



## Market Viewpoints

Manish Singh

March 2013

**Nothing in the world can take the place of persistence. Talent will not; nothing is more common than unsuccessful men with talent. Genius will not; unrewarded genius is almost a proverb. Education will not; the world is full of educated derelicts. Persistence and determination alone are omnipotent.**

-- Calvin Coolidge

### *Storia d'Italia: Caos e ingovernabilità*

There was no "Silvio lining" in the Italian election "playbook" but it was not uneventful by any means and, if anything, the concerns have grown rather than receded.

In 1992-94 Italy was widely believed to have been reborn from the *Caos e ingovernabilità* (chaos and ungovernability) that had plagued it for years. The (mis)rule and the corruption of the political parties had finally been exposed by a fearless group of magistrates. The Second Republic was born. Sadly for Italy - *la storia si ripete* (history repeats itself). A quick read of "La Casta" ("The Caste"), by journalists Gian Antonio Stella and Sergio Rizzo gives us some insight into what the Second Republic has become.

- Over the last decade the country's GDP has grown at the slowest pace anywhere in the EU, and labour productivity has barely improved
- Italy's economy shrank -2.6% in 2012 and public debt rose to 127% of gross GDP from 120.8% in 2011
- High-speed trains run on less than a third of the tracks in France
- The overall rail network is just 13 kilometers longer than it was in 1920
- Alitalia has 23 long-haul passenger jets compared to Lufthansa's 134
- Per capita income – still increasing at a modest 2% a year between 1980 and 1995 – has been virtually stationary since 2000

Despite this:

- The annual budget of the Italian Presidency is nearly four times that of Buckingham Palace

- Federal legislators earn more than twice as much as their French counterparts, and nearly four times more than the Spanish
- They have voted into law a number of perks, including chauffeured limousines, free air travel, private tennis lessons, haircuts, and generous pensions for life (for which they are eligible after barely thirty months in office)
- In 2007, Italy had no fewer than 574,215 *auto blu* – official limousines – for a governing class of 180,000 elected representatives; France has 65,000 and the US has approximately 90,000

It was therefore no surprise that in the recent national elections, Italians decided to reject the major parties and vote for *Movimento 5 Stelle* (M5S) and its leader Beppe Grillo, a comedian and an activist with a deft ear for political satire. Mr. Grillo may be a comedian, but he is certainly not a clown. In fact, some of the policies he is advocating should see him get elected as EU President, let alone the Prime Minister of Italy. For example:

- "Maximum two terms for members of parliament (MPs) and any other public role."
- "Cuts in long-term benefits to politicians, wages of MPs proportional to the average national wage and elimination of refunds to politicians."
- "No double-roles permitted for politicians, ineligibility of MPs with criminal records, and compulsory entry exam for all MPs on the Italian Constitution"
- "Forbid the appointment of people with definitive criminal convictions as administrators in companies that either have the State as a shareholder or are quoted on the Stock Exchange"

The rally in risk assets so far this year has been due to a combination of factors - healthy corporate earnings, a pick-up in M&A, continuing easy monetary policy, inexpensive valuations, and most importantly, the



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macro calm delivered by European Central Bank (ECB) actions in Europe. All the above underpinnings still remain, with the ECB still acting as the “keeper of calm”. Valuations haven’t changed much either. The S&P 500 is still trading at 14x the current consensus for S&P earnings (\$109). I feel very comfortable about my end of year S&P target of 1554, which is based on earnings of \$111 and a P/E of 14. Equity markets could go lower in March and April but a bearish trend is unlikely.

### ***Austerity: The economics of self-flagellation***

If one needed any proof that austerity without a plan to regenerate growth doesn’t work, we just got it in Italy and the UK.

The Italian voters associated austerity with a slump; rising unemployment and social stress and by a majority vote rejected the economics of self-flagellation better known as austerity.

In the UK, despite the Chancellor’s championing of an austerity policy, the nation recently lost its coveted AAA credit rating due to the lack of growth and the shortfall in meeting debt reduction targets. However, if you heard Chancellor Osborne’s remark you would think that the downgrade is no big deal and that austerity is still working. Mr. Osborne is like the kid who falls off his bike and says - I meant to do that.

