



Market Viewpoints

Manish Singh

April 2013

Coming together is a beginning; keeping together is progress; working together is success.

-- Henry Ford

With every passing day, the Eurozone resembles the legendary Potemkin village – a fake construct that hides behind its facade a potentially damaging situation. Every time there is a crisis, the Eurocrats in Brussels have a new “construct” to calm the markets, but the picture behind the scenes is getting worse. If the original Potemkin village was a small settlement, the Eurozone is a Potemkin village on a Jurassic scale. Nothing will ever change the reality in the Eurozone – the individual countries have very different underlying productivity rates, as well as social and political systems and therefore a fixed exchange rate (the Euro) cannot bind them together without straitjacketing and destroying some of them (as is becoming evident now). Amid the Eurozone gloom, hope springs eternal for the US economy. February personal spending numbers, released last Friday, suggest the US economy grew at a clip over +3.5%. No doubt the “wealth effect” of increasing house prices is fuelling this rise in personal spending of US consumers. Despite my bullish views on the US economy, I expect things to slow down in Q2 as the impact of Sequestration grows and the debt ceiling debate is back in focus. The seasonal trend of a strong Q4 and Q1 followed by a weak Q2 could materialize yet again.

Potemkin village

Legend has it that in 1787, Russian Minister Grigory Potemkin, in an effort to impress Empress Catherine II on her visit to the Crimean Peninsula, constructed “fake villages” along the Dnieper River. He assembled these villages at the turns of the river just before the royal barges came into view so that the Empress could be comforted by excited, happy and grateful peasants cheering her on. When the barge went out of view, Potemkin would uproot these settlements and transport them, by night, further down the river, only to assemble them again ahead of the royal barges' onwards journey down the river the next day.

With every passing day, the Eurozone resembles this Potemkin village story – a construct that hides behind its facade a potentially damaging situation. Every time there is a crisis, the Eurocrats in Brussels have a new “construct” to calm the markets, but the picture behind the scenes is getting worse. If the Potemkin village was a small settlement, the Eurozone is a Potemkin village on a Jurassic scale.

Nothing will ever change the reality in the Eurozone – the individual countries have very different underlying productivity rates, as well as social and political systems and therefore a fixed exchange rate (the Euro) cannot bind them together without straitjacketing and destroying some of them (as is becoming evident now). Seeking to keep them all together is as useful as shovelling snow during a blizzard.

Aggregate GDP figures do not uncover the underlying disparities that have been accumulating within the Eurozone. Since 2000, the Industrial production index in the Eurozone is flat but the industrial production in Germany is 35-40% better than in France during this period. Yet, since 2000 the French GDP has grown by +108% whereas Germany's GDP has grown by only +90%. How is this possible? The answer: Higher government spending in France, where debt-to-GDP rose from 60% to 90%. This has helped keep GDP growth in France ahead of in Germany. If you were to use GDP as the only metric, you would actually conclude that France is doing well! It is not just France; the same is true of Spain and Italy. Rising sovereign debt has masked the collapse of the private sector production in the non-German European economies over the last decade.

If a united Europe was meant to bring convergence, it has done everything but converge the economies. The



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convergence in borrowing costs, which was seen as the triumph of the Euro, has come back to bite and made the underlying divergence worse. What the Euro has delivered is nothing more than false prosperity in the South that has bred a sense of entitlement and opposition to any structural reform. 83% of Spaniards, 69% of Italians and 58% of the French own their homes. By comparison, only 44% of Germans own their home. According to a recent Bundesbank study, the average household wealth in Germany is 195,000 Euros, compared to 229,000 Euros in France, and 285,000 in Spain.

Anti-Euro sentiment is on the rise and it has brought the government formation in Italy to a standstill. As I pointed out in my last newsletter <http://crossbridgecapital.com/market_viewpoint/2013/CRO_MarketView_March_2013.pdf>, Italy is the one to watch for any signs of a complete breakdown of the Eurozone. As Italy goes, so goes the Eurozone.

