CROSSBRIDGE CAPITAL

Market Viewpoints

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> The more the State "plans" the more difficult planning becomes for the individual.
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> - Friedrich Hayek

Summary:

Despite its high debt to GDP ratio, Italy's main problem isn't that it borrows too much - the issue is its non-existent growth. Italy, the third largest economy in the Eurozone hasn't grown in any meaningful way for over two decades. Tinkering on the edges and paying lip service to reform mean that the outlook isn't very bright for Italy. The European Central Bank's (ECB) easy monetary policy over the last five years, may have pushed the recent GDP growth rate in Italy to +1.5%' but what will happen when the ECB winds down its Quantitative Easing program and interest rates begin to rise? A re-run of the rising sovereign bond yield and questions about the viability of Italy's economy are bound to resurface. In terms of equity markets, I don't believe we have entered a new market regime, despite the recent market move. We are probably entering a transition phase and despite the market rhetoric, it is premature to conclude that the US Federal Reserve is behind the curve. The steady rally up we have seen over recent years may be behind us and what we will see going forward are moves both up and down i.e. welcome back to the two-way market. I still expect the S&P 500 Index to notch an +8-9% return this year - at least 200 points higher from the current level. What I am more concerned about is the rapidly deteriorating political equation in Germany. For the first time, the Far-Right Alternative for Germany (AfD) party has now surpassed the centre-left Social Democrats (SPD) in a national poll. How long before the AfD becomes the largest party in Germany? Inconceivable one might say, but not impossible. As Angela Merkel has moved leftward to occupy the space formerly taken up by the centre-left, the AfD has little competition for anything right of centre.

Tiramisu

One of Italy's most popular desserts is *tiramisu*. A mouth-watering blend of the rich flavours of cocoa and espresso with mascarpone cheese, layered with light and delicate sweet sponge savioardi ladyfinger biscuits. The name *tiramisu* literally means "pick me up."

Italy goes to the polls on March 4 and the country could do with a healthy dose of "pick me up." Italy, the third largest economy in the Eurozone hasn't grown in any meaningful way for over two decades. It has a debt/GDP ratio of 135% (the fourth highest in the world behind Japan, Greece and Lebanon) and a youth unemployment rate of over 35%. According to the anti-corruption organization Transparency International (TI), of all the developed economies, Italy is the most corrupt and, in the EU, it is outdone only by Greece and Bulgaria.

However, opinion polls don't hold much hope for a "pick me up." No single party or indeed no pre-poll alliance is expected to secure a majority. The most likely outcome is a hung parliament that leads to the formation of a grand, cross-party coalition supported by the larger parties. Forza Italia, party of former Prime Minister Silvio Berlusconi, seems to be in a strong position to influence the formation of the next government. While I do not see any immediate risk of Italy leaving the Euro, one must still bear in mind this quote from Berlusconi in October 2015 -"I remember, after the Second World War, there was a second currency in circulation, parallel to the Lira, from 1943 to 1953. I don't say let's get out of the Euro, but there is no legal directive in the European acquis that would prevent from introducing a national currency. We already have a name for it, it's called Lira, and the exchange rate against the Euro would be given by the market. Why not give it a try?"

Despite its high debt to GDP, Italy's main problem isn't that it borrows too much - the issue its nonexistent growth. Italy has shouldered debt-to-GDP ratios well above 100% for almost two decades now and, in 1999, when Italy officially adopted the Euro, its debt-to-GDP ratio was 126%. Italy has hardly grown during this time. According to a study by think tank the Bruegel Institute, the average annual rate of growth per head in Italy between 1999 and 2016 has been zero. For comparison purposes, that of Spain has been 1.08%, France 0.84% and Germany 1.25%. A Non-existent growth makes the debt problem worse as the risk of servicing the debt rises and threatens economic stability (as was the case post 2008). A full-blown meltdown then was prevented when the European Central Bank (ECB) stepped in and launched a Eurozone-wide rescue that brought the sovereign bond yields down drastically.

