's AAA rating) - has a face-saving about-turn to do. Undoubtedly, the Sat-Nav voice that we are all too familiar with, "turn around when possible", will come in handy.

Where to invest

Falling inflation is particularly good for Emerging Markets (EM) and we have seen EM central banks cutting rates (India) or getting ready to cut rates (Russia, Poland, Hungary). The regime change at the Bank of Japan (BoJ) and the rate cut delivered by the ECB last week also keeps risk supported. Improvements in the Euro area financial conditions (particularly in the periphery sovereign bonds) mark a sharp contrast to developments last year at this time.



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Had the US Jobs report last Friday come in a little weaker than expected, we would have seen a dip in the market and had it come stronger we would have also likely seen a dip on fears that the Fed would put the brakes on monetary easing sooner than expected. So it served the bulls well that the jobs created came in at +165,000. Nothing to cheer about, but the risk of an equity correction has been pushed back perhaps until the next jobs report.

As mentioned before, the S&P 500 Index is at an all time high, and while I don't feel overly bullish, I do not advocate selling equities either. Like I have said, cash doesn't pay much at the moment. I still prefer to stay long equities and buy some protection. A July 2013 1500 strike PUT on the S&P 500 (approximate cost 0.63%) should give the cover you need to stay long equities.

A Deutsche Bank research note highlighted that the S&P was up +12% in the January - April 2013 period. Since 1960, there have been 14 years with 10%+ S&P price gains between January and April: 1961, 1963, 1967, 1971, 1975, 1976, 1983, 1986, 1987, 1989, 1991, 1995, 1998, and 2012. Of these, the average May - September and October - December price gains have been +2.6% and +2.9%. Thus, a strong Spring tends to bring a benign summer and good second half returns.

My preference is still US and Japanese equities, but keep an eye on the ECB and its plan to get SME loans going. This would be extremely bullish for European equities and is perhaps a play for Q3-Q4.

The defensive (Telecoms, Utilities, Healthcare, Staples) sectors are likely to do well through the summer with a strong finish to the year led by cyclical stocks (Financials, Energy, Industrials, Technology, Consumer Discretionary, and Basic Materials). 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, GOOG, SAP, IBM, CAN, LNKD
Financials: C, JPM, CS, UBS, BARC
Industrials: GD, UTX, HON, GE, DHR
Energy: MPC, HAL, SLB, BHI
Healthcare: JNJ, MRCK, PFE
Consumer Discretionary: CBS, DIS, BMW, TGT, YUM
Materials: LYB, MON

Foreign Exchange

EUR/USD: my views on EUR/USD are still bearish. In its last meeting, the ECB talked about the possibility of a negative deposit rate to force banks to lend and get the European economy going, which would be EUR positive. However, I believe, the problem with the negative deposit rates is that banks will then go to the second best safety option: sovereign bonds. This will not help the SMEs in the periphery. The credit risk of the SMEs has to be pooled somehow and transferred from the banks to the sovereigns. Therefore only the securitization plan, with the EIB in the lead, would make me EUR bullish.

GBP/USD: I remain bearish GBP over the medium term despite the positive surprise from the UK Q1 GDP data. The +0.3% growth has helped the UK avoid a triple-dip recession. However, many of the other indicators – specifically manufacturing - are less encouraging. Any rebound in GBP is a selling opportunity.

USD/JPY: 100 seems to be the stumbling block for USD/JPY and it has failed to scale this level for over three weeks now, since trading at 99.9 for the first time. While I still believe it is going over 100, will it see 95 before it sees 100? In order for USD/JPY to break 100, Japanese investors need to start making net purchase of foreign bonds. There is also a



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strong correlation between rising U.S. bond yields and the level of USD/JPY. Data show that between November and March 2013, the rally in USD/JPY was accompanied by a rise in Treasury yields. The Treasury yields reversed in March when doubts about the Fed's future policy emerged. Hopefully, the recent FOMC comments and Friday's solid non-farm payrolls numbers could make the rebound in US yields continue thus helping USD/JPY over the 100 mark. Any market correction on the other hand, would promptly see the JPY rise and take it closer to 95.

Gold

Gold is likely to trade as high as \$1,500 but the risk is still to the downside. Disinflation – and a reduction in the “tail risk” are the two key reasons for the gold price correction. The correction is not yet fully done and I would wait patiently before adding any long positions in Gold.

Best wishes,

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