



“ The budget should be balanced, the Treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance to foreign lands should be curtailed lest Rome become bankrupt. People must again learn to work, instead of living on public assistance. ”

– **Marcus Tullius Cicero (106 BC to 43 BC)**

October is traditionally a scary month for equities. One-fourth of all equity crashes (including the big ones in 1929 and 1987) have happened in October. Last month, Federal Reserve bank Chairman Ben Bernanke delivered QEternity (open ended Quantitative easing of \$40bn bond purchases per month) and now we are faced with a 'fiscal cliff'. If the history of this Congress is any guidance, bickering aside, at the eleventh hour, the 'fiscal cliff' will be averted. US Manufacturing data released this Monday by the ISM (Institute of Supply Management) bucked the trend by rising to 51.5 from 49.6 previously. This snaps a string of three consecutive sub-50 readings. The details behind the headline were also better than expected, as new orders and employment both rose. I maintain my positive view on equities over bonds. The weakness we have seen towards the end of September will be bought back and most certainly in the rally that will ensue when Spain asks for a bailout and the OMT is activated. Recently, when President Obama was asked about his biggest mistake, he said it was 'messaging', not, 'policy'. If policy prescription is right, big economic declines are followed by a big economic recovery. The recovery that followed during January 1983 - December 1985 resulted in a cumulative GDP growth of +18.95%; this time around, in the period from July 2009 - June 2012 cumulative GDP growth was a subdued +6.75%.

### Who's afraid of the fiscal cliff?

The simple answer is we should all be. We are sitting in a car which is being driven by US lawmakers who have hardly made any laws or passed a budget for the whole term of this 112th Congress. So far, the inaction of the Congress and the failure of the President to get things done have produced an unbearable ennui.

Last month, Federal Reserve bank Chairman Ben Bernanke delivered QEternity (open ended Quantitative easing of \$40bn bond purchases per month). At the press conference that followed, he reminded us of the significance of going over this cliff:

*"If the fiscal cliff isn't addressed, as I've said, I don't think our tools are strong enough to offset the effects of a major fiscal shock, so we'd have to think about what to do in that contingency."*

A quick reminder of what is this 'fiscal cliff' - based on current law, US fiscal policy is due to tighten by over \$600bn at the start of 2013 - the equivalent of around 4% of US GDP as Bush era income tax cuts expire and a number of automatic spending cuts kick in.

If the history of this Congress is any guidance - passage of TARP (Troubled Asset Relief Program), raising the debt ceiling, bank bailouts and auto bailouts, bickering aside at the eleventh hour, a 'fiscal cliff' will be averted.

Post the Presidential election in November, irrespective of the result, both parties face the inevitable prospect of living with each other for four more years and will be judged by voters on their response to dealing with this 'fiscal cliff'. Neither side would like to start a new term in Congress by sending the US over the cliff and held responsible for it. Meanwhile, the current Congress has quietly agreed to fund the government through March 31; so there will be no threats of a government shutdown on December 31.

Here in Europe, on any given day you can do a full round (or two) of buying and selling Spanish debt on speculation alone. Like we saw last week - SELL because Spanish banks will need larger than estimated amount of help; BUY because Spain will ask for a bailout anytime now; SELL because they will be subject to austerity; BUY because that will reduce their borrowing and debt; BUY again as the headlines flashed "Spanish banks beat cash injection expectations".

Last week, both Spain and France presented their budgets - more austerity and more hard times are predicted. President Francois Hollande of France has implemented his 75% tax rate. It's likely the boundaries of South Kensington will have to be extended across the river to Battersea to cope with the influx from France!

The Spanish bond yields are hurting again but PM Mariano Rajoy is refusing to submit and seek a bailout.

The chances of Spain making it through without needing a bailout are slim. Rajoy should seek the bailout, the ECB would then buy Spanish bonds and the European crisis would move beyond talk of sovereign yields to focus on growth and much needed reform.

As summer gives way to the autumn chill, the street protests are back in peripheral Europe. A people's revolt against European policymaker's plans is the single biggest 'risk factor' that could derail everything. Somebody said if Greece is the fuse then Spain is the bomb. Our best hope is for this bomb to be diffused soon.

### **Obama vs. Romney:**

The latest numbers from Real Clear Politics (RCP) average of twelve national polls indicate President Obama as 49% - 45.3% favorite to retain the White House. So let me summarize my thoughts on Obama's first term in office and then share my thoughts on Mitt Romney. You may choose to disagree with any or all I say below.

