



Market Viewpoints

Manish Singh

April 2014

"When one door of happiness closes, another opens, but often we look so long at the closed door that we do not see the one that has been opened for us."

- Helen Keller

Of all the world's central banks, the outlook of the US Federal Reserve is the most clear: Tapering of bond purchases will continue at the rate of USD10 billion per meeting, with rate hikes expected to start by the middle of next year. The European Central Bank's (ECB) approach is bi-polar - acknowledging the deflation risk in the Eurozone on the one hand but lacking the urgency of implementing a policy to avert it on the other. The Bank of Japan (BOJ) is still only halfway to achieving its +2% inflation target whilst the Bank of England (BoE) is debating the timing of the first rate hike (likely later this year). The S&P 500 (SPX) and particularly Tech and Biotech stocks have suffered recently. Back in 2011, stocks sold off because there was widespread concern of the US economy tipping back into recession. There is no such fear this time. Today, US GDP is growing at +2.5%, the US Jobs picture is getting better and the unemployment rate is trending lower. Therefore, it is important to keep it all in perspective and not get overly bearish. This week, India went to the polls in what may turn out to be a historic upset for the country's long-ruling Congress party. India's Prime Minister Manmohan Singh and the ruling Congress party have created a bubbling pot of discontent. India needs a leader that can reform government institutions and it may get such a reformer in Mr Narendra Modi on May 16. A good showing by Indian assets will be a big boost to emerging market sentiment as a whole.

To QE or not to QE

*To be, or not to be: that is the question:
Whether 'tis nobler in the mind to suffer
The slings and arrows of outrageous fortune,
Or to take arms against a sea of troubles,
And by opposing end them? To die: to sleep;
No more; and by a sleep to say we end
The heart-ache and the thousand natural shocks*

So begins one of the best known tragedies, Hamlet, by William Shakespeare. In 1602, The Tudor audience saw Hamlet musing on the choice between the inevitable "pain of life" (sea of troubles, slings and arrows, heartache, etc.) and the "uncertainty of what death may bring". In 2014, we see the European Central Bank (ECB) musing over the choice between QE (Quantitative Easing, contentious, challenging to implement and unpalatable to some) or not to QE (Eurozone deflationary trap akin to death for an economy).

Quantitative Easing (where central banks buy loans or other assets from commercial banks) would represent a radical departure for the ECB, which has so far refused to take such a step, not least because of resistance from Germany. Hamlet acknowledged that if one chose death over life and got the judgment call wrong, there was no way back. The ECB is faced with a similar choice as inflation in the Eurozone is still falling and continues to undershoot the target of +2%. This is despite an overnight lending rate of 0% in the Eurozone for the last two years. QE arguably can help beat the deflation trap of falling prices, weakened demand, which leads to wage cuts and even lower prices. This is the fate that Japan suffered in the early 1990s, and is still struggling to come out of two decades later. According to reports in the German daily *Frankfurter Allgemeine Zeitung* (FAZ), the ECB has modelled the proposed bond purchases to show the impact on inflation. Models show that buying EUR1 trillion of bonds could boost inflation in the Eurozone by +0.2% to +0.8%.

The ECB acknowledges that a deflation risk is present in the Eurozone, but argues that this year's late Easter holiday

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has delayed the impact of rising travel and hotel prices, at a time when many people go away in Europe. Therefore, the ECB will wait for more evidence before it decisively tilts in favour of QE. The ECB embarking on QE will be very positive for European equities as we saw in the US.

India's Thatcher moment

At the end of 1978, Great Britain was under the control of powerful trade unions. Food shortages, power cuts, uncollected household refuse, and even the dead were left unburied as gravediggers stayed away from work. Britain's winter of discontent set the stage for Margaret Thatcher to win the 1979 election with a landslide. She took a wrecking ball to the old social democratic political consensus that had prevailed in Britain since 1945. The Keynesian view of government intervention was rejected in favour of Monetarism (a priority to control inflation over unemployment by controlling the money supply) and the supply-side economics (government should intervene only to create a free market). Thatcher's policies worked and the sick UK economy was nursed back to health.

