



## Market Viewpoints

Manish Singh  
February 2015

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***“Those politicians, professors and union bosses who curse big business are fighting for a lower standard of living”***

– Ludwig Von Mises

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The Eurogroup ministers meetings concerning Greece have proven inconclusive and more talks are to be held this week. At these meetings, the biggest disagreement has been over whether Greece should request an extension to its existing bailout program, which runs out at the end of this month. Greece is opposed to the extension yet the creditors believe extending the program is the best way to keep Greece from defaulting until a more comprehensive deal has been worked out. Over the last few days, the risk of Greece exiting the Euro has increased and is now arguably higher than it has been since 2012. Despite the posturing, protracted negotiations and rising risk, I still believe that a deal will be struck. It is hard to believe that Greece would refuse some funding from creditors in exchange for some structural reforms that the government intends to deliver on anyway. If you think Greece is a macro risk then Ukraine is the epicentre of manifold macro risk, given the involvement of Russia and hawkish comments emanating from the US. Seasoned US diplomats and foreign policy experts are getting vocal about arming Ukraine. France and Germany are, clearly and very sensibly, opposed to such assistance. There is little doubt that arming Ukraine would be a bigger catastrophe than the “eastward expansion of NATO” has already proven to be. Therefore, it was heartening to read that after 16 hours of overnight negotiations last week, the leaders of Germany and France had brokered a renewed peace deal to end the conflict in Ukraine. The macro data in the US is looking better by the day, particularly on the jobs front. However, the forward-looking guidance on earnings looks weak. The US equity market, as a whole, is unlikely to register big gains immediately and looks to be suffering from fatigue after a six year Bull Run. Therefore, I believe that sector rotation and stock picking offer the better return potential until such time as the path and quantum of interest rate rises in the US are fully assimilated. Long term worries for Europe around productivity and growth remain but short-term improvements in news flow, a cyclical upside as well as relative undervaluation of European stocks, all point to Europe as a more rewarding overweight position than the US. If you start from a low base, even small improvements can mean big relative improvements, and this is what we are seeing and will see more of in Europe.

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### **Greece: The moment of truth**

The Eurogroup finance ministers meeting last week failed to result in a final agreement. The negotiations lasted for more than six hours, yet there was not much to show for all the effort. The ministers, led by Jeroen Dijsselbloem, the Dutch finance minister along with the heads of the International Monetary Fund (IMF) and the European Central Bank (ECB), pledged to keep talking in the coming days, with a hope that an accord can be reached by the end of the week. “We had an intense discussion...also making some progress, but not enough progress at this point to come to joint conclusions,” said Dijsselbloem. Greek Finance Minister, Yanis Varoufakis remarked - “Now we are proceeding to the next meeting ... hoping that there will be conclusions in a manner that is optimal for both Greece and our European colleagues.”

At the meeting the biggest disagreement was over whether Greece should request an extension to its existing bailout program, which runs out at the end of this month. Varoufakis noted that “Greece would never agree to stay in this program because for us this program has been catastrophic. You only have to walk around the streets of Athens to see it.” Press reports suggest that at the meeting, the Greek officials rejected the wording of the draft statement that contained a sentence suggesting Greece had “agreed to work closely and constructively with the institutions to explore the possibilities for extending and successfully concluding

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the present programme." Meanwhile Greece's creditors believe extending the program is the best way to keep Greece from defaulting until a more comprehensive deal has been worked out and Germany's Finance Minister Wolfgang Schäuble said - "We have this program, and this program either has to be concluded in an orderly manner or we won't have a program." Greece's moment of truth has arrived.

Once the current program expires on February 28, Greece will lose its claim to nearly €3.7 billion in remaining aid from the Eurozone, along with €11 billion still held back in the bank bailout fund. Loans from the IMF would also get blocked as they are conditional on Greece getting parallel support from Europe. Additionally, if the bailout program ends without a clear follow up plan, more citizens and businesses could withdraw deposit from Greek banks, risking a Greek bank run.

To avoid a default and an exit from the European Monetary Union (EMU), Greece urgently needs fresh financial aid. During last week, the risk of Greece exiting the Euro has increased and is now arguably higher than it has been since 2012. In an exit scenario, direct losses for EMU member states and the Euro system should be manageable, although contagion remains the key concern. Despite the posturing, protracted negotiations and rising risk, I still believe a deal will be struck. There was enough by way of comments from before and after the Eurogroup meeting to suggest so.

