



Market Viewpoints

Manish Singh

July 2015

“Wisdom outweighs any wealth”

- *Sophocles*

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A North-South ideological divide in Europe is now out in the open. In one camp, the pro-austerity Northern Europe, made up of Germany and its allies, (Finland, Netherlands and Austria); and in the other, the profligate Southern Europe made up of Greece, Italy, Portugal and Spain. A creditor North and a debtor South: an intra-EU colonialism of sorts. The much-vaunted “European solidarity” is but a myth and the mutual interests are not moderating but reinforcing each other in polarised directions. I have long believed that Greece would stay in the Eurozone and my belief has always been predicated on the view that Germany would do whatever was needed and would bear the “cost” to preserve the Euro. Events over the last few weeks have made me question my view. The German position on Greece and its hard-nosed negotiation tactics surprised many. This crisis has exposed a fault line too: France and Germany do not share the same vision of Europe. Notwithstanding the fact that Greece secured a third bailout, I have now come to the conclusion that, on balance, the likelihood of Grexit is now higher than Greece actually staying in the Euro. A third bailout is by no means a carte blanche and there are many strings attached that could trip up Greece. Besides, a third bailout deal won't prevent Greece from plunging into a deep recession this year and perhaps next.

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Grexit averted? No, merely delayed

In Shakespeare's Henry IV, Part I when Prince Hal finds the cowardly Falstaff pretending to be dead on the battlefield, the prince assumes Falstaff has been killed. After the prince leaves the stage, Falstaff rationalizes, “The better part of Valour, is Discretion; in the which better part, I have saved my life.”

Over last six months, Greece and its leaders have raged against their creditors and showed valour in resisting more austerity. This charade couldn't have gone on forever and on Monday July 13th, Greece faced a stark choice – acquiesce to the uncompromising Eurozone demands for more austerity or leave the Euro. Greek Prime Minister Alexis Tsipras, like Falstaff, exercised discretion and surrendered to the creditor's demands. Greek rage turned into resignation.

The Greek debt crisis is no different to the many sovereign debt crises of the past– an over leveraged nation unable to meet its debt obligations and facing falling growth prospects. Such a crisis has only one solution - default, restructure and depreciate. In Europe, Iceland did this recently. Greece would have been better off taking this route in 2010, but the technocrats in the Eurozone thought otherwise.

The Troika of – the International Monetary Fund (IMF), the European Central Bank (ECB) and the Eurogroup have provided Greece and its banking system loans of nearly €340 billion - twice the size of the Greek GDP. As argued in [this paper](#) a third of the money has flowed out of the country to bail out private creditors – mainly French and German banks; another third has gone to fill the hole created in the Greek banking system due to capital flight; and the remainder has gone to finance the current account deficit. Less than 10% - or €35 billion of the money - was ploughed into the Greek economy to aid growth. Meanwhile, Greece's GDP cratered and is now 25% below its 2009 level. In times of crisis when private confidence is low, government spending plays a crucial role. Unfortunately an indebted Greek government - in a Euro straitjacket - could do little to improve the plight of Greece and its people.

I have long believed that Greece would stay in the Eurozone and my belief has always been predicated on the belief that Germany would do whatever it takes and bear the “cost” to preserve the Euro. Events over last few weeks have made me question my view. A majority in Germany (not least its Finance Minister) believe that the Euro can survive a Grexit, and that Greece is an isolated case, perhaps beyond redemption. The

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German position on Greece and its hard-nosed negotiation tactics surprised many and outraged a few. This crisis has exposed a fault line too: France and Germany do not share the same vision of Europe. France believes in a Europe of solidarity; Germany believes in a Europe of rules and responsibility. *The Varoufakis tapes reveal – France is “terrified” of Berlin’s austerity.* As things stand Germany runs Europe due to its economic might.

It was summed up in this exchange a few years ago between German Chancellor Angela Merkel and then French President Nicholas Sarkozy.

Sarkozy had turned to Merkel and said "We are made to get on. We are the head and legs of the EU." To which Merkel is said to have replied - "No, Nicholas, you are the head and legs. I am the bank."

Notwithstanding the fact that Greece has secured a third bailout, I have now come to the conclusion that, on balance, the likelihood of Grexit is now higher than Greece actually staying in the Euro. A third bailout by no means is a carte blanche and there are many strings attached that could trip up Greece. Besides a third bailout deal won't prevent Greece from plunging into a deep recession this year. Greek economy is now projected to shrink 2-4% in 2015 and miss its already lowered primary surplus targets. Of course this means the country's borrowing needs increase going forward, worsening its debt/GDP. The bottom line the cost to keep Greece in Euro will keep rising and Germany doesn't trust Greece; negotiations will be fractious and debt write-off unpalatable to the electorate of creditor nations. According to a survey last week, commissioned by German ZDF television,

- 73% of German people didn't expect Greece to implement the harsh reform and austerity measures that the country agreed
- 71% of German people believed that Greece could not avert a default even with the third bailout
- For 50% of the German people, the strict reform and austerity measures imposed were appropriate. For another 20% Germans, the measures were not harsh enough
- The poll also found that Finance Minister Wolfgang Schäuble won more support for his tough position on the Greek crisis than Chancellor Merkel

Greece needs debt forgiveness and it is amply clear Germany does not want to grant this. Furthermore, a North-South ideological divide in Europe is now out in the open. The pro-austerity Northern Europe, made up of Germany and its allies. (Finland, Netherlands and Austria); and the profligate Southern Europe made up of Greece, Italy, Portugal and Spain. A creditor North and debtor South: an intra-EU colonialism of sorts. The much-vaunted "European solidarity" is but a myth and the mutual interests are not moderating but reinforcing each other in polarised directions.