The Cyprus "bail-in" and capital controls are the first clear signs of financial repression in the Eurozone. Financial repression will morph in different ways. The "bail-in" is one, and a "wealth tax" could be next. We see the debate on a "wealth tax" in the UK with politicians falling over each other to take over where Robin Hood left off. At this rate, it may not be long before having a full tank of petrol will qualify you for such a tax.

Hope springs eternal

Last week, the Eurozone Manufacturing Index came in at 46.8, down from 47.9 the month before. Every country in the Eurozone (including Germany) had a sub-50 reading. Anything above 50 indicates expansion from the month before. Anything below 50 indicates contraction. The manufacturing number for the Eurozone has now remained below the 50 mark since August 2011.

We also see yet more fiscal slippage and this is without any acceleration of structural reforms.

- France's 2012 deficit came in at 4.8% of GDP overshooting the 4.5% target
- Portugal's 2012 deficit grew to 6.4% of GDP, well above the 4.4% target
- Spain is seeking to ease its fiscal target for 2013, from 4.5% to 6% of GDP

Amid the Eurozone gloom, hope springs eternal for the US economy.

- The companies in the S&P 500 have healthy balance sheets. The total leverage - debt/equity for the Index is down to 108% from an average of 173% over last two decades and well below the highs of 220% in 2004-05. The Interest coverage ratio (EBIT/ Net Interest payment) is up to 7.2x from an average of 3.8x of the last two decades and the lows of 1x in 2008-09
- US current account, as a % of GDP, is under repair moving from a deficit of -6.5% in 2005 to the current level of -2.5%
- As income has grown, US consumers' debt payment/disposable income has fallen from 14.1% in 3Q07 to 10.4% in 1Q13
- Exports make up 9.8% of US GDP; and only 1.5% of these are exported to the Eurozone. Therefore, while the problems in the Eurozone will have an effect on US sentiment, they will not have a material effect on US earnings. On Tuesday this week, the S&P 500 closed at a new record high of 1570.25
- US house prices are firing on all cylinders. The latest S&P Case-Shiller Index reported prices were up a further +1.02% in January. This is the 12th consecutive monthly increase. The index is up +8.08% on a year-on-year



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(YoY) basis

- US factory orders came in above expectations (+3%) with strong orders for autos and aircraft, which perhaps offsets some concerns following Monday's disappointing ISM manufacturing number (51.3 vs. 54.0)

Where to invest

The week will see a spate of Central Bank activity. This morning we had the Bank of Japan (BoJ) policy announcement, the first with the new Governor Haruhiko Kuroda at the helm. The BoJ decided to increase the outstanding monetary base by JPY 60-70 trillion every year, estimated to be JPY 200 trillion and JPY 270 trillion at the end of 2013 and 2014 respectively. In particular the JGB (Japanese Government Bond) purchase will be increased to JPY 7 trillion per month from the current JPY 3 trillion. This means a bear hug for the JPY. The BoJ intends to double the average remaining maturity of JGB purchases to seven years and asset purchases will include ETFs and J-REITs. Pushing down long end yields is bullish for Japanese equities and encourages fixed income outflows. The central bank has also set a two year target of achieving its 2% inflation target. The inflation rate currently stands at -0.7%.

The European Central Bank (ECB) and the Bank of England (BOE) also meet later this afternoon. The market isn't expecting a change in policy from the ECB, but Draghi's post-meeting press conference will be interesting in light of the recent events in Cyprus and the disappointing macro data in the Eurozone.

On Friday, we get the US payrolls report for March. Market attention will be on the unemployment rate (currently 7.7% and expected to be unchanged for the month), which is seen as the key metric for the Fed's monetary policy stance. We will also receive the first look at Q1 GDP at the end of April, but the February personal spending numbers, released last Friday, suggest the US economy grew at a clip over +3.5%. No doubt the "wealth effect" of increased house prices is fuelling this rise in personal spending of US consumers.

The S&P closed out March with a gain of +3.5%, (+10.6% YTD) and the index is now +153% from its lows in March 2009. This more than doubling of the index is not without a reason. The EPS (earnings per share), which were \$50.8 at the lows in March 2009, are now expected to be at \$110 i.e. the rally has kept pace with the earnings improvement.

