



## Market Viewpoints

Manish Singh

April 2015

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***“Our elections are free – it’s in the results where eventually we pay.”***

**– Bill Stern**

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Greece could be nearing its own “Lehman moment.” Progress in negotiations with its creditors has been slow around such issues as pension and labour market reforms, the VAT increase, the privatization program as well as the 2015 primary budget surplus. For Greece, covering the primary budget target to make the current repayment schedule meaningful, will become increasingly difficult from mid-May onward. Greece is running on empty and the current level of Greek Credit Default Spreads indicates a 90% probability of Greece defaulting on its debt within a year. However, a political consensus to effectively eject Greece from the Euro is yet to form. On-going Quantitative Easing by the European Central Bank, the Bank of Japan as well as the reluctance of the US Federal Reserve to raise interest rates too soon, has meant that the cyclical momentum for developed market equities is still in place. The Eurozone has seen a good run of better than expected economic data these past weeks and there is a strong likelihood that the Q1 GDP report could register annualized growth of +2-3%. As for Emerging Markets, a repeat of “taper tantrum” is generally viewed as unlikely, given that the path of a US rate rise (when it comes), will be slow and one of gradual increases. The UK election looks like being the tightest general election for decades. With all the party manifestos published and TV debates completed, opinion polls suggest none of the parties will win the upcoming election. The two biggest parties— the Conservative party and the Labour party— are neck-and-neck in opinion polls, yet both are far from securing an overall majority. Prime Minister David Cameron recently said he would not seek a third term. If forecasts are to be believed, he will be lucky to serve a second one. Based on the current projections, an arrangement between Labour and the Scottish Nationalist Party is the most likely combination – adding 280 labour seats to the 50 seats of the Scottish Nationalists, which produces a House of Commons majority. Will it be Prime Minister Ed Miliband and Deputy Prime Minister Alex Salmond? Scary thought.

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### **Greece: running on empty**

Expectations as to whether some partial agreement between Greece and its creditors could be reached ahead of this Friday’s Eurogroup meeting have soured over the last few days. Greece’s recovery is derailed again. After an increase in GDP of +0.6% in 2014, fuelled by tourism and an increase in private consumption, Greece is once again heading into contraction. Progress in negotiations has been slow around such issues as pension and labour market reforms, the VAT increase, the privatization program as well as the 2015 primary budget surplus. To make matters more complicated, the Greek authorities have stated that they will put payments of wages and pensions ahead of payments to creditors. Greece is running on empty and the current level of Greek Credit Default Spreads (CDS) indicates a 90% probability of Greece defaulting on its debt within a year. The International Monetary Fund (IMF) is reported to have rejected a request from Greece to reschedule its payments to the IMF. The fear is that a possible Greek decision not to repay its debts, could trigger an exit from the Eurozone and possibly financial contagion across the Eurozone. Greece could be nearing its own “Lehman moment.”

Last week in Washington, at the Brookings Institution, ahead of the IMF spring meetings, where Greece was the top of the agenda, little common ground was evident in the back-to-back speeches from German Finance Minister Wolfgang Schaeuble and Greek Finance Minister Yanis Varoufakis. Varoufakis continued to pick holes in the existing austerity package, saying that he was against privatizations that were fire sales. He said he was hoping not to meet his European partners halfway but “one fifth of the way.” Schaeuble, meanwhile, insisted that Greece live up to its terms of the previously agreed bailout deal. However, Schaeuble also reiterated that a Euro exit was “only a decision of Greece.”

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This week we learnt that the European Central Bank (ECB) is studying measures to reign in the access of Greece to the Emergency Liquidity Assistance (ELA). The ECB may raise the haircuts banks take on collateral they post when borrowing from the Bank of Greece. Less than two months into the job and, Varoufakis, the academic economist, who calls himself an "erratic Marxist," is causing consternation with his incendiary interviews and undiplomatic demeanour. He is alienating Greek sympathisers within the Eurogroup and is in dire need of a lesson on – how to make friends and influence people. The "Varoufakis problem" is making the Greek debt talks very challenging. I would not be surprised if Greek Prime Minister Alexis Tsipras relieves Varoufakis of his responsibilities as Finance Minister. Many in the Eurogroup would not be too upset to see that. If progress and a degree of goodwill are established, I believe the Eurogroup is prepared to make concessions ahead of a disbursement, even if they wouldn't admit it openly.

