



“ The most important rule of investing is to play great defense, not great offense. Every day I assume every position I have is wrong. Always question yourself and your ability. Don't ever feel that you are very good. The second you do, you are dead. Always maintain your sense of confidence, but keep it in check – **Paul Tudor Jones** ”



Recessionary fears in Europe exist but the US and the Emerging Markets (EM) look much better placed as economic data over the last few weeks have surprised to the upside. Central Banks continue to be in a monetary easing mode with the rate cycle in EM turning, inflationary fears receding and rate cuts to support growth looking more likely. The EM bullish case remains strong as do the cases for high yield credit (to take advantage of the recent sell of), Russian Equities (for valuation reasons) and large cap European and US equities that have lagged the benchmark. We recommend no credit or equity exposure to European peripheral economies. The message is some dislocations take a long time before the final solution is reached, and as an investor, it pays to be nimble and tactical with a shortened horizon. Overall, the risk is more to the upside than to the downside.

European Summit deal: Trick or Treat?

Last Wednesday, European Heads of State and representatives of financial institutions were locked in a frantic attempt to find a solution to Europe's debt troubles. The 'deal' – when it came – got labelled as a 'comprehensive' solution, and if you are keeping count, as I am, this is the third such 'comprehensive' solution proposed by the EU this year.

So is the 'deal' a *trick* or *treat*?

A *'treat'* if you look at the equity market. The S&P 500 index rallied 10.78% in October and 20% percent since the October 4th intraday low (when the rumour of a leveraged EFSF and bank recapitalization plan first surfaced in the press).

A *'trick'* if you look at the Italian bond yield – now at 6.28% and heading towards the critical level of 6.5%, a level which Greek, Portuguese and Irish bond yields have never recovered from.

As with all previous EU summit announcements, the fifteen-page communiqué released last week was not lacking in determination (7 mentions) or commitment (11 mentions) but the details were still missing and the whole thing looked more like a patch than a solution.

It had four main points:

- A 50% haircut on Greek bonds where PSI (private sector involvement) is voluntarily and Greece gets a new tranche of €130 billion in aid.
- European banks will have to come up with €106.5 billion which will bring their Tier 1 capital ratios to 9% (Dexia was supposedly at 12% right before it went bankrupt).
- Leverage the EFSF to one trillion Euros to provide credit enhancement by insuring first loss (20 or 25% as the case may be) on new debt issued by European sovereigns. Towards this end, capital will be sought from the IMF, BRIC nations and sovereign wealth funds and arranged through a special purpose vehicle.
- The resolve of individual member states to advance structural reform and fiscal austerity and increase economic governance.

It is all well to announce the requirement for banks to find €100 billion in new capital. But where will the cash come from? Retained earnings and capital raising in the markets will be a slow process and the national governments are already greatly indebted to be of any further help without triggering a downgrade.

The ECB to the rescue?

Before the summit, German Chancellor Angela Merkel in an impassioned speech to the German parliament raised the specter of the European Union collapsing, along with the decades-long peace that has prevailed, if the Bundestag did not approve expansion and leverage of the EFSF. The Bundestag did give their approval but the approval is conditional on the European Central Bank (ECB) continuing to comply with Article 123 of the Treaty of Lisbon, which prevents it from printing money i.e. monetizing debt and financing deficit – the role a nation's Central Bank has to perform in times of crisis to build confidence in its currency and economy. Central banks in the US, UK and Japan have very much done this during this crisis and in previous ones.

Therefore, it's amply clear that so long as Germany is part of the Euro, the ECB will not come to the rescue of a stricken nation with the full might that is needed. The disappointment with the ECB can be summed up in this quote.

"Everyone needs the ECB to step up to the plate. The ECB has no excuse not to act. In trying to keep its monetary virginity intact, the bank threatens to destroy the Euro Zone. If that happens, nobody will be able to profit from its virginity." – Prof. Paul De Grauwe, Financial Times, August 2011

Without the ECB's support, a leveraged EFSF which is yet to be capitalized is more an empty cannon than the bazooka it's meant to be. A leveraged EFSF still doesn't take default off the table. It merely delays the time to default by rolling over maturing debt but in case of default, the guarantors can't handle losses that big.

Let's look at the math.

