



## Market Viewpoints

Manish Singh

July 2013

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**All that we are is the result of what we have thought. The mind is everything. What we think we become**

-- *Buddha*

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Since its peak in May, the S&P 500 has run into a number of headwinds: Doubts about Abenomics in Japan, tapering in the US, a self-inflicted credit crunch in China, capital flight in the Emerging Markets, a government overthrow in Egypt, and so on. However, we haven't seen any panicked sell-offs. The stock market is placing each issue in context. This is a good thing. Slowly but surely, different sectors and aspects of the economy are returning to more normalized pre-Lehman levels. The US is on an upswing. As the Emerging Markets have recovered and then cratered, the US market has recovered and then recovered more. The US stock market, the US economy, and the US Dollar are all at the top, relative to their peers in Europe, Japan and the Emerging Markets. However, September 18 is still on track to be the day the US Federal Reserve makes its 'tapering' announcement. Should we be afraid of tapering? Of course not. European stocks have not done as well as their US counterparts this year. For H1, the US was up +12.63%, compared to flat or negative performances for the UK, Germany and France. I strongly believe that this quarter could be different. European companies are taking advantage of low borrowing costs and given the "kitchen sink" work must be over by now, it is time for earnings in Europe to start bearing the fruit of the repair work of the last few quarters. I expect European company earnings to surprise to the upside and therefore I would be overweight Europe v/s US this earnings season.

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### Top Gun

If my film knowledge serves me correctly, the movie *Top Gun* ushered in a first - the waving of the U.S. flag in slow motion. Producer Jerry Bruckheimer has since used this visual representation repeatedly in his film career and it also seems to be the dominant image in the post-Lehman world. As the Emerging Markets have recovered and then cratered, the US market has recovered and then recovered more. The US stock market, the US economy, and the US Dollar are all at the top, relative to their peers in Europe, Japan and the Emerging Markets. The US is on an upswing, but no, I am not advocating putting 100% of your money in US equities or the US economy or booking a holiday to Nantucket, far from it.

Over the last two weeks US Fed Chairman Ben Bernanke has been coy with the talk of tapering; the point at which the Fed reduces its \$85 Billion monthly purchases of Treasuries and other securities. However, his comments, combined with improving US economic data suggest that September 18 is still on track to be the day the Fed makes its tapering announcement. The Fed would then start reducing its asset purchases towards the end of Q4.

Should we be afraid of tapering? Of course not.

For one, the Fed is not raising the base rate when it tapers and secondly, the market now seems conditioned to the idea and reality of bond yields rising. On Friday last week, we finally saw a break-down in the relationship between equities and rising 10y US Treasury yields. Up till now, every time yields rose, the market fell. On Friday the UST 10Y yields increased by 24bps to 2.74%, yet the S&P 500 finished higher. This indicates Mr. Market has had time to digest and price in the tapering chatter and is ready to move on. This is positive for the equity markets.



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Slowly but surely, different sectors and aspects of the economy are returning to more normalized pre-Lehman levels. US retail sales, US factory orders, manufacturing and housing all continue to do better. The US jobs report last Friday also came in strong:

- Employment increased by 195,000 in the month of June with upward revisions to prior months. The unemployment rate held at 7.6%. The second quarter saw job creation at the rate of 197,000/month. Q1 was at 207,000/month i.e. there has been no loss of momentum in Q2 despite the fear of budget sequestration in the US
- Average hourly earnings also saw their largest monthly increase since November 2008. This trend bodes well for retail sales in the US

I also like to watch data (highlighted by Bespoke Investment Group) around the sale of pick-up trucks to gauge the health of the US economy. Sales in this class of vehicle are often a sign of strength/weakness in the small business and construction sector. Last Tuesday's numbers from Ford regarding F-150 sales are another strong positive signal.

- During the month of June, sales of F-150 trucks increased more than 20% to 68,000. This represents the largest total since 2005
- Year to date (YTD), Ford has sold 367,000 F-150s. That is also an increase of over 20%, and is the highest YTD sales total since 2006

The key question now for the equity market is: Will the rally continue if earnings disappoint? Even if the rally does stall, I do not see a sustained downside and I continue to be bullish the US Dollar and US economy.

### Pay it forward

In 1841, Ralph Waldo Emerson wrote: "In the order of nature we cannot render benefits to those from whom we receive them, or only seldom. But the benefit we receive must be rendered again, line for line, deed for deed, cent for cent, to somebody."