The causes of poor growth in Italy are plentiful. Where to begin? Insufficient R&D, specialisation in low growth traditional sectors, lack of technology companies, poor corporate governance, high levels of corruption, a poor judiciary and inflexible labour laws, a welfare system based on the protection of jobs rather than workers, a lack of investment, a currency that it can't devalue to gain competitiveness or inflate debt away, the lack of political unity to carry out any reform, the gradual erosion of the manufacturing base and an unofficial economy that is as large as 15% of GDP - to name but a few. In unifying the country in the 19th Century, Giuseppe Garibaldi may have succeeded in bringing together the three distinct regions - the republics of the North, the central Papal States surrounding Rome, and the southern Kingdom of Sicily but Italy has remained a collection of distinct regions. The cultural divides have stayed impervious to the passage of time and change. GDP per capita in the South is nearly 40% lower than in the North and Central Italy.

Tinkering on the edges and paying lip service to reform so far mean that the outlook isn't very bright for Italy. The ECB's easy monetary policy over the last five years may have pushed the recent GDP growth rate in Italy to +1.5%, but what will happen when the ECB winds down its Quantitative Easing program and interest rates rise? A re-run of the rising sovereign bond yield and questions about the viability of Italy's economy and its ability to service its debt are bound to resurface.

Italy, in my mind, is a slow sinking Venetian lagoon which may offer you the pleasant distraction of a gondola ride, but be aware of the risk lurking under the water, as the foundation erodes and the ECB cannot forever keep plumbing the problem away. Italy constitutes the real challenge for the future of the Euro. Of course, getting the Lira alone will not solve Italy's problems. Between the abandonment of the fixed exchange rate of the Lira against the US Dollar in 1973 and adopting the Euro, Italy experienced high inflation and currency devaluation. Whilst at the beginning of the 1970s, one Deutsche Mark bought 160 Lira, towards the end of the 1990s, it bought about one thousand. The Euro, very perversely, may have shielded Italy from its own political fire.

Markets & The Economy

Earlier this month, we saw the S&P 500 Index (SPX) fall by over -10%. The fire didn't spread to other asset classes, and we have since seen the SPX climb steadily back up and recover more than half of that loss. For me, it's the moves in the bond market that concern me most. Remember former US Presidnet Bill Clinton's strategist James Carville's remark - "I used to think if there was reincarnation, I wanted to come back as the President or the Pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody."

The bond market is not giving us a red signal yet, despite the moderate increase in yields we have seen in 10y Treasury bonds. The yield on 10y US Treasury is still comfortably below 3.00% and the yield on the 30y US Treasury has only touched the 2017 highs of 3.20%. These yields make US Treasurys attractive to Japanese, Swiss and European (German) fixed income managers.

The narrative for the recent equity market move goes as follows: The +2.9% rise in average hourly earnings in the US jobs report for January - the fastest since 2009 - spurred fears of rising inflation. It lead to a jump in US yields in anticipation of higher inflation, triggered equity sales and a spike in volatility which, in turn, spurred the unwinding of trades that bet on volatility remaining low. The only problem with this description, is that the market-based measure of inflation does not indicate inflation fears. The 10Y break even, a very good indicator of forward inflation in the US, was at +1.98% at the end of 2017. It reached +2.12% before the jobs report, +2.14% subsequently and currently sits at +2.11%. So, in the immortal words of rock group Supertramp: Crisis? What crisis?

What happened in the recent sell-off is classic financial engineering gone wrong. For the better part of two years, investors bet that stocks would move up in a steady manner and the VIX (the measure of the stock market's expectation of volatility implied by SPX options) would continue to fall. Short VIX traders were playing a zero-sum game and they were convinced that they were winning as the VIX fell from 28 to 9 over the last two years. Then early this month, the trend reversed, and the VIX jumped from 10 to 50, intraday, wiping out all the profit (and the capital) of short VIX traders. One short VIX product, the VelocityShares Daily Inverse VIX Short-Term Exchange-Traded Note (XIV US) saw its market cap crash from over US$3.5 billion to less than $100 million i.e. a loss of over -97% in a matter of hours. Most short ETNs are for short-term speculation and should never be seen as a buy and hold long-term product. In fact, the prospectus of the XIV product clearly stated in bold and underline - " If you hold your ETNs as a long-term investment, it is likely you will lose all or a substantial portion of your investment. The long-term expected value of your ETN is zero." That's right folks, they told investors that the long term value of the investment was zero, yet investors piled $3.5 billion into that product. Next time, I would urge investors to read the fine print and be wary of financial engineering that they don't fully understand.

