



Market Viewpoints

Manish Singh

March 2015

“Experience is not what happens to you; it's what you do with what happens to you.”

– Aldous Huxley

The dovish US Federal Reserve (Fed) has spread its wings, but it's not looking for flight. The year 2014 was when the Fed stopped providing stimulus as it wound up its Quantitative Easing (QE) program, and 2015 will be the year when the Fed raises interest rates. I continue to expect a September lift off in rates. Dropping the word “patient” from its policy statement is bearish only in action and not in intent. US GDP is looking weak in Q1, retail sales are floundering and core inflation was up only marginally in January. Low oil prices and a strong US Dollar are both deflationary and core inflation is anticipated to fall further in the coming months. China is facing a stiff challenge to its growth. Chinese exports collapsed in the wake of the global financial crisis seven years ago and since then economic momentum has continued to slip. It reminds me of what a Chinese policymaker told me recently – when China faces its biggest challenges to growth, you will see some of the biggest and most improbable reforms. Reform of the State Owned Enterprises (SOEs) will be a major theme of Chinese policy this year. The case for Eurozone equities remains strong and this is also evidenced by the Citigroup Economic Surprise Index for Eurozone (CESIEUR) which has bounced from a -50 reading in September 2014, to +40 today, and it outperforms the US index. Accelerated USD appreciation will hurt US earnings; and I would position a portfolio overweight European equities and underweight US equities.

The FOMC dove spreads its wings

On December 16, 2008, the US Federal Reserve cut the benchmark interest rate to zero, and the rate has remained there ever since. The last time the Fed raised rates was in 2006 and last month the US unemployment rate fell to 5.5%, down from a peak of over 10% in October 2009. Jobs are clearly being created, but there is little evidence of the growth in wages picking up.

The US Federal Open market committee (FOMC) concluded its March meeting this week, where it dropped the word “patient” from its policy statement. Up until then, the Fed was “patient” and had said interest rates would be low for a “considerable period,” but the latter phrase was phased out a couple of meetings ago. Now “patient” too has been dropped. The FOMC is still looking for further improvements however, and it is wary of moving too soon to normalise monetary policy. “The committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the committee views as normal in the longer run,” the Fed said in its statement. The federal fund rates would not rise before “further improvements in the labour market” and only when it was confident inflation was moving back to its 2% objective over the medium term.

Fed Chair Janet Yellen summarised it well - “Just because we have removed the word patient from the statement does not mean we are going to be impatient.” The dovish Fed has spread its wings, but it's not looking for flight. The year 2014 was when the Fed stopped providing stimulus as it wound up its QE program, and 2015 will be the year when the Fed raises rates. However, in my estimate we are still at least six months away from the first rate rise this cycle. I continue to expect a September lift off in rates. When interpreting the Fed comments, one should bear couple of points in mind about its Chair, Janet Yellen.

- She is as dovish as it gets. Her prescient comments from the past and related economic outcomes bear proof. Federal Reserve officials spent 2009 worrying about the worst US economic downturn, before responding with the unconventional monetary policy of QE. The QE announcement in March 2009 didn't go far enough for then-

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San Francisco Fed President Yellen. At the central bank's April 2009 meeting, she called for even more stimulus: "I prefer to take appropriate, bold action to stimulate the economy sooner rather than later." She didn't win the argument back then, but as we know now, the Fed went on to ramp up its bond-buying, eventually doing three rounds of QE in the coming years, as the recovery stumbled. Yellen is now Fed Chair, and carries more sway on the committee than in 2009

- Forecasting growth, inflation and the labour market is the single most important job of a central banker. In her years before becoming Chair, Yellen had distinguished herself for consistently more astute readings on the economy than her other Fed colleagues. The *Wall Street Journal* examined more than 700 predictions made between 2009 and 2012 in speeches and congressional testimony by 14 current Fed policymakers. Yellen comes on top, and next best is New York Fed President William Dudley. As far back as June 2009, Yellen remarked - "I think the predominant risk is that inflation will be too low, not too high, over the next several years...I expect core inflation will dip to about 1 percent over the next year and remain below 2 percent for several years" and in April 2011 she said - "recent increases in commodity prices are likely to have only transitory effects on headline inflation." She has been right on both counts

