



“ The fundamental cause of trouble in the world is that the stupid are cocksure while the intelligent are full of doubt. ”

– *Bertrand Russell (1872-1970)*

It's Back to the Future for the markets. Last week, both the Dow and the S&P traded at five year highs with the Indices hitting 14,000 and 1500 respectively. Every time the US market trades at a multiyear high, fears of a pullback descend. Keep in mind however that back in 2007, the US unemployment rate was 4.7%, the 10 year US Treasury yield was 4.68%; both indicators (as we now know) of an overheated economy at the top of the economic cycle. Today, the 10y US Treasury yields 1.98% and the unemployment rate is at 7.9%, both far from a cycle top. Downside risk also remains supported in the medium term by an extraordinary mix of central bank actions and fiscal policies we have seen thus far and they are set to continue. So what could go wrong? The lifeblood of this rally can be traced back to Europe and ECB President Mario Draghi's actions and July 2012 speech, it is therefore imperative for Europe to resolve the upcoming macros issues favorably – the Italian elections, the future of Cyprus in the Eurozone, Spain's budget, and the negotiation of Ireland's existing bailout package. We may have to contend with a volatile February as US budget sequestration and Italian elections loom, but the risk remains to the upside.

In October 2007 when Sarkozy had just settled into the Elysée Palace, Romano Prodi was the Italian Prime Minister, Oil had reached a peak of US\$90 and the Euro was trading at 1.4348, the highest level against the US dollar, The Dow Jones Industrial Average (DJIA or the Dow) touched the 14,000 level for the first time. It closed at a peak of 14,164 on October 11, 2007. Thereafter, the Dow had a “Marty” McFly-like journey into the past reaching 6,626 in March 2009, before starting a travel back to the future.

Last week the Dow arrived at 14,000, again. Movie buffs will know that “Marty McFly, the lead character in the Back to the Future trilogy is still travelling into the future and will arrive on October 21, 2015. At which level will the Dow be when Marty arrives and checks it on his iPad 7, is anyone's guess. However, if I were to guess, I would say the Dow would be over 17,000 by then.

Last time the Dow hit the 14,000 level, the US unemployment rate was 4.7%, the 10 year US Treasury yield was 4.68%; both indicators (as we now know) of an overheated economy at the top of the economic cycle. Today, the 10y US Treasury yields 1.98% and the unemployment rate is at 7.9%, both far from a cycle top.

A mix of staples and cyclical stocks delivered this doubling of the 30 stocks Index from the lows of March 2009, namely- IBM (+85%), McDonald's (+39%), Travelers (+36%), Home Depot (+35%), Chevron (+32%), WalMart (+24%) and Caterpillar (+22%).

Despite the recovery in equity prices, we have not seen a significant recovery in the economy and this shouldn't surprise us. For a good understanding, I would like to reference an excellent paper: The Decade After the Fall: Diminished Expectations, Double Dips, and External Shocks authored by the cerebral wife and husband economist team of Professors Carmen Reinhart and Vincent Reinhart.

In this paper Reinhart and Reinhart look at the 1929 stock market crash, the 1973 oil shock, the 2007 US subprime collapse, as well as fifteen severe post-World War II financial crises – amongst them Spain 1977, Sweden and Finland 1991, Japan 1992; Asia 1997, Argentina and Turkey 2001.

They compared economic performance using annual data in the decade before and the decade after the crisis. I will insert the dates and data from the current crisis to make the conclusions more relevant:

- After a severe financial crisis (2007), an economy goes into a deep and long recession. A shallow recovery follows (2009). In the second half of the decade (2012), expansion takes hold.
- The median post-financial crisis GDP growth decline in the advanced economies is about -1% (Current post crisis US GDP growth rate of +2% is below +3.3% growth rate pre-crisis).

- In the ten-year window following severe financial crises (2007-17), unemployment rates are significantly higher than in the decade that preceded the crisis (US unemployment rate reached 10% from a low of 4.4% pre-crisis and is currently at 7.9%).
- Not surprisingly, in 10 of the 15 cases, the unemployment rate never regains its pre-crisis low (4.4% for US in Q4 2006). No wonder the US Fed has a target of 6.5% and not 4.4%. Some jobs have been lost permanently never to return and innovation is the only solution to the jobs problem.
- In 7 of the 15 cases, there are two recessions in the subsequent decade (will we see two recessions in the US during the next five years? The latest Q4 GDP print was -0.1%). If we see one, let's hope it's a mild one.

Humpty Dumpty sat on a wall

Every time the market trades at a multiyear high, fears of pullback descend. Now that both the Dow and the S&P are trading at five year highs, everyone is wondering whether Humpty Dumpty is about to have a great fall?

I don't believe so.

First, the "fiscal cliff" back-down and now the debt ceiling back-down are proof that behind the posturing, US policymakers of both hues, red and blue, know that the recovery is weak and it's not the time for austerity. There is one fiscal drag that remains (that could make February a volatile month for equities), the budget sequestration in the US: \$1.2trillion in automatic spending cuts over ten years starting March 1. I have a feeling that like the other recent deadlines, this will be re-negotiated and perhaps re-phased or even deferred until after the mid-term elections of 2014.

Second, a multiyear high doesn't necessarily bring a pullback, but higher valuations do. The S&P 500 closed on Friday at a level of 1513.17. The last time it traded at this level was in late 2007. At that time, the P/E ratio on the S&P 500 was 17.5. As one would surmise, earnings have grown since that time and the current P/E ratio of the S&P 500 is just 14.7. To be trading at a 17.5 P/E, the index would need to rally by more than +16%, assuming zero earnings growth.