This week, India went to polls in what may turn out to be a historic upset for the country's long-ruling Congress party. India's Prime Minister, Manmohan Singh, and the Congress party have created a bubbling pot of discontent. The GDP growth rate has halved to +5%, even as inflation has stayed high. Numerous scandals over the last two terms of the parliament have severely eroded the current government's credibility. India last undertook reforms in 1991 in the face of a balance-of-payments crisis. Since then the nation has been governed by a consensus of policies that indulged in populism and redistribution, with disastrous consequences. Indian elections often deliver a fragmented verdict but this time seems different. India's Thatcher in this election is Mr. Narendra Modi, the leader of the Bharatiya Janata Party (BJP). Like Thatcher, Modi advocates a small government and a high level of governance. He has little time for red tape and bureaucracy. Modi is a nationalist and polarizes opinion, a legacy that Thatcher is also said to have held.

India needs a leader that can reform the government institutions and bring in the supply side reforms that Thatcher implemented. Opinion polls indicate Modi is set to become the next Prime Minister of India. International investors have pumped about US\$3.7 billion into India's equity market in March alone on the back of this optimism. The votes will be counted on May 16. A rally in Indian equities/assets has begun and the currency is appreciating. A good showing by Indian assets will be a big boost to emerging market sentiment as a whole.

Where to Invest

Of all the world's central banks, the outlook of the US Federal Reserve is the most clear: Tapering of bond purchases will continue at the rate of USD10 billion per meeting, with rate hikes expected to begin by the middle of next year. The Bank of England (BoE) is debating the timing of the first rate hike (likely later this year) and the ECB's approach is bi-polar - acknowledging the deflation risk in the Eurozone on the one hand, but lacking the urgency of implementing QE to avert it on the other. The Bank of Japan (BoJ) is still only halfway to achieving its +2% inflation target, and the probability is still high that it will consider additional easing going forward.

The S&P 500 Index (SPX) is back to being range-bound, with an unexplained recent sell-off in the Tech and Biotech sectors. I say "unexplained" because US GDP is growing at +2.5%, the US Jobs picture is getting better, and the unemployment rate is trending lower. Back in 2011, stocks sold off because there was widespread concern of the US economy would tip back into recession. There is no such fear this time. Therefore, it is important to keep it all in perspective and not get overly bearish. Given the rally we have seen over the last two years, a breather is reassuring as it keeps valuations from over-reaching. The SPX is barely positive YTD, and has moved in the narrow range of 1840-1885 most of the first quarter. As I wrote last month, April could be a difficult month for equities and a range-bound move in the SPX is likely to continue.

While the SPX has remained flat, Europe (SX5E) is up +2.4% for the year. Emerging Markets (EM) have turned around and the MSCI Emerging Market Index (EEM) Index has rallied +10% since mid-March. You will recall my change of view on EM in last month's newsletter and I continue to be more positive on EM equities. In the week ending April 2, EM bond and equity funds both experienced inflows for the first time this year, a further sign that optimism is growing towards developing world assets.

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The case for equities remains positive. I stay bullish on Europe, cautious on Japan, and moderately bullish on US equities. I also turn more positive on EM equities.

- My sector preferences in the US are Financials (XLF), Technology (XLK), Consumer Discretionary (XLY) and Energy (XLE) and Healthcare (XLV).
- Given the recent selloff in internet stocks, I thought I will highlight this amusing 1995 *Newsweek* article by Clifford Stoll where he deemed the Internet as "nothing more than a passing fancy, a noisy, cluttered nuisance of random data." He scoffed – "you can't tote laptop to the beach, buy books and newspapers straight over the Internet, no online database will replace your daily newspaper, no CD-ROM can take the place of a competent teacher and no computer network will change the way government works!" Okay, he may have got the last part right. The point is that internet stocks may appear overvalued, but their utility cannot be denied. Stocks like Google (GOOG) and Amazon (AMZN) present good buying opportunities.
- Some of the other stocks I hold/like to hold in our discretionary portfolio: Apple (AAPL), Salesforce (CRM), Citigroup (C), JP Morgan (JPM), Pfizer (PFE), Schlumberger (SLB), Freeport McMoran (FCX), General Electric (GE), P&G (PG), Rio Tinto (RIO LN), Glencore (GLEN LN), Nestle (NESN VX), UBS (UBSN VX), BNP (BNP FP), Philip Morris (PM), L'Oreal (OR FP), Pepsi (PEP), Roche (ROG VX), Volkswagen (VOW GY), Cognisant (CTSH), Petrobras (PBR), Gazprom (OGZPY US) and Standard Chartered (STAN LN).

