CROSSBRIDGE CAPITAL

Market Viewpoints

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> **Everyone wants to live at the expense of the state. They forget that the state wants to live at the expense of everyone.**
>
> - Frederic Bastiat

Only a few weeks ago the market was weighing the probability of a recession risk in the US this year. Today, sentiment seems to have vaulted to the other extreme and is anticipating an interest rate rise in June, a move, that until recently, had been considered all but off the table. I am sorry that the market will be disappointed. The US Federal Reserve (Fed) may, at best, use its June meeting to telegraph that the probability of a rate rise is increasing. I suspect that even in July the Fed may sit on the fence and only raise rates in September. Let's not forget that the elephant in the room is China and its currency, the Chinese Yuan (CNY). The USD/CNY peg creates a direct link between China and US monetary policy. Of course, some will argue – forget about the Chinese. That strategy however, was tested in August last year and January this year, with messy outcomes. The Fed has seen the trailer and I doubt they want to now sit through the full movie during an election year. There are less than four weeks to go until the *Brexit* vote. It's very likely that the UK will vote to stay in the EU. However, referendums are not merely a consultative exercise but often have big long term implications. The 2014 Scottish referendum is a case in point. Although the majority voted to remain part of the Union, the Scottish National Party (SNP) emerged with unprecedented dominance over Scottish politics. The EU referendum will see a rise in Euroscepticism in the UK and certainly within the ruling Conservative party. The result is likely to be a UK that attempts to be more assertive in its dealings with the EU for years after a vote to stay.

"Banana" risk

In the 19th century, economic downturns were called "depressions." However, the real depression of the 1930s was so deep and the term got such a bad name that the term "recession" was coined to refer to subsequent economic downturns. Alfred Kahn, one of President Jimmy Carter's economic advisers, was once rebuked by the President for publicly mentioning the risk of a "recession". Mr. Kahn substituted the word "banana" for "recession" in his subsequent speeches.

Only few weeks ago the market was weighing the probability of a "banana risk" in the US this year as the Q1 GDP printed at +0.5%. Today, the markets seem to have vaulted to the other extreme and are anticipating an interest rate rise in June, a move that, until recently, had been considered all but off the table. I am sorry that the market will be disappointed. The Fed is in no hurry to raise rates and neither should they be. They may, at best, use their June meeting to telegraph that the probability of a rate increase is rising. I suspect that even in July the Fed may sit on the fence and only raise rates at its September meeting.

Can the Fed raise rates in an election year?

Yes they can and they have. In the past 30 years, the 1996 election year was the only election during which the Fed made no major policy moves. The Fed raised rates during the election years of 1984, 1988, 2000 and 2004 and cut interest rates in 1992 and 2008. In 2012, the central bank launched the third round of its controversial bond buying program known as quantitative easing (QE).

The expectation of a rate rise was built on what markets saw as a "hawkish" April Fed meeting minutes which were published last week. What normally happens after a hawkish minutes is that either the data doesn't quite live up to the Fed's expectations to pull the trigger, or global markets take a tumble and the Fed is forced to postpone its plans. I don't see the latter happening but the former is quite likely. The US jobs report that came out the week after the April announcement was weak, adding only 160,000 jobs and since then jobless claims have also been rising. There's an even chance that the US jobs report for the month of May (out next Friday) will also be weak.

Let's not forget the elephant in the room is China and its currency, the Chinese Yuan (CNY). The USD/CNY peg creates a direct link between China and US monetary policy. China is in midst of a rebalancing and it certainly doesn't want to see a tightening of its monetary policy via the Fed. Of course, some will argue – forget about the Chinese. That strategy, however was tested in August last year and January this year, with messy outcomes. The Fed has seen the trailer and I doubt they want to now sit through the full movie during an election year.

I do not want to sound as though I am bearish on US growth. To the contrary, I haven't quite bought into the whole "secular stagnation" theory. Low growth yes, secular stagnation no. Alvin Hansen, a professor at Harvard University was the one who introduced Keynesian economics in the US during the 1930s and helped create the Council of Economic Advisors. His first book at Harvard was titled *Full Recovery or Stagnation?* (1938). He outlined what came to be called the "secular stagnation thesis." He claimed that the American economy would never grow rapidly again because all the growth ingredients had played out, including technological innovation and population growth. The only solution, he argued, was constant, large-scale deficit spending by the federal government. How wrong he turned out to be.

Brexit: UK will vote to stay, but Euroscepticism will rise

There are less than four weeks to go until the *Brexit* vote - Britain deciding whether or not to leave the European Union (EU). This is a decision that could have dramatic political and economic consequences for both the UK and the EU. A *Brexit* would further impede the already strained integration process in the EU, with the risk of a dangerous domino effect.

The Leave camp argues that the EU has become a club that is an overpriced cartel, excessively bureaucratic, anti-democratic, and economically ruinous. The Remain side argues about the risk to the UK economy from an exit - not just to the currency but to foreign investment, the UK's balance of payments, and the renegotiation of more than 100 international trade and investment agreements. To be honest, in view of the large UK current account deficit (5% of GDP), a post-*Brexit* Sterling devaluation could prove beneficial to boosting British exports.