It looks increasingly likely that any agreement between Greece and its creditors will only come at the 11th hour. A €200 million payment is due from Greece to the IMF on May 1. The Eurogroup is scheduled to meet on May 11, while €800 million is due to the IMF the following day. For Greece, covering the primary budget target to make the current repayment schedule meaningful, will become increasingly difficult from mid-May onward.

I still believe that Greece and its creditors will come to an agreement which will prevent a default. But what happens if Greece defaults (most likely on its payments to the IMF in May)? Some suggest the ECB will cut the ELA facility, which is the life support that keeps the Greek banking sector alive. I don't think that the ECB will suspend all ELA lending to the Greek banking system in the first instance of default. Here in my [Bloomberg interview](#) commenting on Greece where I discuss the likely outcome for Greece going forward. Cutting ELA funding to Greece would be a significant over-reach of the ECB's mandate. Besides the legal framework within which the ECB operates, does not specify with any clarity how the ELA should operate and the conditions under which the ELA facility can be withdrawn from a member state's central bank. Therefore it will not be an ECB decision but a Eurogroup decision i.e. a political decision which the ECB would implement. A political consensus to effectively eject Greece from the Euro is yet to form.

### **UK Elections: High stakes, low clarity**

With all the party manifestos published and TV debates completed, opinion polls suggest none of the parties will win the upcoming election. The two biggest parties—the Conservative (Tory) party and the Labour party—are neck-and-neck in opinion polls, yet both are far from securing an overall majority. Prime Minister David Cameron recently said he would not seek a third term. If forecasts are to be believed, he will be lucky to serve a second one. The support for the Conservatives is at around 33%, well down on the 37% they enjoyed on Election Day 2010.

The UK's House of Commons has 650 seats and 326 is the magic number to reach for a majority. Cameron failed to win a majority last time, securing 302 seats and that was before the rise of UK Independence Party (UKIP), which is now polling at 13%. The Labour party is falling well short of the magic number as well, but they are losing seats to the Scottish Nationalist party (SNP), who are also their likely coalition partner to form the next government.

The question as to whether Cameron can win a second term as Prime Minister, depends on two factors.

Firstly, can the Tories remain the largest party, even if they don't pass the magic 326 seat mark and, secondly, will this election return enough Liberal Democrat members to parliament, to make up the numbers for a redux of a Tory-Lib Dem coalition?

There is good chance that the Tories will emerge as the largest party and this is important because convention suggests that the party with the largest number of seats, will make the first attempt to form a government, either through a formal coalition or a looser alliance of parties.

It's the second factor that may end Cameron's dream of a second term. Liberal Democrats are currently polling at around 8-9% of the national vote, a third of what they achieved in 2010. This would leave them with just 28 of their current 56 seats. There is even a chance that their leader, and Deputy Prime Minister, Nick Clegg may lose his seat in this election.

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This election looks like being the tightest general election for decades and at the moment Cameron's chances of a return to 10 Downing street hangs in balance. If the Tories fail to form a government, the party will return to opposition and seek to regroup under a new leader (perhaps London Mayor Boris Johnson) and decide how best to deal with UKIP, who's emergence would have been the single biggest contributor to a Tory loss.

Based on the current projections, an arrangement between Labour and the Scottish Nationalist Party (SNP) is the most likely combination – adding 280 labour seats to the 50 seats of the SNP, which produces a Commons majority. Will it be Prime Minister Ed Miliband and Deputy Prime Minister Alex Salmond? Scary thought.

### Where to invest

On-going Quantitative Easing (QE) by the ECB and by the Bank of Japan (BOJ) as well as the reluctance of the US Federal Reserve (Fed) to raise interest rates too soon, has meant that the cyclical momentum for developed market equities is still in place.

The ECB has pre announced its policy of bond buying until September 2016, so there is not much to follow in terms of ECB speak. The Euro area has seen a good run of better than expected economic data these past weeks and there is a strong likelihood that the Q1 GDP report could register annualized growth of +2-3%. The second round effect of this could lead to a renewed uptick in growth and earnings expectations for the Euro area. This growth is not just export-led; there has been a surge in consumer spending on durable goods. A windfall from lower energy cost and reduced mortgage rates are contributing to increased consumer spending. The faster production to meet this increased demand for durable goods, has boosted employment and consumer confidence. This could be the start of a recovery in the Euro area.

