



“ Never appeal to a man's 'better nature.' He may not have one. Invoking his self-interest gives you more leverage.

- Robert Heinlein



## Summary

Angela Merkel has loomed large on Germany and Europe for the last 15 years, yet, if Edmund Stoiber had not lost the 2002 German election to Gerhard Schroder by the thinnest of margins, the world wouldn't know of Merkel the way it does now. Merkel's pro-migrant policy in 2015 divided the centre-right in Germany and fuelled the rise of the far-right, which entered the national Parliament for the first time after September's elections. While Germany is clearly going to feel the pain of an unstable political environment, following the collapse this week of coalition discussions, the bigger casualties are the Eurozone and the European Union (EU) who have come to rely on a steady and stable Germany for leadership and direction. Without Merkel it will be like the EU has lost its "good shepherd", as it deals with growing populism in Eastern Europe and with *Brexit*. There is little appetite in Germany for "more Europe." Merkel's stint as the "leader of the free world" has been very short-lived. A wise leader knows when it's time to go. Does Angela Merkel?

In the US, the Federal Reserve (Fed) released the minutes of its last meeting. These confirmed what the market already anticipates – an interest rate increase at its next meeting in December. All eyes, however, are on the US tax reform Bill which, if passed, could alter both the growth and the inflation outlooks and push the Fed to raise rates more aggressively than currently forecasted.

## Auf Wiedersehen, Frau Merkel?

It's Thanksgiving! A time of family gatherings and feasting on the traditional culinary delights of turkey, stuffing and pumpkin pie. When F. Scott Fitzgerald wasn't writing such classics as *The Great Gatsby*, he filled his notebooks with jokes, essays, and recipes. Here is Fitzgerald's list of [13 ways to deal with leftover turkey](#). Number 5 on the list is Turkey Mousse: "Seed a large prone turkey, being careful to remove the bones, flesh, fins, gravy, etc. Blow up with a bicycle pump. Mount in becoming style and hang in the front hall." I, of course, don't recommend you to do any such thing. Enjoy the tradition (and the turkey) and deepen family bonds. Happy Thanksgiving!!

From turkeys to the topic du jour - Germany. It will not be a particularly happy Thanksgiving for Chancellor Angela Merkel, who is struggling to form a government three months after elections were held. Merkel has loomed large on Germany and Europe for the last 15 years, yet, if Edmund Stoiber had not lost the 2002 German election to Gerhard Schroder by the thinnest of margins - 6000 votes out of over 46 million votes cast - the world wouldn't know of Merkel the way it does now. In 2002, Stoiber the Christian Social Union (CSU) leader politically outmaneuvered Christian Democratic Union (CDU) Chairwoman Angela Merkel and was elected the CDU/CSU's candidate for the office of Chancellor, challenging the incumbent, Social Democratic Party (SPD) leader Schröder. In the run-up to the national elections, the CSU/CDU held a huge lead in the opinion polls and Stoiber famously remarked that "...this election is like a football match where it's the second half, and my team is ahead by 2-0." Famous last words. Schroder mounted a huge comeback, and the CDU/CSU were narrowly defeated.

When Germany went to the polls on September 24, 2017, Merkel was expected to win the election easily and continue as Chancellor for a fourth term. Merkel was even anointed as the "leader of the free world" by the fawning political media looking for a figure to rally behind in the aftermath of Donald Trump's victory in the US. Damaged by Merkel's handling of the 2015 migrant crisis, the CDU won only 33% of the vote, down from over 41% in 2013 and the lowest share since 1949. Instead of recognizing the election result as a warning sign from disappointed citizens, Merkel merely remarked with the aloof statement: "I don't see what we should have done differently."

Merkel's pro-migrant policy divided the centre-right in Germany and fuelled the rise of the far-right, which entered the national Parliament for the first time. Merkel was still hopeful she could put together a coalition; A so-called "Jamaica" coalition – so nicknamed because the colours of the three parties' in such a collation, would mirror the colors of the Jamaican flag. The coalition didn't work out and this has put Merkel's political future in doubt.