- Asked by a reporter before the meeting whether Greece's exit from the Euro area is on the table, Mr Varoufakis emphatically responded "of course not."
- Greek newspapers indicate that Greek Prime Minister Alexis Tsipras, in his meeting with the Organisation for Economic Co-operation and Development (OECD) chief Angel Gurría, highlighted that the government would work with the OECD to implement radical reforms, arguing that tackling corruption and tax evasion was an act of solidarity towards taxpayers, who paid for austerity policies.

What cannot be ruled out is that Greece may seek external help if it finally decides not to back down and refuses the extension of the current bailout program. Mr Tsipras has spoken by phone with the Chinese Prime Minister, Li Keqiang and Russia's foreign minister Sergey Lavrov said his government would consider financial aid if Athens made a request.

It is hard to believe that Greece would refuse some funding from creditors in exchange for some structural reforms that Mr Tsipras intends to deliver on anyway, particularly with respect to taxation, in exchange for a re-profiling of the Greek debt. The eleventh hour of deal making may last a week or even a month if things progress at the current pace, but I am hopeful and believe that Greece will remain in the Eurozone.

### **Ukraine-Russia: glimmer of hope**

Nearly a quarter of a century after the collapse of the Soviet Union, arguably things are far more strained between the West and East than at any point during the Cold War. Russian President Vladimir Putin is the most powerful Russian leader ever and he has concentrated more power in himself than any of his predecessors. The reason I say this is, that even during the Cuban missile crisis of 1962, Soviet leaders were constrained by the Politburo. Now, there is no Politburo to control Putin and according to Russia's chief propagandist, Dmitry Kiselev, even a decision about the use of nuclear arms "will be taken personally by Mr Putin, who has the undoubted support of the Russian people."

According to a report in *The Economist*, by next year, Russia's defence spending will have tripled in nominal terms since 2007, and it will be halfway through a ten-year, 20 trillion Rouble (\$300 billion) programme to

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modernise its weapons. Spending on defence and security is expected to climb by 30% this year and swallow more than a third of the federal budget. Putin is fond of saying that nobody should try to shove Russia around when it has one of the world's biggest nuclear arsenals. Kiselev puts it even more bluntly: "During the years of romanticism [i.e. detente], the Soviet Union undertook not to use nuclear weapons first. Modern Russian doctrine does not. The illusions are gone." Putin and the Russian elite's perception of the West as a threat to the very existence of the Russian state could be a very dangerous outcome for the world.

Therefore, if you think Greece is a macro risk then Ukraine is the epicentre of manifold macro risk, given the involvement of Russia and hawkish comments emanating from the US. Seasoned US diplomats and foreign policy experts are getting vocal about arming Ukraine, so it can better resist and maybe even defeat the Russian-backed rebels in its eastern provinces. France and Germany are clearly and very sensibly opposed to such assistance. Putin may be on back foot due to collapse of crude oil prices but he has lost none of his charm when it comes to signalling his hard man look. The Russian leader was in Cairo last week for meetings with his Egyptian counterpart, and presented the former general with a modest gift: a Kalashnikov assault rifle. This was his way of saying that the Western sanctions relating to Russia's actions in Ukraine, have not curtailed Moscow's influence in the world.

There is little doubt that arming Ukraine would be a bigger catastrophe than the "eastward expansion of NATO" has already proven to be. Therefore, it was heartening to read that after 16 hours of overnight negotiations last week, the leaders of Germany and France had brokered a renewed peace deal to end the conflict in Ukraine. There is a deal, but the illusion of peace persist and we know it too well. The last ceasefire deal agreed to in Minsk in September never took hold as fighting flared up on the ground. The new deal however raises the hope of containing (if not ending) a long-term conflict on the doorstep of Europe and scaling back tensions with Russia. German Chancellor Angela Merkel told reporters in Minsk - "What we've reached now gives us more hope than if we hadn't agreed on anything. We don't have any illusions that a lot of work is still required but there's a real chance for things to take a turn for the better." Resolution of Ukraine-Russia crisis will give big and welcome boost to market risk sentiments.

### Where to invest

It's been more than three months since the US Federal Reserve completed "tapering" its asset purchases at the end of October. So how has that changed things for the market? Since the end of tapering, volatility has increased in every asset class, be it equities, crude oil or foreign exchange.

- The S&P-500 (SPX) Index average daily move, a mere 42 points per day in October has nearly doubled to 77 points per day.
- The change in crude oil volatility is even more noteworthy. The average daily move in oil has risen from 0.8% in July to 1.0% in October and to 3.1% now.
- Crude oil volatility has resulted in lower crude prices, however, increased SPX volatility has resulted in a higher SPX. The SPX has fought back from decline despite four instances of greater than -4% declines since early December.