On the topic of US inflation and the fear of it, a debate is raging in the US policy world and this *Wall Street Journal* op-ed titled "The Fed's missing guidance" by Martin Feldstein is an essential read. He warns - "Experience shows that inflation can rise very rapidly. The current consumer-price-index inflation rate of 1.1% is similar to the 1.2% average inflation rate in the first half of the 1960s. Inflation then rose quickly to 5.5% at the end of that decade and to 9% five years later. That surge was not due to oil prices, which remained under \$3 per barrel until 1973." History teaches us that a rapid expansion of the money supply eventually leads to rising inflation. The Fed's policy of QE has so far not led to expansion of the money supply. The trillions of dollars that commercial banks received from selling assets to the US Fed were not converted into money balances and lent out, but were deposited back at the Fed. The real sources of the inflation are these deposits. The risk is that the commercial banks can use them to start lending when corporate borrowers with good credit come a-knocking. As Mr Feldstein points out, the Fed's traditional anti-inflation strategy - raising the federal funds rate at which banks lend to each other - won't work, as commercial banks have so much in excess reserves that they do not need to borrow from each other. It is worth bearing this in mind for later this year or next. What does this mean for assets? It will be good for equities and commodities, and bad for bonds.

Currencies and commodities

Investors have continued to unwind their long USD positions following the US jobs report last week, which printed below expectations. US Federal Reserve Chair Janet Yellen will be pleased to see the USD weaken and will take it as a sign that the market understands that US monetary policy will remain extremely accommodative, despite the continuation of tapering of asset purchases.

USD has been under pressure against most of the G10 currencies:

- Stronger-than-expected industrial production in the U.K., drove GBP/USD higher.
- Whereas BoJ Governor Haruhiko Kuroda's comment that no additional easing is required at this time sent the Nikkei, USD/JPY and other Yen crosses sharply lower. Kuroda also noted that the downside risks to the economy had diminished and that the labour market is tight and wages should rise following negotiations. This optimistic view reflects that the BoJ plans to be reactive and not proactive to a slowdown in the economy.
- The EUR/USD is well-supported by ECB, which will not commit to QE without seeing more data.
- A rise in commodity prices, demand for higher yielding currencies, and the prospect of China announcing a mini stimulus has kept investors long AUD/USD.

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- I expect USD/JPY to trade in range of 101-103.50; GBP/USD 1.66-1.6850, EUR/USD 1.3650-1.3850 and AUD/USD to top at 0.95.
- USD is likely to trade weak versus EM currencies as flow into EM assets has returned, and macro conditions in EM improve following rounds of national elections in India, Turkey, Indonesia, and Brazil.

Gold is out of favour from an immediate inflation risk point of view, but events in Russia keep it from dropping below \$1,200. As I have mentioned in the past, historically low interest rates and quantitative easing should increase the demand for gold. Now that both are likely to taper off, gold's appeal to investors will diminish too. I am a seller of Gold at \$1,350 and an accumulator at the 1050/1100 levels.

Brent Oil prices made a new YTD low last week as they reached below the \$105 level. The prospects of the resumption of Libyan exports is adding to seasonal weakness, although the occupation of a government building in Eastern Ukraine by pro-Moscow protesters, has helped keep Brent bid for now. Brent is likely to trade in the \$105-\$110 range.

Best wishes,

Manish Singh, CFA