So where are we now in terms of the equity market? Let's say that the steady rally up we have seen over recent years may be behind us and what we will see going forward are moves both up and down i.e. welcome back to the two-way market. Everyone is watching one key measure - US inflation and where it's headed - for that will drive interest rates and bond yields and transmit calm (or panic) to other asset classes.

Is inflation a worry in the US? In the short-term: No. Various structural reasons remain - demographics, shale oil, Amazon, Artificial Intelligence and China, to name but a few - still exist and will likely have a bigger negative impact on inflation. A recent *Wall Street Journal* article highlighted that the Robots are coming for garment workers and Asian nations could lose more than 80% of their garment, textile and apparel manufacturing jobs as automation spreads.

Crude oil is also topping out and energy has always played a big role in fuelling inflation. As increasing demand keeps meeting supply, Oil has the potential to re-enact the swoon of 2014. Increasing supply from Nigeria and the jump in Libyan oil output are both bearish for oil prices. Production from countries outside OPEC keeps growing and threatens to undermine the effectiveness of OPEC's output controls. Earlier this month, US crude output climbed to 10.25 million barrels per day (mbpd), a record, and is expected to average nearly 10.6 mbpd this year and 11.2 mbpd in 2019. The US deficit in crude oil and refined products has shrunk to 4 mbpd in 2017 from 12 mbpd in 2007. The Energy Information Agency predicts that the US will become a small net exporter by 2029, and if all other energy is included, by 2022. In my view, Brent could test the lows of $45 if bearishness grows.

In a nutshell, I don't believe we have entered a new market regime despite the recent market move. We are probably entering a transition phase and despite the market rhetoric, it is premature to conclude the the US Federal Reserve is behind the curve. I still expect the SPX to notch an +8-9% return this year - at least 200 points higher from the current level.

What I am more concerned about is the rapidly deteriorating political equation in Germany in a national poll, the Far Right Alternative for Germany (AfD) party has now surpassed the centre-left Social Democrats (SPD) for the first time. A poll commissioned this week by the *Bild* newspaper showed the AfD at 16% support compared to the SPD at 15.5% — a new low for what has traditionally been one of Germany's largest parties. Polls tend to underestimate support for parties like the AfD branded as being on the more extreme edges of politics. So I would expect that in reality, the AfD is not 'narrowly ahead' but well clear of the SPD in German voters' minds.

The AfD is now the second largest party in Germany. The rise of the AfD is understandable. The two parties – the Christian Democratic Union (CDU) and the SPD, who got hammered in the last elections, are defiantly attempting to cobble together a coalition and continue the policies that made them unpopular. That's like sticking two fingers in the eye of those voters who disagree with them. You may like or dislike *Brexit,* but, in this country, the UK Independence Party (UKIP) is now effectively dead as long as the UK leaves Europe. Their job is done. When politicians listen to the people that pay their wages and give them a voice in a democratic vote, the country can ward of extreme political fears from going mainstream and eventually materialising. As Angela Merkel has moved leftward to occupy the space formerly taken up by the center-left, the AfD has little competition for anything right of centre.

I continue to remain underweight the Eurozone and overweight the US, because of the relative strength of the US economy. If you look at the chart of Eurostoxx 50 Index, you will find that the index is still down by more than -10% over last three years. During the same time period, the SPX is up by over +35%.

In terms of stocks I like: JP Morgan (JPMUS), Bank of America (BAC US), Citi (C US), , VISA (V US), Blackrock (BLK), Allergen (AGN UN), Celgene (CELG UW), Gilead Sciences (GILD US), Apple (AAPL UN), Google (GOOG US), Microsoft (MSFT US), Amazon(AMZN UW), Alibaba (BABA US), Baidu (BIDU US), JD.com (JD US), Salesforce (CRMUS), Home Depot (HD UN), Estee Lauder (EL US), Glencore (GLEN UN), Rio Tinto (RIO LN), Freeport McMoran (FCX US), Pioneer Natural Resources (PXD), Schlumberger (SLB US), Danaher Corp (DHR US), WallGreenBoots (WBAUS), CVS Health Corp (CVS US), Delta Airlines (DAL US), YUM Brands Inc. (YUM US), BNP Paribas (BNP FP), Barclays (BARC LN), Intesa Sanpaolo (ISP IM), Vinci (DG FP), Eiffage (FGR FP)

Best wishes,

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