Dropping the word "patient" is bearish only in action and not in intent. US GDP is looking weak in Q1, retail sales are floundering and core inflation was up only marginally in January. Low oil price and a strong US Dollar are both deflationary and core inflation is anticipated to fall further in the coming months. Having said that, even if the first rate hike were to come in June, given the current economic outlook, I do not see more than a 50bps hike in the Fed funds Rate for all of this year. Unless we see sustained growth in the Eurozone or in Japan, the Fed will be under no pressure to raise rates rapidly.

One more thing to bear in mind. US President Barack Obama concludes some form of nuclear deal with Iran, which brings Iran's oil production back on stream, then one can say farewell to rate rises for the rest of the year as the oil price will collapse (and hence core inflation). The deal with Iran may come at the end of this month.

Chinese whispers of reforms

China registered a GDP growth rate of +7.4% last year and its target for this year is +7%. Lowering the target doesn't make it any more achievable. The Chinese economy this year is off to a weak start and there is little evidence that the interest-rate cuts and other measures taken in recent months to spur bank lending, are doing much to stem the slide in growth of China's \$10 trillion economy. Chinese exports collapsed in the wake of the global financial crisis seven years ago and, since then, economic momentum has continued to slip. It reminds me of what a senior Chinese policymaker told me recently – when China faces its biggest challenges to growth, you will see some of the biggest and most improbable of reforms. We may be seeing signs of change already. We learnt two things last week:

- Reform of the State Owned Enterprises (SOEs) will be a major theme of Chinese policy making this year. There is a plan to merge SOEs to achieve cost reduction and privatise some SOEs partially if not fully. Beijing's bid to encourage privatization is driven by a hope that private ownership will create more of an incentive for SOEs to follow best business practices. China has over 150,000 SOEs at the national and local level, ranging from well-known behemoths like China Petro, China Mobile, and China Shipping to smaller provincial-level firms. Many of these SOEs suffer from serious internal problems of mismanagement, inefficiency and inaccurate accounting methods leading to reduced profitability. According to *The Economist*, returns on investment for SOEs are at around 5% compared to over 9% for private firms. The complacency of China's government mandated monopolies/SOEs are now becoming a greater drag on China's growth and crowding out private sector investments and restricting competition
- Currently, the People's Bank of China (PBOC) maintains a cap on the rate banks can pay depositors. A Chinese depositor at present can earn no more than 3.3% on a yearly deposit —an interest rate level China's big banks rarely reach. With cheap funding, large, state-owned banks channel inexpensive loans to SOEs further fuelling inefficient allocation of capital. Meanwhile a vast shadow-banking sector has emerged to serve borrowers who are looking for better deposit rates. Freeing up interest rates would promote healthy competition among banks and help allocate credit more efficiently. A higher and market determined deposit rate would

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translate to higher consumer spending. China seems to be getting ready to act on this and it would be a good omen for global growth

Where to invest?

After a good February, global equity markets lost some ground in the two weeks before the FOMC, but the run up in Eurozone equities has very pleasing still and, particularly so, if you were hedged in EUR/USD. Wisdom Tree Europe hedged ETF (HEDJ US) is an instrument of choice for this investment.

USD/JPY weakness is coming to bear again on Japanese equities both in local currency and USD terms; the Topix Index is up over +10% this year, driven not just by JPY weakness but also actual EPS momentum. Wisdom Tree Japan Hedged ETF (DXJ) is an instrument of choice for this investment.

However, the MSCI Emerging Markets Index has been a different story altogether this year. The Index is down over -7% but India (INDY US) is the clear outperformer (+5%), on the back of a reforming Indian economy. This trend is set to continue. India is in a sweet spot – falling oil prices, a reformist government, easing currency, and a current account moving from deficit to surplus. Therefore, if the US rate rise fear were to impact Indian equities, it would only be a buying opportunity.

