CROSSBRIDGE CAPITAL

Market Viewpoints

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Governments never learn. Only people learn.

- Milton Friedman

With no policy change expected and no press conference scheduled at Wednesday's Federal Open Market Committee (FOMC) meeting in the US, attention will be focused on the post-meeting statement. I expect the tone of the statement to be modestly upbeat as compared to the previous statement. With the March FOMC meeting, and the recent speech by US Federal Reserve Chair Janet Yellen at the Economic Club of New York, the Fed has changed strategy. It is now more cautious and more aware of global conditions and, as a result, don't believe it will change this approach again so quickly. In my view, it is a close call between one or two interest rate hikes this year, with the first hike not coming until July at the earliest. The US economy has plenty of steam to continue expanding. On top of this, if the Democrats win the White House (and it's likely they will), we will undoubtedly see fiscal expansion and increased government spending funded by a higher deficit and higher taxes. The S&P500 Index (SPX) above 2100 will beget volatility, since it's within touching distance of its all-time high. I would advise not to be deterred by volatility and instead build new long positions in favourite stocks or Indices when the opportunity presents itself. If a *Brexit* referendum were to be held today, the Remain camp would win. Whatever the result on June 23, the *Brexiters* are not going anywhere, unless the Remain camp wins by more than 20 points or more, and that is highly unlikely. Low interest rates are making life challenging for Germany's savers and politicians. German Finance Minister Wolfgang Schäuble, earlier this month launched an extraordinary attack, blaming ECB President Mario Draghi for the surprising success of the Eurosceptics in German state elections. Comments like these are very dangerous for the future of the Eurozone.

The ECB's Schäuble problem

Back in the days of the Deutsche Mark, Europeans often joked that Germans "may not believe in God, but they believe in the Bundesbank" - Germany's central bank. Today, it would seem that God may fancy his chances of winning the God vs. Central Bank debate, after Germany's combative Finance Minister Wolfgang Schäuble launched an extraordinary attack, blaming European Central Bank (ECB) President Mario Draghi for the surprising success of the Eurosceptic Alternative for Germany (AFD) party in German state elections.

To quote him - "I said to Mario Draghi . . . be very proud: You can attribute 50% of the results of a party that seems to be new and successful in Germany to the design of this [monetary] policy." He added, "I am not happy about low interest rates. I would prefer higher interest rates."

The remarks vibrated in many quarters, and not only because they were an attempt to politically influence an "independent" central bank, but they were also coming from the country that, many believe, shares the responsibility for the Eurozone's economic imbalances.

Low interest rates are making life challenging for Germany's savers. German pension funds have high exposure to fixed income instruments (almost 65%) and are underexposed to equities and real estate, which have performed well in the prevailing environment of low rates and Quantitative Easing (QE). According to a survey by the Mercer group, the exposure of German pension funds to equities is only 11%, compared to almost 29% for France, 31% for Switzerland and 39% for UK pension funds.

According to *The Wall Street Journal*, Germany is one of the few Eurozone economies where losses from lower interest income outstripped the gains from lower interest payments - a cumulative loss of €367 per capita between 2010 and 2015. The Eurozone as a whole averaged a cumulative gain from low rates of €400 per capita, and Portugal, Greece and Spain all saw cumulative gains above €1,200 per capita. The resentment in Germany is understandable. There may be a limit to how much savings Germans are prepared to sacrifice for a Eurozone economic vision. Perhaps Schäuble sees the support for the Euro cracking in Germany and wants to remind Draghi not to forget a balanced interpretation of his "mandate."

Ultimately, it's not the ECB that is to blame, but the nineteen Eurozone governments who have failed to implement structural changes and fiscal policies that will create jobs and growth. Isn't it strange that new immigrants coming to Europe can't get a toe-hold in the job market, but they can find refuge in the welfare system? The social democratic model in Europe is facing an existential threat but the politicians don't seem to realise this. If they do, they don't seem to care enough to do anything about it. For the last six years, the ECB's loose monetary policy has created the necessary conditions to carry out reforms, but little has been done.