Third, Wall Street's enthusiasm for equities is still subdued and equities are not overbought or over-recommended, yet. One indicator I like to follow closely is the Bank of America Merrill Lynch's "Sell Side Indicator"- The Sell Side Indicator is based on the average recommended equity allocation of Wall Street strategists as of the last business

day of each month. This proprietary monthly sentiment gauge is currently at 49.8, i.e. Wall Street is recommending its client a 49.8% allocation to equities. A number below 55 historically has been bullish for equities. The indicator does not turn bearish on equities until allocation has reached above 66%.

So what could go wrong for Humpty Dumpty? Given that the lifeblood of this rally can be traced back to Europe and ECB President Mario Draghi's actions and July 2012 speech, it is imperative for Europe to resolve the upcoming macros issues favorably – the Italian elections, the future of Cyprus in the Eurozone, Spain's budget, and the negotiation of Ireland's existing bailout package. So far, the calmness in Europe looks set to continue. Europe even had a bank failure last Friday (SNS Reaal, the fourth largest Dutch bank was nationalized at cost of €3.7bn to taxpayers) but markets scarcely noticed. Did you?

The US Q4 earnings season is nearly over and it has been a good one. Over three-fourth of companies (by earnings weight) in the S&P 500 Index have reported. 74% of them reported better earnings than the mean estimate (with average earnings surprise of 5%) and 66% reported better sales. The Financials, Consumer goods, and Basic Materials sectors had the highest earnings surprise for the quarter. The estimates put 2012 final EPS (earnings per share) moderately above US\$103. The corporate guidance thus far supports 2013 bottom-up EPS of US\$110-112. Using a historical median P/E levels of 14.5, gives an end of year S&P range of 1595 - 1624 (well above my end of year target of 1554 which is based on earnings of US\$111, P/E of 14 and makes a concession for loss of momentum in the rally as we go through the year).

Where to invest?

The housing market in the US clearly bottomed out in 2012. This will heal the balance sheet of households and financial intermediaries with large exposure to the housing sector. The first two major data points of the new year – the US Jobs report and the ISM data from last week further support the notion that US economy is on a growth path, albeit a below trend one. US housing, consumer spending and business investment were stronger in Q4. US automakers posted double-digit sales gains for January: Ford +21.8%, Chrysler +16.4%, GM +15.9%. The ISM Manufacturing index rose to 53.1 from 50.2 in December with just two of the index's ten subcomponents below the 50 threshold of growth versus contraction.

The risk remains supported in the medium term by an extraordinary mix of the central bank actions and fiscal policies we have seen thus far. This has been my basis for

long call on equities for the best part of last year and the basis for this year as well.

Among the sectors and themes: Plays on global growth and capital spending (Technology, XLK, Materials, XLB and Industrials, XLI, Energy, XLE, Consumer Discretionary, XLY), dividend growth (Financials, XLF and Technology, XLK), and defensive but undervalued (Healthcare, XLV). Some of the stocks I like:

Technology - AAPL, GOOG, IBM, INTC

Energy and Materials - CVX, SLB, HAL, DD, FCX

Financials - JPM, BAC

Industrials - GD, UTX, EMR, HD

Consumer Discretionary- MCD, PEP, PG

Healthcare - PFE, MCK, AMGN

Currencies have seen big moves recently - and as anticipated JPY, CHF and GBP all weakened and EUR strengthened. Eurozone sentiment and widening policy differentials between the ECB and the US Fed sent the Euro to 1.37. An even bigger move has been seen in the EURJPY (+25% up move since November 2012). Surely this will get European exporters worried.

So where next for the EUR? After advocating a Long EURUSD for over three months now, I feel the time is fast approaching to short EUR (the move may have already started). I see EUR topping out at 1.40, if it gets there. The ECB may do some "verbal easing" if not a rate cut. Mr. Draghi's upcoming ECB press conference (February 7) could "talk down" the EUR. A strong Euro may give comfort to policymakers defending Europe but it increases economic divergence within the Eurozone and punishes the less competitive economies.

January has not been a good month for safe assets. However of the lot, Gold has out-performed the Swiss franc as well as US Treasuries, and all three have outperformed the JPY (which is undergoing a planned devaluation). Global reflation themes are here, but Gold lacks a catalyst in the near term to take it higher. Opportunistic selling may actually take it lower. Technically, Gold at \$1650 has strong support.

In the industrial metals complex, Copper is coming back into favor, but the surge is going to be tepid and slow. Bulls will wait for more data that a) confirms China's growth rate and b) confirms a decline in copper inventories.

Crude Oil at \$97 and Brent at \$115 firmed up with tensions in the Middle East adding to price movement on reports of

Israeli strikes on the Syrian-Lebanese border. However, I would not put a long trade at this level unless there was a concrete sign of escalation. The risk to Crude is more to the downside, given softer global growth estimates.

As for bonds, if you are a buy-and-hold investor, you have nothing to worry about and local currency bonds in Emerging Markets still offer good yield and currency appreciation. If you are an investor who likes to trade bonds for total return, I will keep my fingers crossed that you find an exit when the "bond bubble" finally unravels. This late in the bond-buying cycle, adjusted for risk, equities clearly offer a better investment than bonds.

Best wishes,



Manish Singh, CFA

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