



Market Viewpoints

Manish Singh

August 2013

Whenever you find yourself on the side of the majority, it is time to pause and reflect

-- Mark Twain

2013 has been a buoyant year for US equities and aside from a few sputters, the rally continues. The big question is do we see a *sizzle*, a *snooze* or even a *meltdown* from here on out? A sizzle -and a quick move higher- is unlikely, a snooze is more likely before we resume the upward climb to the 1744 level on the S&P 500 by year end. A big market correction or meltdown very often is a result of an unexpected event appearing on the horizon. Perhaps this risk will be limited going forward precisely because such events – a slowdown in China or tapering in the US are already known. I am still positive on US equities, however I am more comfortable shifting the allocation from overweight US equities to a more balanced US-European equities mix. Over the next two quarters, European equities offer a better return than US equities. Emerging Market (EM) equities have stopped declining as more long-term money finds its way back to these countries. Japan is a structural long trade, if you can stomach the volatility.

By George, it's a b(u)oy(ant market)

If the House of Windsor were a stock, the arrival of Prince George of Cambridge last week amounted to a major earnings boost and a stock upgrade. We witnessed column inches of articles and wall-to-wall coverage for what is simply a married couple having a child. There was the customary debate about monarchy and its benefits to the UK. I, for one, support the constitutional monarchy. Can you imagine a President Hollande or a President Prescott in the UK?

2013 has been a buoyant year for US equities and aside from a few sputters, the rally continues. The S&P 500 Index is up over +18% YTD and the developed markets have outperformed Emerging Markets (EM) by over +23%.

The FOMC statement last night was on the dovish side. There was a mention that inflation persistently below the 2% target could pose risks to economic growth. There was also a new mention of rising mortgage rates as a potential restraint on growth. Unsurprisingly, there was no mention of possible tapering. The FOMC wouldn't want to pre-commit to September tapering. The statement on forward rate guidance and threshold policy also had one change - the Committee "expects" a very accommodative policy to remain appropriate has changed to the Committee "today reaffirmed its view" about this accommodative policy. I read this as the FOMC's desire to push back against expectations of an early rate rise. As his term at the Federal Reserve comes to an end, Ben Bernanke desires to return monetary policy to more normal times, where the focus is on interest rates rather than on the balance sheet. I fully expect the FOMC to taper asset purchases at its next meeting in September.

We are more than half-way through the Q2 earnings season in the US and more than two thirds of companies have reported better than expected earnings. Disappointingly, more than half have guided lower for the next quarter. Despite this, the price action has been very positive and indeed supportive, as talk of tapering by the US Federal Reserve is digested. The S&P 500 Index rose by over +5% in the month of July and came within whisker of the psychological 1700 level.

The big question is do we see a *sizzle*, a *snooze* or even a *meltdown* from here on out? A sizzle -and quick move higher- is unlikely, a snooze is more likely before we resume an upward climb to the 1744 level and a P/E of 16 by year-end. As for a meltdown, that is the only fate of my Milky Way chocolate bar during this British summer! We generally see big market corrections only when an unknown risk appears on the horizon. Perhaps this risk will be limited going forward



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precisely because the events – a slowdown in China and tapering in the US - are already known. Having said this, the path to 1744 could run through the low 1600's with any combination of factors weighing in such as GDP disappointment, a pull-back in the US housing sector as higher rates get priced in, or even a rally in Japan checked by the proposed increase in sales tax.

I know what you said last summer

Last summer European Central Bank (ECB) President Mario Draghi said – *Within our mandate, the ECB is ready to do whatever it takes to preserve the Euro. And believe me, it will be enough.*

There is a saying - *A man says a lot of things in summer he doesn't mean in winter.* This was not the case with Mr Draghi. He meant it in the summer, in the winter and he continues to mean it today.

As the healing continues in Europe, risk appetite has grown. As reported by the *Financial Times* the issuance of subordinated bank debt has grown by over 100 percent in the first half of 2013 compared with the same period last year. Additionally, US money market funds have nearly doubled their allocations to European bank deposits and securities over the past 12 months.

Later today, investors await central bank announcements from the ECB and the Bank of England (BoE) as well as a slew of economic data including Chinese manufacturing and US Non-Farm Payrolls. I expect the US Non-Farm payroll numbers to be strong. The market is getting comfortable with the Fed's near-term policy outlook and the BoE has joined the ECB in giving "forward guidance" (Can't they call it guidance? I thought guidance was always forward, who gives backward guidance?)

The BoE will hold fire on more monetary easing and will rely on this "forward guidance" to communicate monetary policy. The ECB on the other hand is likely to do more to make things better. When we last heard from the ECB in July, they were concerned about the outlook for the region. Mr. Draghi said that monetary policy would remain accommodative as long as needed because there are downside risks to the economic outlook. As a majority of European leaders head off on holiday, the German leaders head back to their constituencies to prepare for national elections. Improving economic conditions in the Eurozone, as evidenced by the recent manufacturing data and a German Chancellor about to head to the polls, will prevent the ECB from taking any big actions until after the elections are over in Germany.