Japanese equities continue to perform with the Nikkei 225 Index hitting a high of 20,000 after a wait of 15 years. The BOJ is considering lowering its +1% inflation forecast for fiscal 2015 amid the slump in oil prices and a slow recovery in domestic consumption. The new figure will be included in a semi-annual report due out April 30. You will recall, BOJ Governor Haruhiko Kuroda has declared that he will not hesitate to unleash additional easing should price growth stall. The BOJ will be keeping a close eye on economic indicators until the April 30 policy meeting. If the BOJ reduces the inflation forecast, they will most certainly offer more easing, and this will keep the equity market rallying.

As for Emerging Markets (EM), a repeat of "taper tantrum" is generally viewed as unlikely given the path of a US rate rise (when it comes) will be slow and one of gradual increases. Oil prices seem to have stabilized and a collapse to below \$40/bbl looks unlikely for now, given the creeping doubts about the Iran-US nuclear deal. Asian growth looks very positive with India and Indonesia seen as the great hopes. China looks to be slowing down, but with plenty of stimulus measures at its disposal.

Earlier this week, the People's Bank of China (PBoC) announced a 1% cut to the reserve rate requirements, a move not wholly unexpected, but its size was twice as big as anticipated. It gives credence to China's Premier Li Keqiang's comments last month to actively step in, should the economic slowdown begin to hurt jobs. China is growing at a +7% rate and it is important for the sake of global growth that China does not suffer from a dramatic slowdown. Some economists sneer at +7% growth, but let's not forget that in USD terms, this rate of growth now adds to China's GDP at about the same rate as a +12% increase four years ago, when the Chinese GDP was \$5 trillion. It's \$9.2 trillion today.

My preferred longs continue to be Europe, Japan, EMs and the US (in that order). This is not to sound bearish on US equities, but I would position a portfolio as overweight European equities and underweight US equities. Within the US sectors my preference is for – Healthcare (XLV), Technology (XLK), Consumer Discretionary (XLY) and Financials (XLF)

Some of the stocks I favour –

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Citi (C US), JP Morgan (JPM US), Gilead Sciences (GILD US), Apple (AAPL US), Amazon (AMZN US), Cognisant Technology (CTSH US), Starbucks (SBUX US), Anheuser Busch (ABI BB), Pepsi (PEP US), P&G (PG US), UBS (UBSN VX), Richemont (CFR VX), Volkswagen (VOW GY), Airbus (AIR FP), United Technologies (UTX), Barclays (BARC), Societe Generale (GLE FP), Roche (ROG VX), Novartis (NOVN VX), Vinci (DG FP), Salesforce (CRM US), Rio Tinto (RIO LN), Glencore (GLEN LN), Alcoa (AA US), Michael Kors (KORS US), Petrobras (PBR US), SLM Coup (SLM US), Nordstrom (JWN US)

### Currencies

At the ECB's press conference last week, momentarily interrupted by a colorful confetti-carrying activist jumping on the table in front of ECB President Mario Draghi, Draghi expressed his satisfaction with the smooth implementation of QE and the effectiveness of the program thus far. The tone of the press conference was positive and upbeat with Draghi saying that the recovery is broadening and strengthening. He further added that the central bank could adjust QE if needed. This optimism has helped to stem the slide in **EUR/USD**. However, European rates continue to go more negative and therefore the upside to EUR/USD is capped for now, unless we see a robust Q1 GDP number in the Eurozone. EUR/USD should trade in the 1.05-1.10 range for the next month or so. Only when the US starts raising rates will EUR/USD slip to near parity or below. I expect the US Fed to begin to raise rates in September.

The **GBP/USD** currency pair has been trading for the past few weeks on political rather than economic concerns, as fears have risen that the Tories may fail to secure a second term. Overall, the UK economy continues to show steady progress, with the unemployment rate now at its lowest level since the pre-2008 credit crisis. If the Tories surge ahead in the poll, GBP/USD will stay above 1.50; if not, GBP/USD could drop to 1.45 or below as the currency pair anticipates increased government spending and slippage on fiscal targets.

Best wishes,

Manish Singh, CFA