



Market Viewpoints

Manish Singh

August 2014

“I would never die for my beliefs because I might be wrong”

- Bertrand Russell

The message that the “US Federal Reserve is behind the curve” is resonating with some investors, who fear 1970’s like inflation is making a comeback. I personally believe that inflationary outlook is benign and will likely stay as such. The high inflation witnessed in the 1970’s was underpinned by three key factors – GDP growth averaged 4-5%, the unemployment rate was as low as 3.5% and, most crucially, the labour force was highly unionized. In a unionized labour force, wage increases are easily met and indeed passed on by the producer to the consumer, in the form of higher prices at the till. Over the past fifty years, the power of unions has been greatly reduced in the US. Italy is in a triple-dip recession due to lack of reforms. Lack of reforms scare off new investors, as well as stop existing investors from spending. Italy’s “significantly low” level of private investment is a direct consequence of the absence of reforms and the lack of clear government policy and is not due to the cost of capital. The ECB has intensified preparatory work related to outright purchases of Asset-Backed Securities (ABS). The ABS purchase rhetoric from the ECB raises the likelihood of it actually happening. In my view, the risk light on equities is still green but with some flashes of amber. I remain bullish on equities until at least the September Fed meeting and will then reassess. The comments from this meeting will help me decide if the light goes from amber back to green or from amber to red.

Not quite the summer doldrums

The month of August is proving to be anything but tranquil. The multi-year equities Bull run hit a buffer as positive data from the US was trumped by geopolitical risk and the fear of a rise in US interest rates. In my opinion, the fear of a correction is overdone. I see this more as a technical than a fundamental sell-off, as S&P 500 Index (SPX) failed to stay above (the very Orwellian) level of 1984. Bizarrely, Financials outperformed the index in this sell-off. Almost all big corrections are foreshadowed by a correction in Financials. In the current context, Financials are delivering record earnings (and paying record fines, one may say).

The message that the “US Federal Reserve is behind the curve” is resonating with some investors who fear 1970's like inflation is making a comeback and bringing with it a rapid rate rise as the Fed plays catch up. I personally believe the inflationary outlook is benign and will likely stay as such. Therefore, the Fed will continue to be in an easy money mode even as its Quantitative Easing (QE) program comes to an end.

Why do I think so?

- The US Unemployment rate is at 6.2%; a full percentage point above the Fed’s favorite unemployment indicator, the Non-Accelerating Inflation Rate of Unemployment (NAIRU); the US economy is yet to grow over +3% at a consistent rate, and the crucial ingredient for inflation - wage growth - is still missing. The case for immediate inflationary pressure is therefore weak
- The high inflation witnessed in 1970's was underpinned by three key factors – GDP growth averaged 4-5%, the unemployment rate was as low 3.5% and most crucially, the labor force was highly unionized. In a unionized labor force, wage increases are easily met and indeed passed on by the producer to the consumer, in the form of higher prices at the till
- Over the past fifty years, the power of unions has been greatly reduced in the US. The approval to disapproval ratio for the unions, which stood at 72 to 19 in the 1970's, has since significantly narrowed to 52 to 41

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Meanwhile, in the Eurozone, data out last week indicated that Italy had slipped back into recession for the third time since 2008. A triple dip recession coupled with a youth unemployment rate of 43.7% is a cause for concern. European Central Bank (ECB) President Mario Draghi singled out his home country, Italy, for some chiding at the press conference last week. Draghi made a renewed call for structural reforms, noting that countries that have reformed their economies are showing a stronger economic performance than the ones who haven't. Draghi bluntly commented -*"I keep on saying the same thing, really - I mean, of reforms in the labor market, in the product markets, in the competition, in the judiciary, and so on and so forth. These would be the reforms which actually have and have shown to have a short-term benefit,"* and added, *"the general uncertainty that the lack of structural reforms produces is a very powerful factor that discourages investments."*

Lack of reforms scare off new investors as well as stop existing investors from spending. Italy's "significantly low" level of private investment is a direct consequence of the absence of reforms and the lack of clear government policy and are not due to the cost of capital. The ECB's measures to date have ensured that nominal interest rates are low and real rates are even negative in some regions of Europe.

As if there was not enough anxiety already, Portugal had to bailout Banco Espírito Santo, a bank undone by its exposure to its struggling corporate parent. Banco Espírito Santo sounds like a line from a prayer but no amount of praying helped its equity and junior debt holders who were bailed-in (their stake reduced to nearly zero, an early test of new European rules intended to make sure that investors, and not just the taxpayers, face the brunt of the financial losses when banks fail). The senior debt was bailed-out in a very swift recapitalization measure by a state injection of €4.9bn. Banco Espírito Santo provided something of a preview of what may happen in October when the ECB discloses the results of the Asset Quality Review (AQR), an exhaustive review of bank holdings in the Eurozone.

Cold war, cold comforts

As tensions between Ukraine-Russia have increased, Cold War references have re-entered the lexicon. The European Union (EU) agreed to impose sanctions on Russia, treading a thin line between moral rectitude and scoring an own-goal. An own-goal because Russia supplies about a third of the EU's gas needs and is its third largest trading partner. In a tit-for-tat response to these sanctions, President Vladimir Putin decided to deny his countrymen Parmesan and Camembert (among other things) by imposing a ban on food imports from the EU. Russia is Europe's second-largest market for food and drink with exports worth €12 billion in 2013. The ban could yet extend to the automobile, aviation and shipbuilding sectors. Is this the start of Cold War 2.0? Only time will tell.

