



Market Viewpoints

Manish Singh

July 2016



When plunder becomes a way of life, men create for themselves a legal system that authorizes it and a moral code that glorifies it.

Frederic Bastiat



Modern banking was born in the Middle Ages in Florence, Italy. Florentine banks lent money to kings, emperors and popes. However, the current state of Italy's banking system is a long way from its successful past and it is teetering on the brink of disaster. Italy's banks hold bad debt to the tune of €360 billion, or 20% of the country's GDP. So far, Italy's efforts to reform its banks have been half-hearted and severely underfunded. Now PM Matteo Renzi wants to "bail out" the Italian banks using Italian taxpayer's money. But the "bail out" falls foul of EU's 2014 post-crisis "bail-in" rules for bank rescues which require bank bondholders to take haircuts on bank losses before taxpayers do. Renzi can ill-afford to "bail-in" pensioners holding their savings in Italian bank bonds. Therefore, a solution to the Italian banking crisis is a matter of political will, which in turn revolves around the German stance. I expect the austere Germans to "give into" Italian demands, if only to stave off a "systemic crisis" in the Eurozone. It's too early to say how the EU-UK *Brexit* negotiations will go. The EU's single market aims to guarantee the free movement of goods, capital, services and people among the EU's 28 member states and German Chancellor Angela Merkel has so far indicated that she is not willing to negotiate concessions with this principle. However, in diplomacy everything is up for negotiation if conditions demand. A long delay in agreeing the terms of a EU-UK trade deal is going to be costly for both sides. I am hopeful good sense will prevail and a mutually acceptable solution will be found. I have now pushed out my US interest rate hike expectation from September to October and I still maintain that upside to equities is limited and one is better off buying on dips rather than chasing rallies.

Le sofferenze

Modern banking was born in the Middle Ages and the early Renaissance in Florence, Italy. The florin, the little gold coin that takes its name from Florence and minted there from 1252 was the most trusted currency in Europe. Florentine banks were like the HSBCs of today - international banking giants, with branches dotted all over Europe. The Florin currency was so successful that by the 14th century, 150 European states had issued their own copies of the gold bullion coin. Florentine banks lent money to kings, emperors and popes. It was these banks that extended substantial loans to Edward III of England to finance the 100 Years' War against France. However, the current state of Italy's banking system is a long way from its successful past and it is teetering on the brink of disaster.

In Italy, they call it "*le sofferenze*" - the suffering; and there is billions of it on the balance sheets of Italian Banks. If not dealt with urgently, it threatens to make the whole Eurozone suffer and in an extreme case, even risk the breakup of the Eurozone. For decades, Italy's banking system has been notorious for clubby relationships with regulators and politicians, who shielded it from foreign takeovers, competition or consolidation. Now, all these bad practices have come home to roost. In Italy, 18% of loans are non-performing. That is nearly 10 times the level in the US and the UK. The bad loans amount to 20% of Italy's GDP and Italian sovereign debt as a percentage of GDP at 140%, is the highest in the Eurozone.

So far, Italy's efforts to reform its banks have been half-hearted and severely underfunded. Italian Prime Minister Matteo Renzi has now floated the idea of a government-led bank restructuring (or bailout) that would cost as much as €40 billion. But the European Union's (EU) 2014 post-crisis "bail-in" rules for bank rescues require bank bondholders to take haircuts on bank losses before taxpayers do. That's politically problematic in Italy. Bank of America estimates that 14.6% of Italian household wealth is tied up in bank bonds - amounting to €235.6 billion. So, bailing them in to recapitalize the banks, as EU rules demand, would be an unmitigated disaster. Renzi can ill-afford to "bail-in" pensioners holding their savings in Italian bank bonds. It could bring down his government and hand over the power to the Eurosceptic Five Star Movement which recently won the mayoral elections in Rome and Turin. An unstable Italy makes for an unstable Eurozone. The talk of the EU unravelling would gain currency.

Brexit has increased pressure on the EU to be more sensitive to the specific needs of a single country. Deutsche Bank's chief economist David Folkerts-Landau has called for a €150bn bank bailout fund to be established, giving the authorities the clout to recapitalize troubled lenders in the Eurozone.

A solution to the Italian banking crisis is a matter of political will, which in turn revolves around the German stance. I expect the austere Germans to "give into" Italian demands if only to stave off a "systemic crisis" in the Eurozone. EU leaders will probably

search for some middle-through solution that they can claim will satisfy the new "bail-in" rules while staving off any systemic financial threat from Italian bank failures. Also, there seems to be sufficient wriggle room within the existing rules to avoid a full-blown bail-in approach. Article 32 of the Bank Recovery and Resolution Directive (BRRD) explicitly foresees some exception to the bail-in rules in the case of systemic risk. It is hard to argue that the Italian case does not pose a systemic risk to Italy and indeed to the Eurozone. Also, a timely fix to the Italian banking sector would be the best way to show that the EU is ready to do what it takes to minimize the *Brexit* repercussions on the region's economic and political outlook.

May in July

There are decades where nothing happens, and there are weeks where decades happen. Such is the pace of change unfolding around us. Last month, the UK took perhaps the most momentous decision since King Henry VIII broke from the Roman Catholic Church in the 16th century, so he could marry as he pleased. This break from the EU however, is driven by a different kind of lust: One for sovereignty, enterprise and greater success. The fundamental difference between the EU and the UK way comes down to how each thinks about Law. In continental Europe, the mindset is that if government hasn't specifically authorized an activity, you have to stop and ask yourself if you are allowed to do it. Result - delay, inaction and endless bureaucracy to draft new laws. In the UK, the mindset is that you can do whatever you like unless it is specifically prohibited by law. The uncertainty is replaced with predictability and confidence to engage in economic activity that drives growth.