I suspect that the ECB is a far easier target for Schäuble than to criticize his peers in the Eurozone. Comments like these make me quite pessimistic about the prospects of the Eurozone in the medium term. However, Schäuble should also not forget that Germany's destiny is linked to the fate of the Eurozone. The Eurozone has benefited Germany and destabilising it doesn't help Germany's cause.

Brexit debate: how did we get here?

Britain's troubled relationship with Europe has divided public opinion, torn apart political parties in the UK, as well as bemused and angered its continental European neighbours. Yet, just think about it, the father of a "United" Europe was not a Frenchman or a Belgian or a German, but an Englishman – Sir Winston Churchill. Long before World War II, but with memories still fresh of World War I, Churchill argued for a *United States of Europe*.

Very few may know, that in the desperate days of June 1940, in a last ditch effort to stop France from falling to the Nazis, Churchill's plan was a full political union (quite unthinkable today) i.e. Britain and France would become a single country. An "indissoluble union" with one war cabinet running the "joint organs of defence, foreign, financial, and economic policies" on both sides of the Channel. The British Cabinet backed it, but with one exception: There would not be a single currency. Days later, France fell and with it, the idea of political union.

After the War, Churchill once again argued Europe needed to unite. However, Churchill's successors sat on the sidelines, sceptical that it would work. The idea of a "Federal" Europe an anathema. Meanwhile, France and Germany wasted no time in pursuing the goal Churchill had so passionately argued for. First, the European Coal and Steel Community was created in 1951 as a way to "make war [in Europe] not only unthinkable but materially impossible" and then the EEC (the European Economic Community) was born in 1958, to bring about economic integration between its member states.

The UK leadership had a change of heart in 1961 when it was beginning to make economic sense, and then Conservative Prime Minister Harold Macmillan applied to join the EEC, only to be vetoed by the French. French President Charles De Gaulle's hatred of all things American meant that he could never endure Macmillan's promotion of Anglo-American ties. De Gaulle who did so much for European integration, had a patriotic side too. He always advanced his country's interests and increased the prestige of France. De Gaulle thought British entry, because of Britain's connections with the USA, would endanger France's position in the EEC and that Britain would never fully sacrifice her independence to create a new European political entity, as envisaged by France and Germany.

While De Gaulle was correct in his analysis, keeping the UK out for a decade, in retrospect, was a mistake for two main reasons. First, the UK didn't feel it had an "ownership" stake in the EU and second, the EU institutions in their formative stages for a decade, didn't benefit from the UK's inputs on building a less bureaucratic and more "market friendly" system in Europe. The UK entered the "common market" in 1973, but only two years later found itself arguing about whether it should leave again. In the four decades since, this question has remained unresolved.

For those wanting to leave the EU, the sticking point is EU's move towards "ever closer union" and the inability of the UK to "control its borders" to prevent migration to the UK from within the EU. The UK already has a special status within the EU and several exemptions, but that's not enough for *Brexiters*. According to the latest poll published in *The Daily Telegraph*, if a referendum were to be held today, the Remain camp would secure 52% of the vote and Leave would have 43%. Whatever the result on June 23, the *Brexiters* are not going anywhere, unless the Remain camp wins by more than 20 points or more and that is highly unlikely.

Where to invest

Why has the SPX 500 index rallied over +10% since Feb lows?

Why has the dollar tumbled -4% this year?

Why have Biotech stocks sold off and energy stocks rallied?

The answer to all of the above is "positioning." The obsession of market participants with what everyone else is invested in, tends to overshadow the "fundamentals" at the best of times and becomes even more pronounced when real economic growth is low, as is the case now, and upside is limited. More market "herding "abounds and it creates opportunities to buy oversold stocks.

There are two key meetings this week. The FOMC meeting on Wednesday and the Bank of Japan (BOJ) meeting on Thursday.

With no policy change expected and no press conference scheduled at the FOMC meeting, attention will be focused on the post-meeting statement. I expect the tone of the statement to be modestly upbeat from the previous statement. With the March FOMC meeting, and the recent speech by Fed Chair Janet Yellen to the Economic Club of New York, the Fed has changed strategy. It is now more cautious and more aware of global conditions and, as a result, I don't believe it will change this approach again so quickly. In my view, it is a close call between one or two rate hikes this year, with the first hike not coming until July at the earliest.