Of late however, the US stock market has broken through its 1990 to 2005 range which it has been stuck in since the beginning of the year. In the same period the Eurostoxx 50 (SX5E) has rallied over +7.5%, vindicating my overweight Eurozone stock recommendation. Japan is showing signs of a pulse again, with the Nikkei 225 Index up +2.5% so far this year and USDJPY regaining the 120 level. The strong USD has

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reversed the gains in the Emerging Markets and has had one other effect; it has wiped out nearly 3% or \$2.3 trillion – an economy the size of Brazil - off global GDP.

The macro data in the US is looking better by the day, particularly on the jobs front. The US economy added 257,000 jobs in January, and revisions to the data of prior months bring the total US non-farm jobs created in last three months to over one million. Wages rebounded too, with average hourly earnings up +0.5%, the largest monthly gain in wages since November 2008. On a headline basis, the unemployment rate rose, as the labour force participation increased with more job-seekers returning to the job market. According to the University of Michigan survey, consumers have not been this upbeat since January 2004, when the economy was booming.

The Q4 earnings seasons saw over 70% of the SPX constituents beat on Earnings-per-Share and over 50% on revenue. However, the forward-looking guidance was weak. The US equity market as a whole is unlikely to register big gains and looks to be suffering from fatigue after six years of a Bull Run where the P/E ratio has expanded handsomely. Therefore, I believe that sector rotation and stock picking offer the better return potential until such time as the path and quantum of interest rate rises in the US are fully assimilated.

Talking of sectors, we have seen a good rally in the energy sector recently and yet still, sentiment remains weak and there is more room for a rally. The only time sentiment in the energy sector was weaker than today, was at the height of the financial crisis in 2008. The Financial and Industrial sectors are also suffering from weak sentiment, though not as badly as the energy sector. A weak global economy and the resulting strength in the US Dollar are the causes of it. Besides as USD has strengthened, domestically exposed US stocks have gained favour, but this looks overdone. European stocks in my view, have more room to rally and a favourable outcome with Greece will be an added boost.

Long term worries for Europe remain, but short-term improvements in news flow, a cyclical upside, an increase in bank lending following the ECB's measures, as well as relative undervaluation of European stocks, all point to Europe as a more rewarding overweight position than the US.. As European data improves, US data looks to be weakening. This month, the index of economic surprises for Europe surpassed the US for the first time since last May. Given that the ECB's Quantitative Easing (QE) program had just been announced, the improvement was not just been function of central bank liquidity. If you start from a low base, even small improvements can mean big relative improvements and this what we are seeing and we will see more of it in Europe.

I therefore keep Europe as overweight. In Japan, the positive earnings revisions and valuations no longer look onerous compared to other equity markets. However, the long equity trade is inextricably linked to JPY weakness. There has been a pause in JPY weakness, but the JPY weakness episode is by no means over.

The stocks I like to hold in our discretionary portfolio are JP Morgan (JPM), Bank of America (BAC), BlackRock (BLK), Goldman Sachs (GS), UBS Group (UBSG VX), Gilead Sciences (GILD), Actavis (ACT), Medtronic (MDT), Roche (ROG VX), Pfizer (PFE), Home Depot (HD), Google (GOOG), Apple (AAPL), Amazon (AMZN), Cognisant Technologies (CTSH), Walt Disney (DIS), Starbucks (SBUX), Glencore (GLEN), Rio Tinto (RIO), Intesa Sanpaolo (ISP), Barclays (BARC), Inditex (ITX), Anheuser-Busch Inbev (ABI BB), Total (FP FP), Halliburton (HAL)



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### Currencies

EUR/USD shorts will be particularly vigilant about the negotiations over Greece. You will recall in last month's newsletter, I recommended a long position in EUR/USD around the 1.10 level. My long view is based on the belief that *Grexit* will be avoided and the US Fed having talked up the rate rise in December, will sound more dovish come March. The latest CFTC report shows Euro short positions at their highest level since June 2012, as traders are positioned for a *Grexit*. Therefore, a reverse when the deal comes, will be a sharp one. A bounce to 1.18/1.20 is still my base case scenario, before EUR/USD can weaken again.

The Bank of England (BoE) released its inflation report last week. The BoE remains optimistic on the UK growth outlook and while it kept the 2015 GDP growth forecast unchanged at +2.9%, it raised the 2016 growth forecast from +2.6% to +2.9%. In a note, the BoE remarked - "Under the central case as set out in today's Inflation Report the MPC judges it more likely than not that Bank Rate will increase over the forecast period". However one needn't be excited about an immediate rally in GBP/USD, the politics and impending elections in May will weigh and cap any rally in GBP/USD. The risk to GBP/USD remains to the downside.

Best wishes,

Manish Singh, CFA