Just over a week ago, it looked as if we would have to wait until September to get a new Prime Minister. Then, in a surprise turn of events, the Conservative party leadership contest concluded without the need to ballot the party members and Theresa May became Prime Minister of the UK. May wasted no time in appointing key Eurosceptics to *Brexit*-related roles in her government. The three *Brexiters* tasked with the roles are - David Davis the Secretary of State for exiting the EU, Liam Fox Secretary for International Trade and Boris Johnson the Secretary of State for Foreign Affairs. May's rhetoric ("*Brexit means Brexit*") and her choice of personnel should lay to rest the idea that there could be a *Brexit* U-turn.

Attention is now focused on what *Brexit* will actually mean. What will the UK's negotiating strategy be and exactly where will the UK government try to position itself on the trade-off between access to the single market and the free movement of people. A poll for the BBC conducted by *ComRes* released last week, found that two-thirds of UK voters wanted the new PM to prioritise single market access over restricting the free movement of labour. I believe May's government will do everything to maintain UK's access to the single market.

Some EU leaders would like the UK to trigger Article 50 without any further delay. However, yesterday the UK Government lawyer Jason Coppel told London's High Court: "The current position is that notification will not occur before the end of 2016." Additionally, on Tuesday, London's High Court ruled that a case brought by investment fund manager Gina Miller should be the lead action in the Article 50 claims to be heard in October by Britain's Lord Chief Justice. Britons voted 52% - 48% in favour of leaving the EU but the legal action over whether the government can trigger Article 50 without the approval from parliament, is one of a number of challenges, that could delay a *Brexit*. The UK should not be in a hurry to trigger Article 50 until the May government has carefully considered and decided on just what type of exit the UK is seeking from the EU.

It's too early to say how the negotiations will go. The EU's single market aims to guarantee the free movement of goods, capital, services and people among the EU's 28 member states and German Chancellor Angela Merkel has so far indicated that she is not willing to negotiate concessions with this principle. However, in diplomacy everything is up for negotiation if conditions demand. A long delay in agreeing terms of an EU-UK trade deal is going to be costly for both sides. I am hopeful good sense will prevail and a mutually acceptable solution will be found.

Where to invest?

Global growth has been weak and the global economy remains susceptible to a number of shocks. The impact of ongoing events - terrorist attack in France, failed coup in Turkey, and the upcoming political events in Italy and the US, should translate into heightened political uncertainty and pose risks to the global macroeconomic outlook. Having said that, if the impact of political events turns out to be more benign and is accompanied by a timely fiscal response (and it seems Japan and the UK are getting ready for one), then the growth outlook could surprise to the upside.

I have now pushed out my US interest rate hike expectation from September to November. The ongoing strength of the US dollar is having the same effect as a rate increase on the US economy.

In Japan, Prime Minister Shinzo Abe's ruling coalition's landslide victory for Parliament's Upper House gives him the mandate needed to intensify *Abenomics*, both through fiscal and monetary policies. While many people keep focusing on important constitutional reform, Abe's aim to defeat deflation is still very high up on his agenda. Abe also needs a stronger economy to achieve his other political objectives. It seems all the stars are aligned for a move higher in USD/JPY and therefore in Japanese equities, which have been worst performing among the developed market equities this year. It remains to be seen how far that rally can continue, but Japanese equities and USD/JPY should remain bid until at least the Bank of Japan (BOJ) meeting on July 29.

Global central banks have shifted in a more dovish direction, once again, since the *Brexit* vote. It also seems that a loosening in fiscal policy (at least in the UK and Japan) is increasingly on the cards. Besides, I sense that the Negative Interest Rate Policy (NIRP) may soon be replaced by central banks supporting fiscal expansion in a form of fiscal Quantitative Easing (QE). This could take the form of infrastructure spending, which would be very supportive to growth and would keep equity prices from crashing.

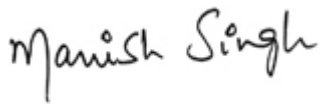
I still maintain that upside to equities is limited and one is better off buying on dips rather than chasing rallies. GBP/USD still looks all set to trade at or below 1.25 when the Bank of England (BoE) embarks on easing in August. A favorable resolution of the banking crisis in Italy would see a relief rally in Europe, which should be used to lighten up positions in European financials. Emerging Markets look particularly attractive given that US rate rise fears have receded and energy prices remain

low. As I have mentioned above, Japanese equities should continue to rally. I would suggest one use the rally to reduce the long position rather than add new ones.

In the US, among the sectors, I like Technology, Healthcare, Consumer and Financials. I sense that we will see more M&A activity in the Technology sector with Twitter (TWTR) a likely target after we saw LinkedIn (LNKD) acquired by Microsoft (MSFT). French stocks will likely benefit as fiscal targets are loosened going into the national elections next year, but Europe has plenty of risks ahead.

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), Allergan (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), 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).

Best wishes,



Manish Singh, CFA

United Kingdom

9 South Street
London W1K 2XA
United Kingdom

Singapore

One Temasek Avenue
23-05 Millenia Tower
Singapore 039192

Monaco

Le Park Palace,
Bloc A, 8ème Etage
5, Impasse de la Fontaine
98000 Monaco

Visit our website:
crossbridgecapital.com