The day after taking office, Obama had an approval rating of 69% - the highest of any new president since John F. Kennedy (72%) and within weeks Obama's approval rating reached an enviable 82%. He could do no wrong. Until he did. With the economy showing signs of revival in mid-2009, Obama and his team embarked on self-congratulation prematurely. A June 2009 headline in the Financial Times pronounced the White House "Upbeat on Economy." The President and his team with the zeal of a reformist group and with the knowledge that they controlled both houses of Congress embarked on partisan bills - healthcare reform or Obamacare. By pushing for a partisan solution on healthcare, the fate of any bi-partisan activity to revive the economy was jeopardized. The recovery ran into trouble in early 2010 and voters punished the Democrats by handing the House majority to Republicans in the 2010 mid-term elections. A partisan situation became worse as a Republican controlled House embarked on teaching the Democrats and the President a lesson in partisanship. The economic rescue programs started by the Obama administration in early 2009 made a big difference but a more aggressive program stretching beyond 2009 almost certainly would have made a bigger difference, but it never came. Recently, when President Obama was asked about his biggest mistake, he said it was 'messaging', not, 'policy'.

If President Obama's 'policy' was indeed working, \$14trillion of spending and 43 months later the unemployment rate wouldn't still be above 8% and the real GDP growth wouldn't be slowing +2.4% in 2010 to +1.8% in 2011. If the policy prescription is right, big economic

declines are followed by a big economic recovery. In the early 1980's, the US economy was battered by recession and stagflation, the recovery that followed during January 1983 - December 1985 resulted in cumulative GDP growth of +18.95%. This time around, in the period from July 2009 - June 2012 cumulative GDP growth was a subdued +6.75%.

If Obama's policy was working and business confidence and sentiments rising, BONDS and GOLD would not be the investment of choice (as they still are); instead money would flow to risky ventures and small businesses to create jobs.

This brings me to the challenger in the red corner, Mitt Romney. Polls as late as August indicated Obama had lost ground among independents as economic conditions worsened. However, when the independents look at Romney they find him still speaking to his own party and not communicating to them. The three Presidential debates (October, 3, 16 and 22) are Romney's last chance to speak to the independents and make his case.

Romney needs to highlight his executive experience of being Governor of as Democratic a state as they come, Massachusetts. Faced with a Democrat majority in the legislature he listened to them, negotiated with them and achieved a great deal including a health-care bill that didn't cause a fraction of the resentment we have been witness to with Obamacare. He is not a conservative right-winger and nor should he pretend to be one, he is not a reformer, he is not a political animal, he is a plain businessman who knows how to make money and create jobs. The US needs a business focus again. The Presidential debates can be a factor but given the lack of enthusiasm for either candidate, the turnout will matter. If the Republicans manage a high turnout, Romney may yet send Obama packing.

### **Equities**

October is traditionally a scary month for equities. One-fourth of all equity crashes (including the big ones in 1929 and 1987) in the past have happened in October. Should we be worried this time around? I don't think so. The ECB's pro-activeness in helping to solve the Eurozone crisis has reshaped its perception in the market and helped get rid of its Bundesbank-like origins and behavior under its previous President. The market is waiting for the ECB to activate its OMT (Outright Monetary Transaction) program. It remains to be seen if such a program makes a big statement and drives yields lower or whether the ECB purchases bonds cautiously and fails to impress the markets.

In the US, the double dip we saw in the housing sector in 2011 is behind us. On a month-over-month basis, every single one of the 20 cities tracked by Case-Shiller housing index increased in July. Additionally, 16 of the 20 cities are up year-over-year. As a negative, US orders for durable goods - those big-ticket items like autos and machinery - have fallen. The latest data indicate orders for durable goods fell -13.2% in August and inflation-adjusted personal income fell -0.3%. However, most importantly the September US Manufacturing data released this Monday by the ISM (Institute of Supply Management) bucked the trend by rising to 51.5 from 49.6 previously. This snaps a string of three consecutive sub-50 readings; a reading below 50 indicates contraction of the economy and a reading above 50 indicates expansion. The details behind the headline were also better than expected as new orders and employment both rose. Inventories actually fell which is good for the factory sector because backlogs were up. If demand stabilizes, production, which was up slightly, should rise higher in the months ahead.

I maintain my positive view on equities over bonds. The weakness we have seen towards the end of September will be bought back and most certainly during the rally that will ensue when Spain asks for a bailout and the OMT is activated.

