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CROSSBRIDGE CAPITAL

Market Viewpoints

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May 2017

Asking liberals where wages and prices come from is like asking six-year olds where babies come from.

\- Thomas Sowell

Summary:

Political passions are running high in Washington, and following the news that President Trump may have tried to coerce FBI director James Comey out of investigating Michael Flynn's ties to Russia, the word "impeachment" has entered the US political lexicon once again. But even with a handful of lawmakers eyeing this possibility, impeachment is still a long-shot. Trump is still very popular within his voter base and most Republican Congressmen owe their seats to Trump's victory. A massive shift in public opinion across the country would need to happen in order to pressure Republicans in Congress to take on President Trump. If there is no evidence that implicates Trump, I suspect that this will be the media's last hurrah and Democrats will suffer most for fanning wild speculation. Those rooting to see the back of Trump should beware of the fantasy that the nation's problems would be solved if only Trump could be made to disappear. Millions of Americans still have legitimate concerns about everyday economic life. Middle America has seen its jobs disappear to technological change, local factories have closed, and towns and cities have lost their prosperity. Not recognizing this as the bigger problem that faces America, displays a rudimentary misunderstanding of those who voted for Trump. It would be foolish to say that a major scandal involving the President would have no impact on financial markets, but it would likely be temporary. The ultimate driver of the S&P 500 and financial markets over the long-term, is economic growth in the US and abroad and both these measures are holding up quite well.

A Trump impeachment? Don't bet on it

The New York Tribune, called him an "aching tooth in the national jaw, a screeching infant in a crowded lecture room." One Congressman dismissed him as "an ungrateful, despicable, besotted traitorous man—an incubus." As President, he offended friend and foe alike with his unrestrained rhetoric and his political enemies suspected that he colluded closely with enemies of the state. Does all this sound familiar? No, I am not talking about President Donald Trump but US President Andrew Johnson, who came to power in 1865 after the assassination of President Abraham Lincoln.

In my reaction to the US election (November Market Viewpoints 2016), I wrote that Trump's victory closely resembled that of Andrew Jackson, the seventh President of United States, who railed against the "corrupt aristocracy" and sought to advance the rights of the "common man". As President, Trump is very quickly morphing into the "wild and unpredictable" Andrew Johnson and he has the same level of "distrust for government officials" as President Richard Nixon. Political passions are running high in Washington, and following the news that Trump may have tried to coerce FBI director James Comey out of investigating Michael Flynn's ties to Russia, the word "impeachment" has entered the US political lexicon once again. But even with a handful of lawmakers eyeing this possibility, impeachment is still a long-shot.

Article II, Section 4 of the US Constitution, states - ''The President, Vice President and all civil Officers of the United States, shall be removed from Office on Impeachment for, and Conviction of, Treason, Bribery, or other high Crimes and Misdemeanors.''

Impeachment is exceedingly rare. In the history of the US, Congress has initiated a mere 62 impeachment proceedings, with 19 cases going to trial and just eight federal officials being convicted. The House of Representatives has impeached only two presidents, Johnson in 1868 and William Clinton some 130 years later. The Senate however eventually acquitted both. No member of the Senate or House has ever been removed via impeachment. Nixon is the only high-ranking US official who probably would have been removed from office, had he not resigned in 1974 after the Watergate scandal.

Trump is still very popular within his voter base and most Republican Congressmen owe their seats to Trump's victory. A massive shift in public opinion across the country would need to happen to pressure Republicans in Congress to take on President Trump. For that shift to take place, very credible "smoking gun evidence" has to emerge that links Trump to "the crime." What we have so far is hearsay and hyperbole. If there is no real evidence, I suspect that this will be the media's last hurrah and Democrats will suffer most for fanning this wild speculation. The US Justice system was founded on the principle of innocent until proven guilty. Those quick to judge Trump have forgotten how incredibly important this principle is to the American people.

Those rooting to see the back of Trump should beware of the fantasy that the nation's problems would be solved if only Trump could be made to disappear. Millions of Americans still have legitimate concerns about everyday economic life. Middle America has seen its jobs disappear to technological change, local factories have closed, and towns and cities have lost their prosperity. Not recognizing it as the bigger problem that faces America, displays a rudimentary misunderstanding of those who voted for Trump.

What would the impact of impeachment proceedings be on financial markets?

During the Watergate scandal from the time the special prosecutor was appointed (May'73) to the time Nixon resigned (August '74), the S&P 500 Index (SPX) fell by over -20%. The problem with the Watergate comparison is that just like any market analysis, you can't view things in isolation. During the time of Watergate, the US economy was in shambles - inflation was on its way to double-digits, oil prices were surging due to the oil embargo, the US economy was in recession, and the US dollar was coming off the gold standard. This time it is different, very different. As much as self-absorbed politicians and the media would have you believe, there's more to US financial markets than just them. It would be foolish to say that a major scandal involving the President would have no impact on financial markets, but it would likely be temporary. The ultimate driver of the SPX and financial markets over the long-term, is economic growth in the US and abroad, and both these are holding up quite well.

Where to invest?

There has been some chatter recently that the data in the US may be turning. Despite this, the SPX has continued to rally to new highs. So is the data really turning? Is a recession imminent? No and No.

I agree that the US is in the late cycle. US growth remains above trend, and perhaps growth momentum has peaked and the US is nearing "full employment." With the ISM manufacturing index, which recently dropped from 57.7 in February to 54.8 in April, we may have entered the "slowdown" phase of the manufacturing cycle.