Merkel has always prized consensus politics over one of principles. Her energy policy is an example. When she came into office she had been a strong defender of nuclear energy and extending the nuclear age in Germany was one of her principles. Yet within six months of extending the life spans of Germany's nuclear reactors by up to 14 years and calling it a "revolution," Merkel did an about-face and rang the demise of nuclear energy. In 2011 within a few weeks of the Japanese nuclear disaster at Fukushima, she panicked under mounting opposition from the Green party. Merkel's *Energiewende* (energy transition) since then, has led to a massive increase in power bills for consumers and industry and the movement abroad of German companies heavily reliant on energy. She forgot Lady Thatcher's dictum that consensus is the process which abandons all beliefs, principles, values, and policies in search of something no one believes in. This was also evident in the recent coalition formation talks, where she tried to broker a consensus between a motley crew of partners, all with ideological disagreements on tax rates, energy, and especially immigration. The talks collapsed in a dramatic manner last Sunday when one leader walked out of the meeting and remarked - "We were elected to bring about change. It's better not to govern than to govern wrongly."

According to a *Die Welt/Civey* poll, 41.7% of voters would prefer snap elections compared with 17.3% who would prefer a grand coalition of Merkel's CDU and the SPD. However, interestingly, the indications are that a fresh election is unlikely to show any significant change in vote share. While Germany is clearly going to feel the pain of an unstable government, the

bigger casualties are the Eurozone and the European Union (EU), who have come to rely on a steady and stable Germany for leadership and direction. Without Merkel it will be like the EU has lost its "good shepherd" as it deals with growing populism in Eastern Europe and *Brexit*. There is little appetite in Germany for "more Europe." Merkel's stint as the "leader of the free world" has been very short-lived.

A wise leader knows when it's time to go. Does Angela Merkel?

#### Where to invest?

The US Treasury curve flattening has been relentless in recent months, as the 10yr – 2yr spread dipped below +0.60% for the first time in over a decade. The 30yr – 2yr spread has tightened below +1.0% also for the first time in over a decade. So what is the bond market telling us?

Rate rise expectations in the short end are building up, but the long end remains benign. Besides, even as the US Federal Reserve (Fed) has begun to unwind its balance sheet, other central banks, including the European Central Bank (ECB), have continued to extend their bond-buying programs. The spread, between the 10-year Treasury yield and 10-year German bond, is around +2%. This pushes overseas investors to buy US government bonds for the substantial income they offer compared to European sovereign debt, helping cap Treasury yields. US tax reform could however send bond yields higher as the US Treasury sells new debt to finance the fiscal deficit.

In last December's newsletter, I wrote that we would see the yield on 10Y US Treasury vault over +2.5% and maybe even higher still. However, the US economy cannot take higher yields and we will see the yield drop back to the +2% level. As it transpired, the yield on 10y Treasury did go higher and over +2.65% in March 2017 and then dropped to a low of +2.05% by early September. You must be wondering what I think about 10y yields for 2018? I forecast the 10yr rate to finish the year in the range +2.85% and +3.0% (it's currently at +2.31%).

This week, the Federal Reserve (Fed) released the minutes of its last meeting. These confirmed what the market already anticipates – an interest rate increase at its next meeting in December. The Fed last raised rates in June to a range between +1% and +1.25%, the second increase of the year.

All eyes, however, are on the US tax reform Bill which, if passed, could alter both the growth and the inflation outlooks and push the Fed to raise rates more aggressively than currently forecasted. A US\$1.5 trillion tax cut (10-year cumulative impact on the US fiscal deficit) is not a small thing. The Joint committee of the United States Congress on taxation reckons the tax Bill would have a US\$114 billion (+0.6% of GDP) impact on the US fiscal deficit next year. Even without this fiscal boost, healthy job growth and a decreasing unemployment rate are a support for wages going forward. Over past 12 months, US job growth has averaged 163,000 per month, while labour force growth has averaged 62,000 per month. The US unemployment rate currently stands at +4.1%, the lowest reading since December 2000 and is already on track to drop below +3.5% in a year from now, even without any fiscal boost from tax reforms. Even the most dovish of Fed members cannot afford to think that the US economy can run a sub +3.5% unemployment rate without a marked rise in inflation. Therefore for next year, I would expect wage increases to be key factor and the Fed to raise interest rates at least three times and maybe even four.

