



## Market Viewpoints

*Manish Singh*

July 2014

Last week saw one of the strongest US jobs data reports since this recovery started in 2009. However, the unemployment rate of 6.1% (now only marginally off the 20 and 60 year average unemployment rate of 6.0%), masks a very soft labour market. The continued growth of part time jobs reflects the structural challenges and changes to the US economy. The equity rally has continued unabated and there's still time to participate in the rally. The Federal Reserve views the totality of the labour market and not simply the headline unemployment rate or the stock market index to determine future policy. Price to Earnings (P/E) expansion can see stocks rise even if earnings lag and play catch up. We have seen this in Europe and the US over last two years. In the Eurozone the reduction in Public Investment is proving to be a major drag on growth. If this were to continue, the Eurozone runs the risk of falling into a new lower trend growth rate. Last week, European Central Bank President Mario Draghi reiterated the ECB's accommodative stance. Emerging Markets will be a bigger story in the second half of this year. The new government in India will push on the infrastructure and manufacturing front to build the capital stock, meet energy needs, and herald much needed supply side reforms.

### Jobs surge in the US, but soft patches remain

After a bad Q1 for equities, Q2 has turned out pretty well, with The S&P500 index (SPX) returning +5.2% for the quarter. The Energy sector performed best, followed by Utilities and Technology. Financials performed worst. Last week saw one of the strongest US jobs data reports since this recovery started in 2009. The US economy added 288,000 jobs in the month of June and the unemployment rate fell to 6.1%, the lowest level since 2008. However, other indicators show the broader economy is still struggling to rebound, specifically the final reading of Q1 GDP showed that the US economy contracted at an annualized rate of -2.9% for the quarter. This is the fastest decline in economic output in five years.

While the top line number in US jobs makes for positive reading, some gauges under the surface show the recovery remains soft. The unemployment rate of 6.1% (now only marginally off the 20 and 60 year average unemployment rate of 6.0%), masks a very soft labour market. Some of the interesting features of this recession and recovery have been the unusually high level of long-term unemployment, the surge in part time jobs and very tepid wage growth for the majority of the workforce.

- After peaking at 45% through 2010-11, the long-term unemployment rate (unemployed 27 weeks or more as % of total unemployed) is at 33%. This is more than double the pre-recession level of 18%.
- The share of the labour force working part-time (fewer than 35 hours per week) rose sharply in June reaching its highest level in more than two years. The continued growth of part time jobs reflects the structural challenges and changes to the US economy
- The labour force participation rate is at an all-time low and the average hourly earnings are still growing at a very modest pace in real terms

Amidst all this, the equity rally has continued unabated and the Dow Jones Industrial Average (DJIA) Index hit a record high of 17,000 last week. Will the Federal Reserve be rushed to tighten soon?

It's still early for that. To talk of US rate hikes now, is like waking up on Christmas morning and thinking about the January sales. There's still time to participate in the rally. The Fed views the totality of the labour market and not simply the headline unemployment rate or the stock market index to determine future policy. Fed Chair Janet Yellen continues to argue in favour of the "separation principles" - that monetary policy should generally be kept separate from financial stability considerations with the latter being best addressed through financial regulation. At the International Monetary Fund (IMF) last week, Yellen said, "The potential cost, in terms of diminished macroeconomic performance, is likely to be too great to give financial stability risks a central role in monetary policy decisions, at least most of the time." The departure from the Fed of noted separation principle-skeptic Jeremy Stein should strengthen Yellen's hand further. The

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focus now turns to Q2 GDP, the first estimate of which should be available by the end of this month. As for the stock market the focus will be on the Q2 earnings season which started this week.

### “Unreliable Boyfriend”

Meanwhile on this side of the pond, the UK is growing at a healthy rate of +3%, whereas the wider Eurozone registered a meager growth rate of +0.9%. High growth rates and surging house prices have presented the Bank of England (BoE) with a big headache. Their flip-flop on the timing of the first rate rise came under criticism from a member of the UK Treasury Select Committee, who remarked – “We’ve had a lot of different signals. It strikes to me that the Bank’s behaving a bit like an unreliable boyfriend. One day hot, one day cold, and the people on the other side of the message are left not really knowing where they stand.” Governor Mark Carney’s first date anxiety – the first interest rate rise - is understandable. Carney has a tough job balancing growth, preventing the property market from overheating, and not falling behind the rate curve. The BoE is widely anticipated to be the first major central bank to raise rates this economic cycle, with the rate rise likely coming in Q4, at its November meeting. For now, in an effort to rein in house prices, Carney announced two macroprudential (anti-bubble) policies

- First, limiting to 15% the number of mortgages that lenders can hand out on loan-to-income ratios of above 4.5
- Second, borrowers will only be given a mortgage if they can pass an affordability test, which sets the interest rate charged at 3% higher than the present level

A recent Deutsche Bank research report found that measures targeted at the housing market - for example loan-to-value or income limits - can help slow mortgage growth but with little spillover effect on house prices. So at best, such policies will make financial institutions more resilient, but for everyone else, the risk of bubbles and credit excess remain. Not quite the outcome the BoE was hoping for.