At such levels of earnings, the current valuation of the S&P 500 amounts to a P/E of 14.3. The 15 year average of the S&P 500 is 16.6. So, despite the rally since 2009, we haven't really seen a P/E expansion and this makes the current rally more stable and any sell-off more contained.

Given their more attractive valuation, I continue to prefer US to European equities. I also prefer UK and Japanese equities to European equities. My faith in the latter two has paid off well so far in 2013, with the indices up +9.7% and +21.6% in local currencies respectively (+2.5% and +11.8% in USD terms). The easy money policy of the BoE and the BoJ is set to continue and so is the weakness of the GBP and JPY, giving an added boost to local equity markets.

Some of the stocks I like in the UK - Prudential (PRU), Taylor Wimpey (TW), Centrica (CAN), Vodafone (VOD), Whitbread (WTB), F&C Asset Management (FCAM), Schroders (ADR), Anglo American (AAL), British Petroleum (BP) and BG Group (BG).

In Japan, I would borrow JPY and buy the Nikkei Index and if you prefer a USD-hedged ETF, I would recommend [Wisdom Tree Japan Hedged Equity Fund](#) (DXJ).

Despite my bullish views on the US economy, I expect things to slow down in Q2 as the impact of Sequestration grows and the debt ceiling debate is back in focus. The seasonal trend of a strong Q4 and Q1 followed by a weak Q2 could materialise yet again.

My overweight sectors and industries are: Financials, Healthcare, Consumer Discretionary, Media, Technology and Energy equipment & services.

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Some of the stocks I like:

Financials - WFC, BAC, C, MS, USB, JPM
Healthcare – MRK, PFE, JNJ, CVS
Consumer discretionary - MCD, CBS, DIS, HD, KO
Tech - GOOG, MSFT, AMZN, IBM, HON
Energy equipment & services: SLB, HAL, BHI, CAM

In the Eurozone, despite the gloom, you could still pick stocks with good cash flow and balance sheets and keep building the European stock portfolio to benefit from any relief rally or thaw in the crisis.

Some of the names I like – UBS, Credit Suisse, SAP, Novartis, Roche, L'Oreal, Unilever, Schneider Electric, PPR, Adidas, Total, Linde, ABI Inbev.

Currencies

As mentioned above, The BoJ's first meeting under the new Governor took place today and the announcements were very significant for the currency market. We saw a sharp move in USDJPY, which is now trading at 95. There is room for further weakening of JPY and it is set to go to 100 at least, if not beyond in the medium term. Mr. Kuroda is shaping up to be the Volker of Japan. Fed Governor Paul Volker defeated inflation in the US in the 1980s. Kuroda's mandate is to defeat deflation: A weaker JPY is one of the key tools to help him achieve this. The enlarged asset purchase program approved today was by a unanimous vote. This strengthens Kuroda's hand and indicates there is a sea-change in the thinking at the BoJ under the new leadership.

Gloomy manufacturing numbers and a forecast jump in the February unemployment rate to 12% in the Eurozone will keep EURUSD firmly anchored. We may see an ECB rate cut but it's not a rate cut that the market is focused on right now given the financial troubles in the periphery of the Eurozone. Clarification will be sought from Mr. Draghi on the ECB's tough stance last week, where the ECB threatened to cut Cyprus off from the Emergency Liquidity Assistance (ELA) program (and thus de facto pushing the country out of the Euro) if no agreement had been reached with the Troika.

GBP is seesawing between weakness and strength on the expectations of a new aggressive BoE Governor and its safe-haven status. The risk is still weighted to the downside and I expect the BoE to do another round of QE in May/June. The GBP is therefore headed to 1.45 and below by the end of Q2 if not before.

Best wishes,

Manish Singh, CFA

I am very pleased to announce that Crossbridge Capital have been shortlisted in the 2013 Magic Circle Awards under the following category;

- **Private Client Asset Manager - Boutique category**

Voting closes on April 26 and we would greatly appreciate your support via <http://www.citywealthmag.com/awards>

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