Manufacturing may have peaked in the US, but one other key indicator –US housing starts that refer to the number of new residential construction projects that have begun during any particular month, continue to show no signs of a slowdown. The last reported monthly number and the 12-month average levels are both still rising, which signal a recession is still not on the horizon, as prior to every recession in the last half-century, housing peaked and began to roll over well in advance of each recession. Current levels of housing starts are only now just at levels that we saw in 2008 at the peak of the last expansion. What makes the current levels even more interesting is that adjusting for the increase in population over time, housing starts would need to be closer to 1.9 million. That's more than +60% above current levels.

The July 17 Fed Funds futures rate is currently at +1.105%, consistent with an 81% chance of a June interest rate hike by the US Federal Reserve. Since the 1950s there has not been a recession in the US unless the US 10-year/3-month term slope (US 10-year Treasury yield minus 90-day US Treasury bill yield) has flattened to near zero. This spread is currently over 1.3%. As short term rates rise and financial conditions tighten due to central banks raising rates, market expectations of growth generally slow, resulting in curve flattening and an eventual slowdown in the economy. Double-digit losses and a bear market follows. There is quite a long way to go in terms of the yield curve flattening before we should be concerned.

Meanwhile, in the Eurozone, the good news is that there are some homegrown reasons for continued solid growth. Recent Purchasing Managers surveys noted strong job creation and rising backlogs of work in both services and manufacturing. Consumer confidence is at a 10-year high. Growth is running at around +2% and, while that may not sound spectacular, it's double the pace of the trend growth of +1% which we have seen for some time in the Eurozone.

While European equities have certainly found favour again, politics in Europe remains far from convincing. There are the Austrian election in October and Italian election thereafter. *The Telegraph* reported this week that, based on a leaked German government report, Europe could face a new wave of migrant arrivals this summer. Up to 6.6m people are waiting in countries around the Mediterranean to cross into Europe, according to details of the classified report leaked to the newspaper *Bild*. They include more than 2.5m in North Africa waiting to attempt the perilous crossing by boat. German Chancellor Angela Merkel's government has not commented on the report, which the newspaper says was marked "for internal use only." There are fears of a dramatic rise in arrivals as the summer weather turns favourable for sea crossings. With the breakdown in relations between Turkey and the European Union, Europe could be in for a challenging time.

The first poll gauging the level of confidence in newly elected President Emmanuel Macron of France shows that 45% of respondents believe in Macron's abilities to steer the country and deliver on his policy agenda. This poll for business daily *Les Echos* shows that Macron polled 19% higher than his predecessor President Francois Hollande did in April. Nevertheless, this is much lower than Hollande's 58% in 2012, Sarkozy's 59% in 2007, and Chirac's 53% in 2002 and 61% in 1995. French voters are perhaps becoming more realistic about the difficulties that the country faces and the challenges that Macron will face in delivering an ambitious reform agenda.

However, there is good news too. Merkel's victories in recent state elections are likely to boost her campaign for the federal election. The defeats in regional elections in the Social Democratic Party's (SPD) heartland may have put to bed any hopes of SPD's Martin Schulz unseating Merkel in September. The Schulz hype and SPD gains induced by it, have evaporated, and a coalition with Merkel as the Chancellor seems the most likely outcome i.e. German elections are unlikely to add any political scare or surprises to the markets.

Overall, I continue to be risk positive and I do not expect a lasting market correction, if one were to occur. We have seen record lows in volatility so this can only go up from current levels, and we did see some uptick in the volatility index last week. One issue of growing concern to investors is Quantitative hedge funds, which now are responsible for 27% of all U.S. stock trades by investors, up from 14% in 2013, according to the Tabb Group, a research and consulting firm in New York. Selling and buying by such funds have the potential to drive market volatility. They usually sell or buy based on the realized volatility measure. On average over the past six months, the difference between the realized volatility of the SPX and that of 10-year Treasury futures is the narrowest since 2004. Any sustained increase in the volatility index will likely beget short sell-offs as funds lighten up on equities.

While I do like European equities, and one should maintain a long position in European equities, for the political reasons mentioned above, I would not go overweight Europe in my portfolio. I continue to hold US equities with sector bias to Industrials (XLI), Technology (XLK) and Financials (XLF). Continue to hold Emerging Market (EM) equities with a bias to India (INDY) where macro conditions continue to improve and reforms are on target. As we head into a slowdown in momentum at the equity index level, it will pay to hold single stocks over Index funds or ETFs, both in the US and Europe

In terms of stocks I like: JP Morgan (JPM US), Bank of America (BAC US), Citi (C US), Allergen (AGN UN), Celgene (CELG UW), General Dynamics (GD US), United Rentals (URI), Northrop (NOC US), BAE Systems (BA/ LN), Boeing (BA UN), Apple (AAPL UN), Google (GOOG US), Microsoft (MSFT US), Amazon(AMZN UW), Home Depot (HD UN), CBS Corp (CBS US), Alibaba (BABA US), Pfizer (PFE US), Publicis Groupe (PUB FP), BNP Paribas (BNP FP), UBS (UBSN VX), Salesforce (CRM US), Estee Lauder (EL US), Johnson & Johnson (JNJ), Walgreen Boots (WBA US), Glencore (GLEN UN), Rio Tinto (RIO LN), Pioneer Natural Resources (PXD), Blackrock (BLK), United Health (UNH), Comcast Corporation (CMCSA), Eiffage (FGR FP), VISA (V US), Baidu (BIDU US).

Best wishes,

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