Rejection of austerity does have severe implication for the Eurozone and the Euro down the line. What happens if Mr. Grillo gets an even bigger majority in the re-election and this drives him to take an even stronger anti-Euro stance? The yields on Italian bonds will undoubtedly rise. Would the ECB then activate their Outright Monetary Transactions (OMT) program to buy Italian bonds? If not, what stops Italy from leaving the Euro? With a primary budget balance (budget surplus/deficit of a government excluding interest payments on its outstanding debt) at 3% of GDP, Italy is one nation that could exit the Euro and survive. It would be ironic if its relative economic strength makes Italy the best candidate for a viable Euro exit

Having spoken to some Italian experts I am led to believe that the majority of the Italians remain pro-European. Carlo Bastasin, an Italian economist at the Brookings Institution says that the recent vote was a vote against high taxes, which were imposed under the

new austerity policies. In Italy, the taxes on business are the highest of any Euro member, and they are severely hurting a weakened economy. Italians see excessive taxes mainly as the consequence of bad political management. The real problem is the breakdown in Italy’s supply of credit. From the beginning of the Euro crisis three years ago, Italy has seen a faster shrinkage in total credit supply than most Euro-area countries, as foreign banks have repatriated their loans. This widespread lack of credit has crushed the private economy. Businesses and households can’t get loans and are cutting investments and consumption at an unprecedented rate. Reviving the market for credit should be the top priority for the new government. The new government must negotiate a deal with the European Union and with the ECB, so that the ECB can support the Italian banks. But this can’t happen unless the ECB is sure that it has a reliable partner in the Italian state and that Italy will remain as fiscally stable as possible.

### ***Where to invest?***

With a gain of over +6.5% in the first two months of 2013 (and +7.4% YTD), the S&P 500 is off to a strong start for the year. However, the market has been pretty flat and range-bound (1515-1490) for more than a month and it could likely stay this way as macro concerns return.

In the US, Consumer Confidence, New Home Sales, Chicago PMI and ISM manufacturing all came in better than expected. At a level of 54.2, the ISM came in stronger than expected and was the highest monthly reading since June 2011. New Home Sales also surprised to the upside, hitting their highest level since late 2008. After lagging Existing Home Sales throughout the recovery, due primarily to the glut of inventory on the market, in February’s report, New Home Sales saw their largest one-month increase since the bursting of the housing bubble. This bodes well for homebuilders and associated stocks (XHB, SPG, EMR, and HD for example).

We also had the second reading of the 4Q12 US GDP. The US economy didn’t contract in the 4Q12. The 4Q real GDP growth was revised up from -0.1% to +0.1% but was still below the consensus of +0.5%. The growth in real final sales was revised up from +1.1% to +1.7%, and the change in inventories was revised down from \$20.0 billion to \$12.0 billion.



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The New York Fed's Quarterly Report on Household Debt and Credit showed that household debt increased \$31bn to \$11.3 trillion in 4Q12. Although this increase was pretty modest, it was notable in that it was only the second quarter with an increase in outstanding debt since the onset of the financial crisis and is a tentative sign that the recent deleveraging cycle is coming to an end.

For equities, the picture outside of the US doesn't look pretty. Besides Japan (EWJ, +6.4%) and Australia (EWA, +6.6%) almost all other equity markets have declined this year. Italy (EWI) declined -12.39%, which erased the January gains to leave it down -7.51% year-to-date (YTD). Among the Emerging Markets, all the major indices are negative YTD. Three of the four BRICS: India (INP, -4.6%), China (FXI, -6.2%) and Russia (RSX, -4.8%) posted over -6% declines in February. Brazil (EWZ, -2.1%) is yet to see positive returns for the year.

European equities: France (EWQ, -0.25%), Germany (EWG, -0.6%), and Spain (EWP, -0.2%) all have a negative performance YTD. Only the UK (EWU, +0.17%) is in positive territory.

