



I never hesitate to tell a man that I am bullish or bearish. But I do not tell people to buy or sell any particular stock. In a bear market all stocks go down and in a bull market they go up. - **Jesse Livermore**



**The second Greek bailout is not a gift. It is a one-pronged austerity drive with no provision for growth. If the Eurozone is to be kept intact, Peripheral Europe will need a plan on the lines of the “Marshall plan,” which engendered the highest rate of economic growth in European history, to carry out reform. The ECB’s two rounds of cheap funding, LTRO, have not eliminated the risk of systemic failure, they have merely taken it off the table. Let’s keep in mind that a trillion Euros of additional bank debt will make any systemic failure in the future even greater than the one we are faced with today. Whether the LTRO liquidity is used by banks to pocket the spread on the carry trade, or lend more to the real economy, will shape what direction the crisis takes next. While I feel encouraged by the improving macro conditions, particularly in the US, and the risk to the market remains more to the upside than the downside, elections in April and May in Europe could cause volatility. The historical strength of the Japanese Yen has hurt the Japanese Equities market in the past, but recent JPY weakness could be here to stay, with the Nikkei being the prime beneficiary.**

In a recent WSJ interview ECB President Mario Draghi was asked - What is the first statistic you look at in the morning? His response – stock markets. If the same publication had asked the same question to his predecessor, Jean-Claude Trichet, you could safely bet a child’s tooth fairy money, that Trichet’s response would not have been the stock markets but the level of European inflation. The two approaches underline the fundamental shift that has occurred in Europe over last four months.

## Second helping or last orders?

The ECB’s second round of cheap funding, LTRO (long term refinancing operation), on February 29, saw another big uptake. LTRO 1 in December had 532 banks borrowing €489 billion; LTRO 2 had 800 banks borrowing €529 billion. At a borrowing rate of 1% for 3 years, this is hardly surprising. If I were a bank I would want some of that too! (If only to buy the Glazers out). A broader and higher uptake bodes well to allay funding stress for banks, both large and small.

While confidence has returned and stock markets have rallied, the biggest contribution of LTRO has been to prevent the collapse of the banking sector. If it weren’t for LTRO, the heightened refinancing cost that banks were facing meant existing assets on their balance sheet (mortgages, loans to consumers and corporates) would not be renewed but instead called by the bank or sold in a forced sale. Forced balance sheet adjustments in one go would have bankrupted the banks and sent the whole system into a death spiral. An argument clearly lost on the single-minded austerity seekers who treat balancing the

fiscal deficit as a mathematical problem that can be solved simply by cutting the excess.

Helped by cheap funding, banks will reengage in profitable (and hopefully sensible) lending, pocketing the spread and offsetting the prior accumulated losses in the process. But this will be a long process so LTRO 2 is not the last we have seen of LTRO. In terms of LTRO’s goal of achieving additional lending into the real economy, LTRO 2 is expected to add almost €310 billion (€193 billion in LTRO 1) i.e. banks will now have more funds to lend. Now whether the banks use this liquidity to pocket the spread on the carry trade or to lend more to the real economy will strongly shape what direction the crisis takes next. Pocketing the spread will mend banks balance sheets but will reduce lending in the economy and stifle growth.

LTRO has not eliminated the risk of systemic failure it has merely taken it off the table. Let’s keep in mind that a trillion Euros of additional bank debt will make any systemic failure in the future even greater than the one we are faced with today.

## Greece bailout: a 'Marshall Plan' not austerity alone else Atlas shrugs

The second Greek bailout has been agreed. In exchange for severe and crippling austerity, Greece gets: A new loan of over €130 billion, €107 billion worth of debt written off, target debt-to-GDP of 120.5% by 2020, permanent presence of Eurozone monitors on the ground in Athens, the Greek constitution to be amended to give priority to debt repayments over the funding of public service and an escrow account set up that must always contain enough money to service its debts for the coming three months. Simple, huh?

This bailout is not a gift. In a reversal of that old saying, it's the Greeks that need to beware of the EU bearing gifts. A one-pronged austerity drive with no provision for growth is making a Humpty Dumpty out of Greece. I am afraid we may soon hear the words – all the EU horses and all the EU men couldn't put Humpty Dumpty together again.

If the Eurozone is to be kept intact, Peripheral Europe will need a plan on the lines of the "Marshall plan" to carry out reform. Funded by the U.S. government, the Marshall Plan spent US\$13 billion after World War Two and engendered the highest rate of economic growth (about 35 percent per year) in European history.

Here are a few key reasons for the success of the "Marshall Plan" as Outlined by Glenn Hubbard and William Duggan, two leading scholars, in "Forgotten lessons of the Marshall Plan"

- Intensive involvement of the private sector.
- The ultimate recipient of each loan—in effect, the unit of economic development—was an individual entrepreneur or business, not a government agency or nongovernmental organization (NGO).
- Money went directly to European governments, but they were required to use it to make loans to local businesses.
- The borrowers later repaid the loans to these governments, which could then lend them out again. This virtuous circle meant that all money spent on public projects would come from loans, most of which were repaid.
- Each European government made economic policy reforms to support its domestic private sector. They made it easier for all businesses, from upstart entrepreneurs to

mid-sized manufacturing and larger enterprises, to thrive.