One last point to note, the austere minded Northerners pushing for a Greek exit ought to remember - there is always someone at the bottom of the class. It's Greece today, but it could be Portugal next and one day Spain or Italy.

What is on Janet Yellen's mind?

The Federal Open Market Committee (FOMC) of the US Federal Reserve meets this Wednesday and there is little risk of an interest rate rise this time around. Perhaps the language will remain general and non committal, concluding that further progress has been made on the path to growth and employment, but some improvement is still desired before rates can be lifted. Such data dependence should allow markets to remain benign and dollar strength to ease, if only slightly.



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With every passing FOMC meeting, we are getting close to an interest rate rise. So what is on US Fed Chair Janet Yellen's mind? When will we see the first rate rise?

In her testimony last week, Yellen was asked about the risks from tightening policy too soon, to which she replied, "There are risks on both sides. Just as we don't want to tighten too soon, to threaten the recovery and jeopardise the return of inflation back to our 2% target, we also want to be careful not to tighten too late, because if we do that, arguably we could over-shoot both of our goals and be faced with a situation where we would then need to tighten monetary policy in a very sharp way, which could be destructive." It's the latter part of her remark that makes me strongly believe that Fed will raise rates at its September meeting.

While the 1937 rate rise was a case of Fed tightening too soon, 1966 rate rise was the case of Fed running it loose for too long. The inflation increase in 1966 was not contained until 1980 when it was running as high as +13.5% and Paul Volcker was in charge of the US Fed. Yellen will be mindful that savers have clearly suffered from the rates remaining at zero for a long time. Now, if inflation were to catch hold they will get the double whammy of losing out on real earnings as inflation eats into their return. This will hit the US consumption too.

Baby boomers have seen this movie before. In 1965, US President Lyndon Johnson was determined to maintain spending on social programs, even as the Vietnam war was straining the federal budget. In September 1965, he invited Fed Chairman William McChesney Martin to his Texas ranch and persuaded him not to raise interest rates. Martin did not hike rates until a year later. It was too late. The inflation genie was out of the bottle. The inflation rate jumped from +1.6% in September 1965 to +3.5% in September 1966, and finally peaked at +14.8% in March 1980. Inflation is hard to control once it beds into the economy and Yellen will be very mindful of what happened in 1966.

How did the equity do during this inflationary period (Sept 1965 to Sept 1980)?

The S&P 500 Index rose by +40%. Unfortunately during the same period, the Consumer Price Index increased by nearly +265% i.e. by large margin equities failed to preserve savers' purchasing power. Meanwhile gold lived up to its "inflation hedge" moniker and rose +1,700%.

Where to invest?

I hope I have not sounded too bearish in the first two sections. My analysis is all very forward-looking, and may not be of immediate concern, but is one to bear in mind nonetheless.

For now, Equities remain a good buy. Although, on a headline basis, equity indices may struggle to show much of an increase in the coming months and any breakout rally will meet the inevitable decline once US interest rates begin to increase in September. Within the indices however, there will be disparities between the sectors and individual stocks. Financials, Technology and Consumer Discretionary stocks will do well, whilst Miners and Energy stocks will lag.

Financial stocks are my top pick going forward. US equities are approaching the point where a rate lift-off is required for further gains and for the market to get comfortable with the rate cycle. The first rate rise may bring some nervousness but as long as the FOMC stays on a path of "one-and-done", stocks will welcome the commencement of tightening. The Fed staff "leak", **Leaked Fed Staff Forecast Reflects Gloomier Expectations for U.S. Economy** confirmed last week, points to one rate rise for the year.

Growth in China has everyone concerned, but it is interesting to note while Industrials, such as United Technologies (UTX) and Caterpillar (CAT) were cautious on China this earnings season, Starbucks (SBUX)

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and Apple (AAPL) were upbeat. What this tells us is that China's economy isn't so much slowing as it is evolving. There is a reduction in emphasis on construction and industrials and a boost in consumer spending. This should be seen as a positive, given worries about China's debt.

Commodities are plagued by oversupply. Oil in particular has to not only contend with shale oil and Iran but there is excess supply from Iraq too. The miners (XLB) and Energy (XLE) stocks look much oversold to me.

In terms of positions: Leading into the likely rate rise in the US in September, I recommend a Europe and Japan overweight and US and an Emerging Market underweight. The S&P 500 Index in the US will likely be over 2200 by the end of the year (7-8% upside from the current levels) after the climb restarts post September. Within the US sectors my preference is for – Healthcare (XLV), Technology (XLK), Consumer Discretionary (XLY) and Financials (XLF).

Some of the stocks I hold or recommend holding – Citi (C US), JP Morgan (JPM US), Bank of America (BAC US), Gilead Sciences (GILD US), Apple (AAPL US), Google (GOOG US), Amazon (AMZN US), Facebook (FB US), Anheuser Busch (ABIB), 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), Rio Tinto (RIO LN), Glencore (GLEN LN), Freeport-McMoran (FCX), Alcoa (AA US), Michael Kors (KORS US), Halliburton (HAL US), SLM Coup (SLM US), Nordstrom (JWN US), Caterpillar (CAT US), Intel (INTC US), Sandisk (SNDK US), Twitter (TWTR US), Walgreen Boots (WBA US), Union Pacific Corp (UNP US)

Best wishes,

Manish Singh, CFA