Where to invest

We are certainly at highs on the S&P 500 index but there is no reason it cannot go higher. Of course, we will see some pull-back with the likely announcement of Fed tapering in September, but equities are going higher. My end of year target on the S&P 500 is 1744.

As I wrote in [last month's newsletter](#), I remain positive on European equities and recommend building long positions. Over the next two quarters, European equities will offer better returns than US equities. In Europe, the Stoxx 600 index is still 25% below its 2007 high and the CAC index in France is 35% below its 2007 highs, even as the S&P 500 Index is well above its 2007 highs. Only the DAX is above its 2007 highs.

European companies have high-fixed costs, meaning they are leveraged, so the rebound in earnings won't come as easily as for their US counterparts. The rebound in European manufacturing and the rise in consumer confidence will help European earnings. The Eurozone Flash manufacturing data popped above the 50 recession/expansion line for the first time in two years indicating that the region's long drawn-out recession may be coming to an end.

I am still positive on US equities however I am more comfortable shifting the allocation from overweight US equities to a more balanced US-European equities mix. Sector-wise, in the US I like: Financials, Technology, Energy and the Industrials sectors. In Europe, I recommend Discretionary, Banks, Mining, IT, Industrial, and Healthcare. Specifically,



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some of the names I like: Accor, Mediaset, Daimler, BMW, British American Tobacco, HSBC, UBS, Barclays, Societe Generale, Prudential, Allianz, Rio Tinto, BME, Vinci, Saint Gobain, Fraport AG, SAP, BSKyB, Roche.

Japanese equities will continue to rally, with a few sputters, and will remain an attractive long bet. Prime Minister Shinzo Abe has sparked a turnaround in Japanese growth and household sentiment, which earned the LDP a huge victory in the recently concluded Upper House elections. The strong advance in June export volume and rising inflation expectations are all good signs for the Japanese economy. The volatility in the Nikkei is not Japan's fault. It is the market's fault, which always runs ahead of the news. Japan under Abe has enacted the start of a multi-year policy change to try to plot a different course for its economic future. After 20 years locked in deflation, I believe it is going to take a lot longer than a few months for the recovery to play out. Japan is a structural long trade if you can stomach the volatility.

Emerging market (EM) equities have stopped declining as more long-term money finds its way back into these countries. I would recommend tactically (not overweight) buying into EM equities, which have been sold down over the last two quarters. Of course, the slowdown in China is of concern but let's not forget there will be a response from Chinese central command if things worsen and we already saw some action last week when the State Council unveiled modest growth-support measures, including support for railway construction, tax breaks for small companies and reduced fees for exporters. China's new leaders are focused on restructuring, but they will be sensitive to downside growth risk. Premier Li Keqiang stated that 7% is an absolute "growth floor" i.e. a number below that begets stimulus. It is worth noting that the world has been waiting for China to stimulate its economy for a long time. Perhaps this time China will, as it is in its interest.

Currencies and Commodities

I still believe in the strength of the USD, at least until interest rates have peaked in the US, and this is not the case yet. However the FX market is prone to short term moves which may not be consistent with the medium to long-term outlook. Therefore, it is best to think in terms of levels.

Improving economic conditions in the Eurozone and elections in Germany will prevent the ECB from taking any big actions. This will keep the **EUR/USD** at the 1.33/34 levels for the next few weeks. At best, the move is going to be range-bound between 1.30-1.35.

GBP/USD, is a short, and even more so, if it gets to the 1.55/56 level, but a break below 1.47 looks some time away. The overall economic picture in the UK shows a pickup in activity but there are rumours of a rate cut and this could be the trigger that takes GBP/USD lower.

USD/JPY is unlikely to break over the 102-103 level anytime soon, unless we see more announcements and the continuation of policies advocated by Mr. Abe. Abe has expressed some reservations regarding the sales tax. He is concerned that a fresh levy on consumers could stifle Japan's nascent recovery before it has a chance to take hold. The currency could be range-bound between 94-100.

AUD/USD is prone to a downside move as commodity and China news worsen. A dovish Reserve Bank of Australia (RBA) Governor Glenn Stevens has indicated a rate cut is on the cards as early as the next meeting in August. A rate cut will take the FX pair to the 0.80/83 levels over the short term. If the RBA doesn't cut rates next week, expect AUD/USD to bounce as investors cover their shorts, but the new level will be a good level to go short again.

Gold comes under renewed pressure as an exit from easy monetary policy is mapped out and signs of inflation don't appear. As I mentioned last time, 1150-1200 is good level to rebuild long positions, but do not expect gold to break over the 1350-1400 level without first seeing signs of inflation.



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Best wishes,

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