For the first time in its lifetime, the European Central Bank (ECB) finally broke away from its sacred "no pre-commitment policy" and provided forward guidance in words similar to the ones used by Bernanke in 2009.

Europe, the UK and indeed the rest of the world have benefited from Bernanke's easy money policy. As the Fed charts an exit, the ECB and the Bank of England (BoE) seem to have taken over the job of providing accommodative policy i.e. *paying-it-forward*.

Mario Draghi, President of the ECB noted: "The council took the unprecedented step to give forward guidance. The council expects all interest rates to remain at present or lower levels for an extended period of time."

Mark Carney, newly installed at the helm of the (BoE) sounded equally dovish. This sent GBP crashing through the 1.50 barrier versus the USD and the FTSE 100 Index up. Both moves are likely to continue.

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Crossbridge Capital LLP

9 South Street London W1K 2XA United Kingdom [www.crossbridgecapital.com](http://www.crossbridgecapital.com)

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For the coming weeks, the focus will stay on macro themes like China, Japan and indeed Europe but investors will refocus on US Q2 earnings which kick-off this week. The Fed tapering, even if announced, is unlikely to be a large reduction at least until the US unemployment rate is below the 7% level (it is 7.6% currently). Therefore, I am not concerned about a downside to US equities.

The strong dollar of the past quarter doesn't make me bullish on US earnings however. Equity strategists also expect only half the amount of gain in earnings in Q2 as compared to Q1. Perhaps the gains in the S&P in Q3 will be smaller than what we have seen in the first half of this year. Given the weakness of other currencies vis-à-vis the US dollar, I expect European company earnings to surprise to the upside and therefore I would be overweight Europe v/s US this earnings season. After advocating overweight US equities for a long time, the UK, Germany and France equities are my suggested overweights now.

Sector-wise in Europe, I recommend Banks, Insurance, Construction, Autos & Parts, Software and Media. Specifically: HSBC, UBS, Barclays, Prudential, Standard Life, Allianz, Vinci, Fraport AG, BMW, Daimler, SAP, Cap Gemini, BSKyB, Reed Elsevier.

In Japan, Abenomics is hitting the mark with deflation ending, and inflation expectations rising. The Upper House elections of July 21 seem to be in the bag for Mr. Abe. The Nikkei index has resumed its upward climb after a temporary slide and has recovered more than half of the ground it lost in May/June. Japanese Government Bond yields have stabilized, and economic confidence is rising. I continue to advocate long and overweight Japanese equity positions.

In the US, I still favor Financials, Technology, Industrial and Energy. One particular stock I will point out is US Insurer UnitedHealth (UNH) – it benefits from Obamacare, a strong US dollar, and most if not all its earnings are domestic. They report their Q2 earnings on July 18.

Some other US stocks I like: Wells Fargo (WFC), JP Morgan (JPM), Citi (C), PNC Financials (PNC), General Dynamics (GD), United Technologies (UTX), CBS Corp (CBS), Google (GOOG), Amazon (AMZN)

### Currencies and Commodities

A strong USD bodes well for equities but is a bane for the commodities sector. Gold is down -27% for the year and now trades at \$1,214 per ounce. With the average hourly earnings increase witnessed in the US, are we seeing the first signs of inflation? It is premature to conclude that from one reading alone. However, if this were to be repeated for July and August, it could bring a bid back in Gold. Either way, investing in Gold is never a way to make a quick buck. Gold at \$1,150-1,200 could have a little more downside, but it does present an opportunity to start building positions again.

In currencies, given the Dovish signs from the BoE and the ECB, short positions in EUR/USD and GBP/USD both have more to gain. My two month target is 1.42 for GBP/USD and 1.25 for EUR/USD.

It seems the move in USD/JPY beyond the 100 level has started once again. USD/JPY didn't wait for the Upper House elections in July; perhaps it is because the data indicate Japan is beating deflation successfully and the polls indicate Abe will easily win.

The credit crunch, and fear of it in China, will keep commodities depressed and this should keep AUD/USD weak. The Reserve Bank of Australia (RBA) last week kept rates unchanged. However, it may be challenged next time around. At



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0.90, AUD/USD may look like a tactical buy but be wary of a move to 0.85 if the RBA cuts rates and China's situation doesn't improve.



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