CROSSBRIDGE CAPITAL

Market Viewpoints

Manish Singh

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Our great democracies still tend to think that a stupid man is more likely to be honest than a clever man, and our politicians take advantage of this prejudice by pretending to be even more stupid than nature made them.

— Bertrand Russell

If the US Federal Reserve wants to meet its target inflation rate, it will have to ensure there is no “slack” remaining in the economy. The unemployment rate is still falling and that would indicate to me, there remains more slack in the US economy. Besides, if the Fed were merely waiting for it to be satisfied with job creation before raising rates, then it would have raised rates by now. However, normalisation of interest rates looms and the “new normal” will be quite different to the old normal. The crisis may be over and the US economy resuscitated, but it is permanently in a different place until such time as we see a fiscal response to address structural needs. An interest rate rise should not be feared. Rising interest rates can be the harbinger of a growing economy; an economy restored to its health. Economic expansion underpins corporate earnings growth, which is one of the most important drivers of long-term stock returns. The temporary selloff in equities when a rate rise cycle starts, has often proven to be a buying opportunity, as subsequent equity market performance has been generally positive.

Houston we have ignition, prepare for Lift-off

These days, interest rates around the world are exceptionally low. The US government can borrow for ten years at a rate of 2.2%, and for thirty years at 3%. The yield on ten-year government bonds is now around +0.5% in Germany, +0.3% in Japan, and +1.86% in the United Kingdom. In Switzerland, the ten-year yield is currently -0.34%, meaning that lenders must pay the Swiss government to hold their money. The benchmark interest rate, known as the federal funds rate (FFR), has been at a record low of +0.25% since December 2008. It’s hard to imagine that the FFR averaged +6% since 1971 and soared as high as 20% in 1980.

If you asked a person in the street: “Why are interest rates so low?” He or she would likely answer that the US Federal Reserve (Fed) has kept them low. That’s true. in a narrow sense. The real answer is because inflation is low. All else being equal, investors demand higher yields when inflation is high to compensate them for the declining purchasing power of money. Inflation in the US has been running consistently below the +2% target since 2008. The bottom line is that the state of the economy, not the Fed, ultimately determines the real interest rate.

So, is the economy sufficiently robust for the Fed to hike rates and begin the return to normality?

When I read the October Fed minutes, it didn’t fully convince me that the Fed would indeed raise rates when they meet next on December 16. The minutes had both a dovish...

"They discussed whether the slowdown in job gains was merely transitory or indicative of a more persistent slowdown in which labor market conditions might no longer improve. A few participants interpreted slower increases in payrolls as evidence that labor markets had tightened"

… and a more hawkish/cautious tone

"It was also noted that a decision to defer policy firming could be interpreted as signalling lack of confidence in the strength of the U.S. economy or erode the Committee’s credibility."

Yet the commentary during the last few days from various Fed speakers indicates that the post-crisis era is finally coming to an end. As regards growth, jobs and inflation it is important to note that since the recovery began in June 2009, the US economy has grown at an average annual rate of +2.2% and is +9% bigger than its pre-recession peak. The U.S. jobs market looks pretty healthy too. The unemployment rate stands at 5.1%, a level that historically has been very near full employment. However, inflation has continued to remain below the Fed’s target of +2%

If the Fed wants to meet its target inflation rate, it will have to ensure there is no “slack” remaining in the economy. The unemployment rate is still falling and that would indicate to me, there is more slack in the economy. Besides, if the Fed were merely waiting for it to be satisfied with job creation before raising rates, then it would have raised rates by now. Meeting the +2% “inflation target” and preventing the tightening of “financial conditions” are two things that are paramount to the Fed, and have kept it on hold for so long.

Whether the Fed raises rate next month or later, what is of little doubt is that normalisation looms and the “new normal” will be different to the old normal. The crisis may be over and the US economy resuscitated but it’s permanently in a different place until such time as we see a fiscal response to address structural needs. That fiscal response is unlikely to come until there is a new occupant in the White House.

If Japan has taught us anything, it’s that slashing rates to zero and beyond is a lot easier than returning them to normal. Like his predecessors since 1990, Haruhiko Kuroda, the current Governor of the Bank of Japan (BoJ) continues to “print money” and “buy assets”, yet achieving target inflation and lifting rates materially above zero has so far proven to be a losing battle.

If the US were to raise rates in December, this may be a shorter rate rise cycle; and perhaps we may see an ease in 2017 if the recent experiences of Australia, Canada, Sweden, Denmark, Norway and New Zealand suggest. An interesting statistic for you: The median number of months before the central banks that raised interest rates, had to start easing again: Sixteen.

How many US Dollars will the Euro buy?

The Fed has flagged December as the potential date for the first hike in interest rates. Meanwhile, European Central Bank (ECB) officials have dropped a series of hints that the ECB will cut interest rates or increase/extend its Quantitative Easing (QE) program, or both, when they meet next week. If both central banks push ahead, it would be the first time in more than 20 years that US rates went one way and European rates the other, in the same month.

In May 1994, five years before the Euro was launched, the Fed raised rates while Germany’s Bundesbank - the rate-setting body for Europe’s largest economy Germany - cut rates. How did the US Dollar fare? Back then, the US Dollar actually declined against the German Mark. Indeed, the Dollar has often fallen once the Fed has begun raising rates. it was the same in the last rate rise cycle in June 2004. In the first six months of the hiking cycle, the Euro rose against the Dollar by over 10%.