So far, the Eurozone's version of QE is having the intended impact and the EUR/USD exchange rate is its main channel of transmission. A weakening currency is good for exports but it increases the cost of imports (energy costs in the case of Europe). Fortunately, energy prices are weak and this is helping the Eurozone as well. The benefits of a weak Euro are now reflected in the ECB staff's upwardly revised projections for GDP. They now point to a real GDP expansion of +1.5%, +1.9% and +2.1% for the next three years. Year-to-date (YTD) fund flow data indicate that there has been an outflow of \$47 billion from US equities and a \$36 billion inflow into European equity funds. The Eurozone doesn't just need a weak currency, but it needs governance reform and European Central Bank President Mario Draghi, is right in saying - "we can rightly be optimistic about the outlook" while stressing that the "nascent recovery provides us with a window of opportunity – with the conditions to press ahead with the reforms that will make the euro area less fragile and vulnerable to shocks."

The case for Eurozone equities remains strong, and this is also evidenced by the Citigroup Economic Surprise index for Eurozone (CESIEUR) which has bounced from a -50 reading in September 2014 (when rumours of a European QE gathered pace) to +40 now, and it outperforms the US index. The US Economic surprise index has moved from +35 at the end of 2014 to -63 today. The Indices measure data surprises relative to market expectations. A positive reading means that data releases have been stronger than expected and a negative reading means that data releases have been worse than expected.

As indicated above, my view is that we are still six months away from a US rate increase; therefore, I am not overly concerned about a sell-off in equities anytime soon. The US equity market trades at forward Price-Earnings (P/E) ratio of 17. Could PE expand more, given the overhang of a Fed rate rise?

According to a research report by Bank of America, monetary policy alone doesn't drive equity returns and P/E multiples.

- Multiple contraction is more a case when a rate rise cycle is a lengthy one, similar to 2004-06, when the Fed Funds rate went from 1% to 5.25%. This saw the S&P 500 Index forward PE multiple contract 2.5 points
- In contrast, the shortest hiking cycle in 1987, which lasted less than a year, saw the multiple expand by 2.2 points
- What appears more important in driving contraction or expansion of the multiple during a Fed hiking cycle is investor sentiment. The tightening cycles that saw the greatest multiple contraction came when sentiment was the most bullish

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- In contrast, investor sentiment today remains extremely bearish, suggesting that there could be upside to valuations, if sentiment were to improve. Interestingly, the 1987 tightening cycle, which saw the greatest multiple expansion, started when sentiments were essentially where they are today

Accelerated USD appreciation will hurt US earnings; of course PE could still expand to make up for it. A third of S&P 500 sales and 40% of its profits are from abroad, but only 25% of profits are earned in foreign currencies.

On balance, my preferred longs are Europe, Japan, India and the US. This is not to sound bearish on US equities, but to 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 favor –

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).

Currencies: The EUR/USD forecasts out from various FX analysts now indicate a depreciation to 0.85 cents/Euro by 2017. If the Euro depreciates too quickly, it may well call into question the life of QE beyond its current end date, as inflation targets are met quicker than anticipated. Recall that the EUR 60 billion monthly purchase of debt “are intended to be carried out until the end of September 2016.” The Eurozone is still in middle of a demand shock as evidenced by low GDP growth and hence a weak Euro is a great help. Having said that, the correction in EUR/USD exchange rate has been precipitous. Purely on an interest rate differential, the FX rate has moved about three times as fast as the change in the interest rate differential, perhaps an indication of the depth of damage to Eurozone demand that needs mending. However, from here on, it is best to be cautious when shorting EUR/USD in the near term. The rip up in EUR/USD this week, post the FOMC meeting, is a good reminder. The Fed is in no rush to raise interest rates, but if the data start to improve they won't hesitate to do so, and this week's change in forward guidance provides them with maximum flexibility to make changes when necessary. The risk to EUR/USD is to the downside, but a rally back to 1.15 or beyond is not ruled out.

Best wishes,

Manish Singh, CFA