The Cold War that the world witnessed in the twentieth century left little untouched. The Olympics, chessboards and space programs became the platforms for reprisals. The Cold war had a sense of inevitability to it. Then the two giants, the US and the USSR, with competing ideologies and sprawling interests around the globe, each felt the need to establish its own world order. Today, it doesn't have to be inevitable. Today, the world is much more linked by trade for one side to come out on top without paying a heavy price for it. The Cold War was not all bad news though; there were some cold comforts. The Internet - which we are so used to now and cannot imagine life without - got its start in the US, as a government weapon program for the Cold War. The Sputnik sent into the space by the USSR got the American scientist and engineers (until then busy designing bigger cars) to set their focus on serious science and technology. New federal agencies like the National Aeronautics and Space Administration (NASA) and the Department of Defence's Advanced Research Projects Agency (ARPA) were set up to develop space-age technologies such as rockets and computers. Growth ensued. Let's hope if Cold War 2.0 becomes inevitable, we also get accompanying innovation and growth.

Where to invest?

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This week we heard from the US Fed Vice-Chair, Stanley Fischer, who sees the labour market still as cyclical and not structural i.e. the economy and labour market could still benefit from easy money for longer. If the US keeps adding 200K jobs per month, and the participation rate rises (as disillusioned job hunters return thinking the economy is getting better), the unemployment rate will stay above 6% giving the Fed more time before embarking on a rate tightening cycle.

I remain bullish on equities until at least the September 16 Fed meeting and I will then reassess. In my view, the risk light is still green but with some flashes of amber. The comments from this meeting will help me decide if this goes from amber back to green or amber to red.

The ECB remains as ready as ever to use unconventional policy measures if medium term growth and the inflation forecast change and present a risk to the Eurozone. The ECB has intensified preparatory work related to outright purchases of Asset-Backed Securities (ABS). The ECB is set to hire a consultant to help it design a simple and transparent program for ABS purchases. The ABS purchase rhetoric from the ECB raises the likelihood of it actually happening.

There is medium term concern for European equities due to the fallout from the Russia-Ukraine situation. Eurozone inflation, which is already at +0.4% (well below the +2% target), could fall further, as Russia's import ban bites, making the job of the ECB even more challenging. The Euro will inevitably weaken as the ECB announces outright QE. Since every cloud has a silver lining, a weaker Euro will be widely welcomed by European politicians and corporates alike, who have long held that the currency's strength was a major headwind to the economic recovery in the Eurozone and was fuelling disinflationary forces. As things get worse, an overweight European equity position becomes a very attractive trade.

My preferred equity Longs are Japan & Emerging Markets, the US and Europe, in that order. I would increase Europe longs if the Euro remains weak.

Why am I bullish on Japan?

Japan's Government Pension Investment Fund (GPIF) is set to pare domestic bonds to 40% of the holdings from its current 60% target and boost local equity holdings to 20% from 12%. This announcement could come early in September. Japan's Q2 GDP report out this Wednesday indicated a contraction of -6.8% (expectation -7.1%), yes, an ugly number and the culprit is Japan's consumption tax, which was raised from 5% to 8% in April. That being said, the key measure of private consumption has shown increase of +1.5% and +0.7% in May and June respectively.

My sector preferences in the US are Financials (XLF), Technology (XLK), Industrials (XLI) and Healthcare (XLV).

Some of the other stocks I hold/like to hold in our discretionary portfolio: Amazon (AMZN), Google (GOOG), Citigroup (C), JP Morgan (JPM), Bank of America (BAC), Standard Chartered (STAN LN), Barclays (BARC LN), UBS (UBSN VX), Schlumberger (SLB), Boeing (BA), P&G (PG), Freeport McMoran (FCX), Glencore (GLEN LN), Rio Tinto (RIO LN), BHP Billiton (BHP US), Nestle (NESN VX), Philip Morris (PM), Pepsi (PEP), Roche (ROG VX), Pfizer (PFE), Volkswagen (VOW GY), Inditex (ITX), Cognisant (CTSH), Gilead Sciences (GILD), Vinci (DG FP), Sanpaolo Intesa (ISP IM), Anheuser Busch (ABI BB), Starbucks (SBUX), Conagra Foods (CAG), McDonalds (MCD US), Caterpillar (CAT US), General Dynamics (GD US), YUM (YUM US)

Currencies

Geopolitical risk makes the USD attractive versus the EUR and GBP. Renewed growth fears in the Eurozone beget a weaker EUR as the probability of the ECB carrying out outright QE rises. The sanctions and countersanctions between the EU and Russia also make a case for a weaker **EUR/USD**. However, a weaker **EUR** drives more flow into the

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Eurozone as investors open positions in anticipation of better European earnings. For the next four weeks, I see EUR/USD range-bound from 1.33 to 1.3450.

USD/JPY suffers from geopolitical risk too. However, impending asset re-allocation at Japan's GPIF will draw a floor under USD/JPY at 101.50 for now.

GBP/USD is in a technical downtrend that could change, if the tone of the Quarterly Inflation Report out this week is hawkish. If there were dissent or even one vote for a rate rise (as chatter has it), the bottom will be in for the currency. If there is no hint of hawkishness, GBP/USD could easily drop to 1.67.

Best wishes,

Manish Singh, CFA