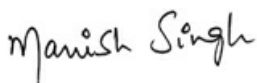
Meanwhile, in the Eurozone, starting next year, the regular bond purchase by the ECB under its Quantitative-easing (QE) program will be cut to EUR30bn from EUR60bn per month. However, if you factor in reinvestment flows of around EUR11bn – the average gross buying rate from January 2018 onwards will be in the region of EUR41bn i.e. two-thirds of the current rate. The ECB's QE was instrumental in helping Eurozone laggards, such as Italy, pull itself out of its worst downturn since the Second World War. Low rates helped kick-start the economy and Italian corporates renegotiated their debt. The interest rates Italian corporate were paying fell to +1.60% this summer from +3.60% in 2012, according to data compiled by the *Wall Street Journal*. The Italian Treasury even managed to sell €5 billion in 50-year bonds last year at just +2.85%. Italy's GDP is growing again and at +1.5%, the fastest growth in seven years. Yet "recovery" is not "resolution." Ironically, the ECB's QE has also had an anesthetic effect on Italy when it comes to structural reform. Italy is starting to have a fascinating debate, not about exiting the Euro, but about introducing a parallel currency alongside it. Its main proponent is former Prime Minister Silvio Berlusconi. He argues that this would be entirely consistent with the existing EU and Eurozone treaties. Companies and consumers, and of course the government, could then choose which currency they wanted to do business in. Recent polls in Sicily indicate Berlusconi's center-right party and the Lega Nord together account for 30% of the vote. With the 5-Star Movement also hostile to the Euro, it is not impossible that Italy could try out a new kind of currency perhaps as early as next year. That will be a very interesting experiment. I will dwell on it and take up this topic again in a newsletter next year.

I continue to be fully invested in the equity markets with an overweight position in US equities with sector bias to Technology (XLK), Financials (XLF) and Healthcare (XLH) but I have my eyes firmly on the inflation data. There is little of immediate concern on that front. Therefore it's advisable to keep your equity longs. I am looking to add to my Emerging Market allocation as well as my Japanese equity position at any sell-off. In the Eurozone, it's stock specific exposure, although I still maintain an underweight position from the MSCI World Index point of view.

I am pleased to share with you that the Crossbridge Capital global equities portfolio (60% US, 20% Europe, 10% Emerging Markets, 6% Japan, and 4% cash) is up +17% (net of all fees) as at the end of October (MSCI World is +16% during the same period). Should you need more information on this or our other investment portfolios, please feel free to get in touch.

In terms of stocks I like: JP Morgan (JPMUS), Bank of America (BAC US), Citi (C US), BNP Paribas (BNP FP), Barclays (BARC LN), VISA (V US), Blackrock (BLK), Allergan (AGN UN), Celgene (CELG UW), Gilead Sciences (GILD US), Apple (AAPL UN), Google (GOOG US), Microsoft (MSFT US), Amazon (AMZN UW), Alibaba (BABA US), Baidu (BIDU US), Salesforce (CRMUS), Comcast Corporation (CMCSA), Home Depot (HD UN), CBS Corp (CBS US), Pfizer (PFE US), Estee Lauder (EL US), Glencore (GLEN UN), Rio Tinto (RIO LN), Freeport McMoran (FCX US), Pioneer Natural Resources (PXD), Schlumberger (SLB US), Danaher Corp (DHR US), JD.com (JD US), WallGreenBoots (WBAUS), Delta Airlines (DAL US), Costco (COST US)

Best wishes,



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