In the Eurozone the reduction in Public Investment is proving to be a major drag on growth. Between 2009 and 2013, spending on public investment in the Eurozone was cut by a quarter. A lower stock of public investment and infrastructure lowers total factor productivity, and hurts GDP growth. If this were to continue, the Eurozone runs the risk of falling into a new lower trend growth rate. Additionally, years of sub-par growth would reduce labour supply through declining human capital.

Inflation in the Eurozone stayed at +0.5% in June (well below the 2% target rate). At the ECB press conference last week, Draghi reiterated the ECB’s accommodative stance. Draghi also clarified the technicalities of Targeted Longer Term Refinancing Operations (TLTRO). The essential question was will the ECB restrict the “carry trade” – whereby banks recycle the proceeds of TLTRO to cheaply fund the purchase of sovereign bonds/risky assets. The answer we got amounted to a NO. The Eurozone banks would be eligible to benefit from the TLTRO as well as the cheap funding it offers. The ECB also announced it would reduce the frequency of its policy meetings to a six-weekly cycle starting in 2015. This is a welcome change. A slower frequency of ECB meetings will contribute to less “noise” in the market.

### Where to invest

In Q1, 74% of SPX companies beat earnings estimates but only 53% beat on revenues. Of the earnings beats, almost 50% repurchased shares. One would prefer to see companies growing their earnings through increasing revenues rather than via share buybacks. The consensus 12 month forward earnings growth expectations for SPX are flat since the beginning of the year. Equities have rewarded investors handsomely, even as skepticism has remained. The SPX has trebled since the lows of March 2009. As the Q2 earnings season rolls into town, do equities correct if earnings disappoint? Or will they be buoyed by growing expectations of a cyclical turn?

I believe we will see the latter, as this rally has more legs. Price to Earnings (P/E) expansion can see stocks rise even if earnings lag and play catch up. We have seen this in Europe and the US recently. Between 2011 and 2013, the Earnings

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per Share (EPS) of components of the Stoxx Europe 600 Index dropped by -5%, yet the Index itself rallied +36%. In the same period, SPX earnings increased by +11% but the index rose by +47%. The main risks to the equity rally in my mind come from economic surprises: the big miss on Q1 GDP, (actual -2.9% vs first forecast of +2.5% serves a reminder), a bond selloff or geopolitical shocks. Even though I believe Yellen is going to err on the side of easy money, the Fed's mandate is not to ensure GDP growth but to ensure maximum employment and stable prices. With employment at record lows, any jump in inflation will make the Fed uneasy.

For now, I remain bullish on equities. Low volatility, little return on cash and inflation well below target, all support a continued rally. After the Q1 GDP shock, Q2 is coming in better but still weaker. Lower trend growth is theoretically not bullish for stocks, but paradoxically, it keeps monetary policy easy, bond yields low and equities buoyed.

My bullish bias is to Emerging Markets (EEM US, VWO US) and Japan (DXJ US), over Europe and the US.

My sector preferences in the US are Financials (XLF), Technology (XLK), Materials (XLB) and Healthcare (XLV).

Some of the other stocks I hold/like to hold in our discretionary portfolio: Amazon (AMZN), Google (GOOG), Citigroup (C), JP Morgan (JPM), Bank of America (BAC), Standard Chartered (STAN LN), Barclays (BARC LN), UBS (UBSN VX), Schlumberger (SLB), Boeing (BA), P&G (PG), Freeport McMoran (FCX), Glencore (GLEN LN), Rio Tinto (RIO LN), BHP Billiton (BHP US), Nestle (NESN VX), Philip Morris (PM), Pepsi (PEP), Roche (ROG VX), Pfizer (PFE), Volkswagen (VOW GY), Inditex (ITX), Cognisant (CTSH), Gilead Sciences (GILD), Vinci (DG FP), Sanpaolo Intesa (ISP IM), EUFN (iShares European Financials) Anheuser Busch (ABI BB), Chipotle (CMG), Starbucks (SBUX) and Conagra Foods (CAG)

Emerging markets (EM) will be a bigger story in the second half of the year and none more importantly than India, where a new leader has heightened market expectations. This Thursday, the new government will outline and present its economic priorities and fiscal plans for the coming fiscal year. I spoke to *Bloomberg* recently on the topic of India and Emerging Markets. (Links to the interview [Part 1](#) and [Part 2](#)). Expect a notable mention if not a detailed plan from the new government on the infrastructure and manufacturing front to build the capital stock, meet the energy needs, boost exports and herald a much needed supply side reforms. Besides India, China and the rest of EM GDP growth is also likely to improve during the second half of this year due to a pickup in Developed Market imports. US imports are tracking +15% gains in Q2, the strongest in almost four years.

### Currencies Outlook

The US Dollar was bought aggressively as non-farm payrolls surprised to the upside and expectation for a Fed tightening was adjusted. The Fed however is in no hurry to tighten. German industrial production dropped -1.8% in the month of May, the strongest pace of contraction since April 2012 and the previous month's report was revised downwards. In the long run, US yields should outperform the Eurozone, especially since there have been many more downside surprises in the Eurozone than in the US.

Over next four weeks, I see EUR/USD gains capped at 1.36 and trending down to the 1.34 level. USD/JPY is likely to stay in the 100.80 and 102.5 range. GBP/USD is likely to stay above 1.70 level and test the 1.73 level. AUD/USD rallies will be capped at 0.95 and trade down to 0.93/0.92 level

Best wishes,

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