- Italy has an outstanding debt of 1.6 trillion, and Spain, 600 billion that is 2.2 trillion Euros combined.
- A Moody's report that looked at sovereign defaults between 1983-2007, concluded that issuer-weighted recovery rates on defaulted sovereign bonds, as measured by trading prices observed at the time of default or distressed exchange, have averaged 54% overall.
- For simplicity if we take 54% as the recovery rate, the losses on Italian and Spanish bond should either nation default on its bond obligation will be 1.1 trillion Euros.
- The EFSF has 250 billion Euros (after deducting the capital it has already committed to the Greece, Ireland and Portugal rescue deals) left to insure losses against an Italian and Spanish bond default.
- It's therefore amply clear why the current measures announced are not enough to calm the fears of the market.

With Germany specifically capping its EFSF loss limit at 210 billion Euros, there is no guarantor of last resort – the first thing investors buying into new sovereign bond issuances will be looking for if they were to settle for a lower yield. And if the yield on Italian and Spanish government bonds remain elevated, the crisis will only get worse.

Klaus Regling, chief executive of the European Financial Stability Facility, is visiting China to attract Chinese money to invest in the "SPIV". Urban dictionary available online gives the following as the meaning of "SPIV"

An 'SPIV' is the name generally given to a shady character who may try to sell counterfeit objects to you at a discounted price.

I am hoping China will not feel the need to check a dictionary before they commit capital to the Europe rescue fund.

In summary, there seem to be only two credible solutions for current troubles that Euro and Eurozone face:

- EMU breaks up with strong/economically similar nations going their own way or forming a new union and the weak indebted peripheral nations allowed to weaken their currency, kick start growth, reclaim their access to 'lender of last resort' i.e. their Central Bank to monetize their debt, and tolerate higher inflation (if need be).
- ECB decides to put its full might behind the EMU by buying large sums of sovereign debts, yields on sovereign debts fall, easing debt service cost on sovereign balance sheet. The Euro and the Union is preserved. In return for this, strict fiscal governance is put in place and implemented in the peripheral nations. Europe moves towards political union.

But will Germany ever sign up to fiscal transfer and the ECB monetizing Greek or Italian debt? In the absence of this, every other solution is just another band-aid, waiting to come apart at the seams.

Global growth: The good news...

Over the weekend the clock went back an hour, an hour I was reminded I could put to good use at home and reduce my debt of housework. An hour is good enough for me but when it comes to Europe's indebtedness, even several hours is not enough. Buying more time is not an option and post the EU summit, Italy holds most of the cards for the next stage of this recovery.

However, the high debt alone is not the main reason for this crisis but the deceleration of growth and growth expectations in the economy is. High debt levels really become a problem if the income growth required servicing that debt starts to fall. Thus, any long-term solution to Europe's debt crisis has to come from policies that support economic growth. In this regard, support from the ECB by way of a rate cut or QE (quantitative easing) will go a long way to ease the troubles.

Globally, economic data for the last couple of weeks has surprised to the upside and therefore has eased recessionary fears. In the US, GDP grew at 2.5% in 3Q, acceleration from 1.3% in 2Q helped in no small measure by a stop in the oil price surge and a pickup in nominal consumption. In the GDP report, the data regarding inventories were much weaker than anticipated, implying that the change in inventories in 4Q will add more to growth than previously expected. The Q3 earnings season has been strong (albeit on lowered expectations). China's hard landing worries, so prevalent last month, have abated, as it appears the country's growth is holding at impressive levels and inflation is cooling.

Central banks globally are in monetary easing mode. In Asia, the rate cycle is about to turn as fighting inflation gives way to supporting growth. Asian central banks have plenty of headroom to cut rates.

In China, Premier Wen Jiabao said he would seek a "well timed and measured pro-active fine tuning" in macro policy. This is the most clear sign yet of monetary easing coming perhaps in a RRR (reserve ratio requirement) cut by year-end and a rate cut by Q1'12. The ECB is expected to embark on rate cut in December; the BoE (Bank of England) has already announced additional £75bn in QE and more could follow. Speculations are growing that US Fed will embark on a new round of QE, this time buying MBS (mortgage backed securities) instead of Treasuries. The ECB's SMP (secondary markets programme) remains active and Mario Draghi, the incoming ECB President said "non-conventional" policies would be kept open so long as markets remain volatile.