The Remain campaign clearly believes its strongest card is the economy. It's not surprising then that the Remain campaign has moved from projecting fear to projecting hysteria, with even the normally calm David Cameron predicting "war" if the UK were to leave the EU. The IMF's Chief Christine Lagarde - clearly in the Remain camp - finds it "credible" that leaving the EU could cause risk to "crystallise" and the UK's GDP could fall by up to -9.5%. That decline is more than in any recession since the Second World War, more than in the Great Depression or the First World War. Exaggeration does not come more blatant than this. The Remain campaign is engaged in softening up the "enemy" with a constant and ferocious pounding. The polls, however, suggest the *Brexiteers* are largely oblivious to the heavy artillery being pointed at them from the bunker at 10 Downing Street and Her Majesty's Treasury. Prime Minister Cameron hopes eventually the war of attrition will pay off and this week he went for the soft spot in the enemy's defences - the risk that a No vote on June 23 could lead to -18% crash in house prices over next two years and an increase in mortgage costs. A cunning tactic indeed as when it comes to the UK's post-EU trading arrangements, the threat to house prices is a serious matter and one that voters will be sensitive to. German Chancellor Angela Merkel, in a nail-biting panic, asked Cameron recently how she could help. Cameron wisely told her not to get involved. The EU Referendum is an emotional subject for the British people.

In an opinion poll conducted by *The Observer* newspaper and published last weekend, 44% of Britons want to remain in the EU vs. 40% who want to leave. This marks a 2% increase in the Remain camp since the end of last month. Also, two major bookmakers offered the shortest odds to date on a vote to Remain. Barring a last-minute stampede towards exit, it's very likely that the UK will vote to stay in the EU.

However, referendums are not merely a consultative exercise and often have big implications. The 2014 Scottish referendum is a case in point. Although the majority voted to remain part of the Union, the Scottish National Party (SNP) emerged with unprecedented dominance over Scottish politics, wiping the Labour party out in Scotland. Rather than dealing with the issue of Scottish independence decisively, the referendum appears to have institutionalized it as a salient feature of Scottish politics.

Similarly, the EU referendum will see a rise in Euroscepticism in the UK and certainly within the ruling Conservative party. Many of those who advocate leaving the EU will continue to argue for the exit, and suggest that another referendum should be held at some point. The leadership of the Conservative Party also appears likely to move in a more Eurosceptic direction even after a vote to stay. Cameron has revealed privately that he fears the EU campaign will give Eurosceptic the upper hand in the Conservative party whether or not the public backs *Brexit* in the referendum. He also believes a *Brexit* supporter is possible to succeed him as Prime Minister. The result is likely to be a UK that attempts to be more assertive in its dealings with the EU for years after a vote to stay.

Where to invest?

Since peaking at 2,130 last May, the S&P 500 Index (SPX) has now gone a year without making a new 52-week high. Since 1929, there have been 20 prior periods where the SPX went 365 days or longer without making a new high. The most recent of these streaks was from October 2007 through October 2009, which lasted 733 calendar days. The current streak, however, is somewhat unique, in that the SPX is less than 3% from its 52-week high, the second smallest decline from the prior 52-week high.

First quarter US Earnings season unofficially came to an end last week with Wal-Mart's report. At the start of earnings season, the S&P 500 was trading at 2,041. On Friday the S&P Index closed at 2,052. The index therefore went nowhere during this reporting period. Equities seem to be responding to macro risks – the Fed, China, and US elections more so than stock specific risk.

As I mentioned above, I don't see the Fed raising rates in June and perhaps not in July either. US staffing firms are reporting slowing job growth, a red flag for the overall economy. A slowdown in temporary hiring normally precedes broader employment downturns which are why such weakness so far in 2016 is ominous and the Fed will be well aware of this.

The big boost to equity markets would be from US fiscal expansion, but that is unlikely before the end of this year. I was speaking to a senior US Democrat economic adviser last week and I gathered that repatriation of corporate cash is quite high up on the Democratic agenda. The one-off taxation of the cash could be used for infrastructure spending. The total amount of cash held by non-financial US companies reached $1.7 trillion according to a new Moody's report. Five companies – Apple, Microsoft, Google, Cisco, and Oracle alone account for $500 billion of that sum. Of the $1.7 trillion, $1.2 trillion is sitting overseas. Assuming a 15% tax, and half of the cash repatriated amounts to a $100 billion fiscal boost for infrastructure spending.

Sell in May, if you will, but do stay. The last two sell-offs in August 2015 and earlier this year ultimately proved spurious and did little more than harm fund performances. Investors will likely be more circumspect this time around before succumbing to pressure from similar sell-offs. As I have been saying for the last few months, this year is one of very small gains but these will be magnified if you can pick the dip. I do see the likelihood of one more dip this year– driven by the market pricing in an interest rate rise and inflation overshooting market expectations.

It's not the initial hikes that concern me or most investors. Market troubles have come from the Fed pointing to a series of clockwork-like hikes once hiking begins. Often this is interpreted as rates rising inexorably above +2%. A summer rate hike by the Fed is unlikely but if they do increase rates, banks will be the big beneficiaries and commodities will suffer from a strong US dollar.

As an investor, it is best to focus on the medium term and not just short-term market volatility. The SPX index above 2,100 will beget volatility since it's within touching distance of 2,130, its all-time high. I would advise not to be deterred by volatility and to 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 (1,950 -2,150), with the downside limited by an attractive yield and central bank support, and the upside capped by a mediocre earnings 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), 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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