Equity market peaks are often accompanied by peaks in EPS (earnings per share) i.e. Peak EPS is sign of market turning. The S&P 500 EPS stands at \$102. Is this the peak? Is the quality of the EPS good for more growth? A JP Morgan report on EPS highlights some interesting facts:

- Current S&P 500 EPS of \$102 is being achieved even as spending on durable goods is only at 20.5% of GDP, well below the prior average of 25.3% (for PEAK EPS).
- Moreover, US housing starts of 736,000 are nearly 50% below the levels seen when S&P 500 companies have historically generated peak EPS.
- Since 1950, in every profit cycle, S&P 500 EPS has exceeded the prior peak by 50%-160% at about 10-year intervals. This implies that current S&P 500 EPS likely will not peak until \$147-160 (based on exceeding prior peak by 60%-80%).

In other words we are far from the peak in EPS and as the US economy recovers, equity markets will continue to do well, with earnings growing and multiples accorded to it rising too. This is not to say there will not be corrections, but the corrections will be good buying opportunities.

My equity sectors of choice: Industrials (XLI), Energy (XLE), Materials (XLB), Consumer Staples (XLP) and Technology (XLK) with preference to the US over Europe and selective large cap stocks in Europe and Emerging Markets.

Some of my favorite stocks from the above sectors are: United Technologies (UTX), Exxon Mobil (XOM), Schlumberger (SLB), Rio Tinto (RIO LN), Coca-Cola (KO), Procter & Gamble (PG), Microsoft (MSFT), Apple (AAPL), Intel (INTC), Anheuser-Busch [ABI BB], Danone [BN FP] and Vinci [DG FP].

Earlier this year I highlighted the seasonality of S&P 500's performance in an election year (courtesy Bespoke Investment Group). I am glad to update everyone that the S&P 500 Index (SPX) has not altered its behavior pattern this Presidential election year so far.

- On average in a Presidential election year, the SPX has made its first half peak on April 6. This year, the first half peak occurred on April 2.
- Following a pullback in the spring, the SPX typically bottoms out on May 28 in a Presidential election year. This year, the spring low came on June 1.
- In an average Presidential election year, the SPX typically rallies through the summer and makes a short-term high on September 7. This year, the SPX also rallied throughout the summer and made a short-term peak on September 14.

What does it say for Q4? The seasonality says that SPX should be weak through to October 10 and then straight up through the end of the year.

### Commodity and Currencies

For Gold investors, the autumn chill has been compensated by the Gold's thrill as prices rose more than 10% over the last month. Regular readers will know my long standing positive view on Gold and if there is any change it has only gotten stronger given the open-ended QE that the Fed has announced.

Bank of America's commodities team have run an analysis that suggests a single month's purchase of mortgage-backed securities to the tune of \$40bn will likely lift gold prices by around 0.7% within four months. As a result, if the Fed buys securities for next two years, a 24-month price target on gold would be \$2,400/oz. (35% above current levels).

Brent is likely to stay in the \$100-110 corridor given Saudi Arabia's comments of increased supply to keep oil prices anchored to \$100. Besides, since this is an election year in the US, a Brent price of \$120 will push gas prices over \$4/gallon and this is unlikely to be tolerated by the current administration.

My currency choices are GBP and USD versus the EUR; and EM (emerging market currencies) versus the USD. However, I do see EUR continuing to hold against USD in the short term as Spain seeks a bailout and the ECB's activation of OMT gives fillip to Europe's confidence. Euro could again test the 1.32 level.

One big policy game-changer that could be envisaged in the coming weeks is much more easing from China than what the market expects (post leadership change perhaps). The Fed is 'all-in' with its ever-easier monetary policy and the US government is hamstrung until after the election at the earliest, but the Chinese authorities could start worrying about economic slowdown in the short term.

A rise in risk appetite will mean USD weakness, as has been the case for quite some time, if you look at the last ten year chart of dollar Index (DXY: The United States Dollar Index or DXY measures the performance of the dollar against a basket of other currencies including EUR, JPY, GBP, CAD, CHF and SEK). DXY declined more than a third from early 2000 to 2008, only the economic crisis and rush for the safety of USD stopped the decline in DXY.

**Corporate Bonds:** A low growth, low rate environment favours corporate bonds. US investment grade corporate credit will provide the yield with little risk of sell off.

Best wishes,



Manish Singh, CFA

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