...and the not so good

The focus is starting to shift to the US debt Super committee and its November 23 deadline. The lack of a deal could very conceivably prompt additional downgrades of the US by Moody's and Fitch who still have USA as AAA rated. Back in August, the S&P 500 index plunged more than 6% in a day following the downgrade. Another US downgrade could hurt domestic sentiment and confidence, and could also have implications for Europe where many of the same dynamics remain in place – high debt/GDP ratio, high fiscal deficit, slow growth and in case of Italy: political wrangling on how best to address debt and deficit.

The threat of recession in Europe is heightened. The most potent indicator of it, German PMI, has declined every month since April this year dropping below the crucial mark of 50. The October data came in at 48.9, a two year low and way below the 62.7 reading this February.

A big week of data is coming up starting with the FOMC meeting in the US. The market doesn't expect the Fed to take any action although Bernanke will most likely be asked about MBS during the press conference. The ECB meets on November 3 and while the market doesn't expect Draghi to cut rates this time, it is keen to hear his remarks regarding the SMP – will he pledge to keep it open? And continue buying more Italian and Spanish debt to tame yields?

The G20 leaders meet on November 3-4, given the European officials are trying to drum up support for the EFSF, a commitment for support with details worked in could help the market.

While the problems with Europe are bearish in the long term, dynamics in the short term are a different matter. After all this Europe debt crisis has been going on for over two years now, and in the two years we have seen many rallies and many sell-offs, more than we would have liked. The message is some dislocations take a long time before the final solution is reached, and as investor it pays to be nimble and tactical with shortened horizon. Overall, the risk is more to the upside than to the downside. However, it will be laced with volatility. Investors have to be nimble, i.e. sell rallies and take profits getting ready for new positions.

A referendum in Greece may complicate things and may lead to risk aversion in the short term but the referendum itself is slated for early next year and we don't know how the question will be framed. Polls still indicate the majority of the Greeks want to stay in the Euro.

Where to invest in these uncertain times

A recent JP Morgan report suggests that investors are underweight risk assets and not positioned for a rally. 40% of active fund managers are trailing their benchmark by 2.5% and Hedge Funds are still net short. Recent upswing in economic data could easily see a rally into yearend as portfolios are adjusted.

At the individual stock level, it is best to screen stocks for – high dividend yield, large market capitalization, an S&P credit rating of at least investment grade – and then choose from the stocks that have sold off most relative to the index.

I would be cautious when buying European financials which continue to look cheap from a valuation point of view; however, they could get cheaper. Buy only as short term trades on the back of positive announcements from Europe but sell into the strength. The risk of the unknown remains and the conversation about more regulation, additional taxes on financial transactions, reduced leverage and high Tier 1 capital ratio will make banks look more and more like utility companies.

The structural bull case for emerging markets (EM) remains. Both the fiscal deficit and public sector Debt-to-GDP is lower than the developed market (DM). The IMF predicts 2011 Nominal growth in EM and the developing world to be four times that of Advanced Economies. However, I would be careful of exposure to Chinese banks and property sector. Government interventions notwithstanding, banks stock will lag if NPL (non performing loans) continue to rise.

Russia has one of the highest levels of FX reserve and public debt is extremely low, at current levels the Russian equity market look very discounted. With forward PE of 5 x it's nearly half as expensive as the EM. The key risk to Russia's positive story is a sharp decline in oil prices. While I am not bullish on oil, I don't see a sharp decline either. For Russia, market risk usually comes from capital flight as political risk increases. With Putin coming back as President, political uncertainty should recede.

EM credit especially high yield has suffered in the recent correction and presents an opportunity. Investment grade US corporate bonds are still a good play given no immediate fears of a rate rise. I would recommend absolutely no exposure to European peripheral bonds or equity unless the ECB steps in to support the Eurozone in a committed way.

All in all – we may not be guaranteed good weather or a solution to Euro crisis but we are definitely guaranteed volatility, especially with the VIX overshooting the 40 mark on more than five occasions in the last couple of months, compared to normal levels of 20. This is where structured products and option strategies come in handy. Here, an investor does not necessarily take a directional view but more of a range-bound view, which helps monetize volatility and correlation which trade at premium during times of market uncertainty. To express a short EUR view, instead of an outright Put option on EURUSD, a Put spread (1.40-1.30) as short term 3 month/6 month trade is recommended. This is cost effective and we know that Europe will continue to come up with patch up solutions so the risk of EUR trading secularly down is not very real yet. Similar strategies can be employed towards equity indices, individual stocks or even interest rates.

Best wishes



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