In the S&P 500 sectors, Energy (XLE), Consumer Staples (XLP), Industrials (XLI) and Healthcare (XLV) have also shown an increase of +8 to +9% YTD. Financials (XLF), Consumer Discretionary (XLY) and Utilities (XLU) have risen by +7% i.e. still better than the +6% of the S&P 500 Index. Technology (XLK) and Materials (XLB) are the laggards having risen only by +3% and Telecom (IYZ) is in negative territory with a performance of -1.6%.

Speaking in front of the US Congress, US Federal Reserve Board Chairman Ben Bernanke said - "We do not see the potential costs of the increased risk-taking in some financial markets as outweighing the benefits of promoting a stronger economic recovery and more-rapid job creation." Bernanke has the clear view that on the way to the exit, too fast is likely more risky than too late.

The global economic environment is stronger than in the spring of 2012 when chances of a correction in the equity markets were more severe. The global manufacturing index is currently enjoying an upswing and US equities are holding up well. I would still advocate long equities over bonds, as the near term risk to equities is likely to be short-lived and causing

temporary downside, offering investors the opportunity to buy the dips.

In terms of sectors, I prefer Technology (XLK) Industrials (XLI) and Financials (XLF). We have the all-important US jobs report on Friday, March 8. If we see a strong report, I would recommend adding long positions in Materials (XLB) and Energy (XLE) too alongside the three sectors mentioned above.

Some of the stocks I like:

Technology - AAPL, GOOG, INTC, MSFT, AMZN CRM, QCOM  
Energy and Materials - APC, BHI, CAM, SLB, PX, DD, FCX  
Financials - JPM, BAC, AIG, C  
Industrials - GD, DHR, HON, UTX, EMR, HD  
Healthcare - PFE, MCK, AMGN

Last Friday, China announced new property control policies. In one of their final policy moves before the new leadership takes over, Wen Jiabao's government announced higher down-payments, a hike in interest rates for 2nd-home mortgages and a strictly enforced 20% tax on profit from sales of homes. This will impact Chinese equities and create an opportunity to go long China (FXI) in the near term.

In Europe, while the equity performance has been disappointing, any rally will largely be predicated by how things evolve in Italy and what the ECB does next. Europe is still in recession and it seems the "transmission mechanism" to get credit flowing is still stressed.

The ECB has its rate setting meeting on Thursday March 7. While the ECB can cut rates, the market is expecting more than that given the recent news from Italy. The OMT program was designed as a crisis-prevention tool with Spain in mind, but could the ECB use it more proactively to help jumpstart Portugal and Ireland's return to the bond markets? If so, this will be a big positive for European equities and global equities in general.

On Thursday the Bank of Japan (BOJ) will deliver a rates decision too, but no major actions are expected until April when Mr. Haruhiko Kuroda will be in place as the new Governor of the BoJ, assuming he gets voted



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through by the Japanese parliament. Japanese equities (EWJ) continue to be a buy.

### Currencies

The *Financial Times* talked about the Pound in an op-ed piece last week entitled – “A not-so-secret sterling devaluation ploy”. The combination of weak growth and a dovish new governor of the Bank of England is rapidly raising expectations for a weaker GBP. I would recommend remaining short GBP/USD and GBP/EUR.

The JPY weakening trade continues with the next big move perhaps not until Mr. Kuroda takes office. However USD/JPY could still inch higher in the meantime. I maintain my near term target of 95 and medium term target of 100.

As the Italian political uncertainty gathered, the EUR/USD traded lower. The EUR/USD is likely to find a bottom at 1.30 and see a move up to 1.32/34 when the Italian government is in place.

AUD/USD sold off due to disappointing economic data in Australia and this is likely to continue given China's new property tax announcement. Stay short AUD/USD with a target range of 1 to 1.1

### Commodities

Commodities overall have been underperforming equities for almost two years now. In the recent commodities sell off, Gold has been particularly hit hard. Gold could still have downside as more investors pare position or take profit to go long equities. A strong Jobs report on Friday could see more sell off in Gold. \$1,522 is the next big level on Gold and, at this level, I would feel comfortable to go long again.

Brent Crude Oil has seen a correction of over 5% last month and this is likely to continue in the near term with global growth expectations not showing any signs of reviving soon.

Best wishes,

Manish Singh, CFA

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