- Creation of a regional coordinating body that handled the distribution of funds among countries. This ensured that countries (and their resident businesses) would compete for funds. If one country did not cooperate, another was happy to take its funds.

A strong Euro has become like the Gold standard for weaker peripheral nations - it forces adjustment in real prices and wages instead of devaluation of currency as a way of reclaiming competitiveness. It creates a recessionary bias, placing the burden of adjustment always on the weak country. Deleveraging through large current account surpluses is the only way forward, but this is not feasible given high external debt and low exports in Peripheral Europe.

Therefore, I fail to see how the Eurozone can be preserved without a meaningful provision of fiscal transfer and reform. With the current circumstances, a pursuit to keep all current Eurozone countries together is frankly just as likely to succeed as a pursuit to find a "Greek taxpayer".

## Buying APPLE: iClever or iSilly?

Apple (Ticker AAPL) trades at a price-to-earnings ratio of 12 times this year's expected earnings; the S&P 500 at 14 times and the Technology sector at 17 times. Therefore Apple – at \$544 a share - is not expensive by any means. At the tech sector average, AAPL should trade as high as \$720 a share.

While other Smartphone companies have customers, AAPL has disciples; therefore AAPL is not after market share but profit margin. Other Smartphones out-sell iPhones but AAPL books a large chunk of profit from the sector. For instance, in Q4 2011, AAPL took a stunning 75% of all Smartphone profits on just a 9 % market share. Furthermore, Steve Jobs was a visionary and has left Apple with a product pipeline of at least 3 years (iPad 3, iPhone 5, AppleTV) into the future, and barring an implementation snag, AAPL should do well and keep banking cash, iClever trade surely!

This Apple is not falling anytime soon. Glad Newton didn't have to contend with this Apple; else his discovery would have been one long wait.

## Asset Class views:

### Equities:

In another encouraging sign of recovery, the US Q4 2011 GDP growth rate was revised up from 2.8% to 3%.

The Fed Beige Book just released highlights that the US economy is improving in just about all of Fed's 12 regional districts.

The S&P 500 is roughly where it was five years back. A return of 0% over the last five years masks a return of over 100% since the lows of March 2009. It goes to show that BUY-HOLD-PRAY is not a strategy when it comes to investing in Equities these days, but that BUY-HOLD-TRADE is.

So what's next? Is it downhill, plateau or uphill for Mr. Market? A plateau seems the least likely outcome given the S&P has broken out to a new bull market high, (last high was 1363.61 on April 29, 2011 for the bull market that started in June 09).

While I feel encouraged by the improving macro conditions, particularly in the US, and the risk to the market remains more to the upside than the downside, elections in April and May in Europe could cause volatility.

Talking of volatility, a June 12 expiry 1350 Put on SPX, gets you through the collective worry of the Greek and French elections as well as the 'sell in May and go away' phenomenon. The Put currently costs 3.6%, but as the market rallies further expect it to get cheaper.

In terms of sector preferences, I continue to prefer Technology, Industrial and Energy sectors. European financial stocks still worry me even though most are selling for less than an ATM fee.

The most interesting market to look at right now is Japan. The historical strength of the Japanese Yen has hurt the Japanese market in the past, but recent JPY weakness could be here to stay, with the Nikkei being the prime beneficiary. An option strategy, either a Call or a Call Spread is an interesting way to play this. Among sectors – Automobile and Industrials are the two sectors of choice if you are looking to buy Equities directly.

**Oil:** All but one of the eleven postwar recessions were associated with an increase in the price of oil; the single exception being the recession of 1960. Is there more upside to Oil? Perhaps. However, I don't see Oil continuing on quite the same trajectory - barring an Israel-Iran war. However Oil staying at this elevated level

is a distinct possibility. Again, long exposure to Oil is too expensive right now, so an Option strategy is recommended (Short Put). Brent at \$125 is no bargain for oil-thirsty Emerging Markets, and this makes me less bullish on Emerging Market assets as a whole.

**Currencies:** Recent EURUSD strength is backed by the LTRO and the Greek bailout but it doesn't clear the horizon of what Europe may face next. Europe is engaged in constant fire-fighting and I would rather wait to short EUR again rather than play long and get caught out. The EURUSD put spread of 1.40-1.30 trade recommendation in the November 2011 newsletter did very well.

**Bonds:** With yield curves already quite flat and low, an equity market rally will only push the yields on core government bonds higher. As a result, such bonds offer little return potential and poor-risk reward characteristics. Corporate bonds are offering diminished returns too and tight credit spreads have made investment grade corporate credit less appetizing. High yield looks better and I prefer the US to Europe

AUDUSD looks overvalued and vulnerable to a correction. Higher commodity prices have taken AUD to a high level. Another 2% rally and it will breach its all time high of 1.10. A further rally in commodity prices is a risk, but a 6-month Put on AUDUSD is worth considering.

Best wishes



Manish Singh, CFA

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