On the other hand the BOJ meeting this week is of greater interest. In Japan, wage increases seem to be losing momentum, the USD/JPY is still 10 Yen cheaper than the last year's range of 120-125 and corporate and consumer sentiment are weak. Therefore, the economic arguments for additional asset purchase are clear. However, the timing is not:

- The BOJ believes in the effectiveness of Negative Interest Rate Policy (NIRP) and would like to see the effect of it play out before deciding to ease more. The BOJ has also indicated that it takes 12 months or so for the change of the monetary policy to take effect on the economy and prices. NIRP was introduced just three months ago
- Between January and March, oil prices have risen, and global economic conditions have improved. Therefore, the BOJ is not under pressure from deterioration in external conditions
- The BOJ is focusing on the new core CPI (excluding fresh food and energy), which saw an increase from +0.7% in January to +0.8% in February. We await the latest reading

So what about global equity markets? The case for long equities is still in place:

- According to JP Morgan, retail investors are still reluctant to embrace the equity rally. Last time they were this reluctant was during 2008. Besides assuming an average oil price of $45 for the year, the worst of equity and hedge fund selling by the Sovereign Wealth funds could be behind us
- The Chinese economic recovery continued in April according to preliminary economic data and this has been a boost for the risk sentiment. Caterpillar, the US industrial company said last week it was seeing some signs of improvement in construction equipment in China, while GE CEO Jeffrey Immelt noted that he was in China last week and "saw improvements in our business"
- Market flow and positioning reports indicate that investors are not overly long equities; i.e. there is more room for upside. Perhaps that is one reason why the SPX ended last Friday unchanged, despite weak data and underwhelming earnings from such influential US companies as Google, Microsoft, Starbucks, and Visa
- Q1 earnings season in the US has gone well so far and definitely better than investors feared back at the Jan/Feb market lows. Nearly 80% of the S&P 500 companies that have reported so far have beaten EPS expectations and nearly 60% have topped revenue expectations

The over-bearishness of January and February has dissipated. A 25bps increase in interest rates every six months does not really affect the economy in any meaningful way. The US economy has plenty of steam to continue expanding. On top of that, if the Democrats win the White House (and it's likely they will), we will undoubtedly see fiscal expansion and increased government spending funded by a higher deficit and higher taxes. We are already seeing a push to raise minimum wages in the US.

As an investor, it is best to focus on the medium term and not just short-term market volatility. The SPX index above 2100 will beget volatility since it's within touching distance of 2130, its all-time high. I would advise not to be deterred by volatility and build new long positions in favourite stocks or Indices when the opportunity presents itself. I suspect that the SPX will remain in a trading range (1950-2150), with the downside limited by an attractive yield and central bank support, and the upside capped by a mediocre EPS outlook.

Some of the stocks I hold/recommend holding; Starbucks (SBUX US), Citi (C US), JP Morgan (JPM US), Bank of America (BAC US), Gilead Sciences (GILD US), Allergen (AGN UN), Biogen (BIIB), General Electric (GE), General Dynamics (GD US), Apple (AAPL US), Google (GOOG US), Amazon (AMZN US), Schlumberger (SLB US), Pepsi (PEP US, McDonalds (MCD US), Richemont (CFR VX), LVMH (MC FP), Kerring (Ker FP), Daimler (DAI GY), Airbus (AIR FP), Roche (ROG VX), Rio Tinto (RIO LN), Halliburton (HAL US), Walgreen Boots (WBA US), CVS Healthcare (CVS US), Home Depot (HD UN), CBS Corp (CBS US), Alibaba (BABA US), Pfizer (PFE US), Michael Kors (KORS US), Salesforce (CRM US), Lloyds (LLOY LN), BNP Paribas (BNP FP), UBS (UBSN VX), Intesa Sanpaolo (ISP IM).

Best wishes,

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