What’s positive for the Euro this time around?

- Germany’s (and to lesser extent France’s) formidable exports help the Euro bloc run a persistent current account surplus. This means Eurozone firms selling goods overseas receive Dollar/Foreign currency, which they sell to buy Euros to bring their profits home. This current account surplus stood at an eight-month high of €29.8 billion in September, according to the most recent data from the ECB.

On the negative front, what reverses the demand for the Euro is of course when the Eurozone economy is in trouble (as has been the case in the last few years) and the surplus benefits are undermined by investor funds flowing out of the Eurozone. Additionally,

- The Eurozone may be heading towards recession again – Q3 growth fell to +0.3% from +0.4% in the Q2
- Mario Draghi, ECB President, has almost pre-announced more QE and easing. A push deeper into negative territory for the ECB’s deposit rate, already at -0.2%, could also be on its way
- German exports are falling despite the Euro’s decline due to slowing growth in developing economies
- Disinflation is still a problem and ECB acknowledged that the dis-anchoring of inflation expectation and large slack in the economy is a dangerous cocktail. Draghi commented at a banking forum in Frankfurt recently that the ECB needed to raise inflation "as quickly as possible". A weak Euro is a natural outcome of such an urgency

I believe therefore that the EUR/USD will hit parity within the next three months, but it’s unlikely to stay there, as the effect of a weak Euro boosts the European economy’s growth.

There will be more ECB QE but the answer to Europe's problem doesn't lie in QE alone. Europe’s problems are the structural issues of rigid labour markets and rigid factors of production. If Europe does not start implementing some “pro-market” reforms, its relative economic and political power will start to diminish. Europe’s economic system is based on the protection of insiders who are trying to maintain their “rents.” In addition, government is always seen as a solution rather than a problem. In one sentence, Europe needs to create a system, which will create incentives for Europeans to be innovative, creatve private enterprises and rely less on the State.

Where to invest?

US interest rates are set to rise and that will cause some to think the equity rally is over. The underlying logic - higher rates will hit consumer spending, impair economic growth, and lower earnings of corporations that would have to pay higher rates on their bonds. The only problem with this logic is that it has little basis in reality.

According to a Bloomberg analysis of US stock market data going back to 1952, on average, stocks have risen +4.2% in the first six months after a rate increase and +5.8% in the following six months. This has been the behaviour of the overall stock market in the past 20 rate increases back to the Truman administration. Of course not all sectors do well. Corporations with good balance sheets (i.e. low debt service costs) do better; US consumer companies generating sales domestically will do well as wage rise leads to higher consumer spending. Speaking of which, if you look at the non-manufacturing component of the US data, it has been doing very well, with the 3-month moving average near 60 (a number over 50 indicates expansion).

Additionally, rising rates can be an immediate boost to banks, brokerages and insurance companies, primarily because this boosts their net income margin as spreads widen.

Rising interest rates can be harbinger of a growing economy, an economy restored to its health. Economic expansion has historically been an underpinning of corporate earnings growth, which historically has often been identified as a driver of long-term stock returns. The last three rising-rate cycles beginning in 1994, 1999 and 2004 saw the S&P 500 Index add +6%, on average, in the subsequent year. The temporary selloff when a rate rise cycle starts, has often proven to be a buying opportunity, as subsequent performance has been generally positive.

With this in mind, and the expansive state of monetary policy in Japan and Europe, I remain constructive on equities not just for the rest of the year, but for first quarter of next year as well.

The QE combined with weak energy prices and a weak Euro will continue to grease the wheels of Eurozone growth.

- I see only small gains at the index level in the S&P 500
- The trades are at stock and sector levels - Technology, Financials, Healthcare and some consumer names
- Maintain an overweight in European equities as weak EUR/USD, low energy prices and rising domestic demand help earnings further
- Maintain a Japan (DXJ) overweight. Japan has become a domestic demand story and with Prime Minister Shinzo Abe looking to reduce corporation tax further, and Japanese stocks should continue to do well
- Underweight Emerging Markets (due to their sensitivity to rate hikes) but overweight on India (INDY US) as the structural reforms gather momentum and urgency

Some of the stocks I hold/recommend holding – Disney (DIS US), Starbucks (SBUX US), Citi (C US), JP Morgan (JPM US), Bank of America (BAC US), Gilead Sciences (GILD US), Allergen (AGN), Apple (AAPL US), Google (GOOG US), Amazon (AMZN US), Microsoft (MSFT), Anheuser Busch (ABI BB), Pepsi (PEP US), UBS (UBSN VX), Richemont (CFR VX), Volkswagen (VOW GY), Airbus (AIR FP), Roche (ROG VX), Novartis (NOVN VX), Vinci (DG FP), Rio Tinto (RIO LN), Alcoa (AA US), FreeportMcMoran (FCX), Michael Kors (KORS US), Halliburton (HAL US), Walgreen Boots (WBA US), Home Depot (HD UN), Intesa Sanpaolo (ISP), CBS Corp (CBS US), Alibaba (BABA US), Baidu (BIDU US), Lloyds (LLOY LN), General Dynamics (GD US).

Best wishes,

Manish Singh

Manish Singh, CFA

United Kingdom
9 South Street
London W1K 2XA
United Kingdom

Singapore
One Temasek Avenue
23-05 Millenia Tower
Singapore 039192

Visit our website:
crossbridgecapital.com

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