CROSSBRIDGE
CAPITAL

Market Viewpoints

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How do you tell a Communist? Well, it's someone who reads Marx and Lenin. And how do you tell an anti-Communist? It's someone who understands Marx and Lenin. – *Ronald Reagan*

An amiable apparatchik by the name of François Hollande has one foot in the door of the Elysée Palace and European policymakers, having flirted with austerity and gotten GDP growth numbers with a negative sign in front, now seem to have rediscovered a liking for growth. In the US, the economic data so far is still pointing to more upside in US equities and the strong manufacturing data out this week reiterated the growing strength of the US economy. Therefore I wouldn't follow the adage of 'sell in May and go away'. In fact, this year, I would definitely stick around. I believe that the ECB will play a larger role sooner than later and therefore I am turning more positive on European stocks. The ECB is the only reliable fire brigade Europe has and not using it to fight the fire of the sovereign debt crisis is madness. I maintain my bullish view on Gold. Gold is not just a weak US dollar play, but a play against paper currencies of any color.

A little less conversation

European policymakers are a strange bunch. First, they took to austerity like a religion and now that the GDP growth numbers are coming in with a negative sign in front, they seem to have rediscovered a liking for growth. A little less conversation about austerity and a little more conversation regarding growth is the new order of the day. However, German intransigence on increasing the ECB's role and Latin insouciance to go the German way, still hold. Throw in the French elections and the rise of the extreme left and extreme right and there is enough material for Molière to pen a script, if he were still alive.

Traditionally, May is the month of pain but this time around it threatened to come a month early. The first week of April saw a 5% correction in the S&P 500 Index and APPLE stock (Ticker AAPL) finally felt the gravitational pull, falling more than 10 %. However, the excellent Q1 earnings that followed for AAPL and for the market as a whole made back the losses by the end of the month. Sufficient to say, the selloff in the market is not finding a firm footing as the tug-of-war between the crisis in Europe and good corporate earnings and macro data in US, continues.

At last week's FOMC meeting, Ben Bernanke reaffirmed the US Fed's forecast to keep rates near zero until 2014. Some US macro data – jobs and GDP growth have come in soft, but, housing, personal consumption and manufacturing continue to get stronger. A 2.2% US GDP growth in Q1 was below expectations - but hardly disappointing - and a very good manufacturing report on Tuesday further underscored the view that the US economy is on a growth path.

Regular readers of this newsletter will know my stance on austerity. I acknowledge the need to reduce debt, but reducing it when there is zero or even negative growth can be extremely damaging and, in some cases, fatal. A balanced medium term plan with front-loaded policies to promote growth is better than a short-term austerity-only plan. In fact, little austerity has been implemented in Europe so far, but the talk alone of cuts and austerity is enough to alarm individuals and businesses into reducing hiring, spending and consumption. The result: Delaying the much-needed economic growth the austerity policy set out to achieve in the first place!

As if things were not bad enough for Spain, their top two football teams were cruelly dumped out of the Champions League and their former colony Argentina has made an audacious attempt to expropriate Spanish oil company Repsol's assets in Argentina. First the rhetoric on the Falklands and now Repsol. If the UK's Prime Minister, David Cameron, is finding it hard to deflect attention from his current political troubles, he may consider hiring Repsol to explore oil reserves off the Falklands, and then the Royal Navy and the Spanish Armada may find themselves on the same side.

An apparatchik in the Elysée

An amiable apparatchik by the name of François Hollande has one foot in the door of the Elysée Palace and it has got people talking about Socialism coming back; I ask, when did it ever leave?

Instead of fearing the left leanings of Hollande, French voters should worry about the 'grands corps de l'État' that is in place. 'Haut fonctionnaires' (civil servants) do not create jobs and having your brightest (from the Écoles) employed in administrative work in state bureaucracies or large private sector corporations is a waste of their talent. France needs labor reform across the board, to unshackle their brightest from a life of a secure job and unleash them as risk takers and innovators. Neither the left nor the right in France has this on their change agenda.

Hollande has softened his rhetoric and wider Europe is coming to grips with the need to supplement the existing 'fiscal compact' with pro-growth measures. In the Odyssey that the European crisis has become, Merkozy looks set to make way for Homer (as some have branded the new partnership between Hollande and Merkel before it is even born).

If Hollande plays it well, contrary to what his detractors say, he could be a good change agent for Europe. I am a person of centre right persuasion but believe there was too much of a consensus in the Sarkozy-Merkel relationship; a rupture of which and a more assertive France would be good for the future of the Eurozone.

The Fed is from Mars and the ECB is from Venus …

The actions of the Fed and the ECB in dealing with the sovereign debt crisis have the markets convinced that the two are from different planets. While the Fed has played its role as lender of last resort perfectly, the ECB has been held back in this crucial role. However, with austerity efforts likely giving way to demands for growth (albeit nominal), it is likely the ECB may join the Fed on Mars and undertake a larger role in solving the European debt crisis.

Like the US, Europe has a banking crisis. Like the US, Europe should have gone down the route of directly recapitalizing the banks à la TARP. The ECB instead went the indirect way of giving the banks cheap loans. Restoring faith in banks is key to supporting the peripheral sovereign bonds. I get a feeling that as austerity calls recede, the power brokers in Europe will let the ECB play its role as a lender of last resort. This is also central argument of Monsieur Hollande who wants the ECB to do more and take the direct approach of supporting the banks and sovereigns.

The ECB operating as a true lender of last resort, like the other central banks – the Fed, the BoE (Bank of England) and the BoJ (Bank of Japan), will shield Eurozone nations from speculative attacks on their bond markets and Europe may then not even need Eurobonds. Eurobonds in reality are a cheap financing option, and not a tool to counter speculative attacks.

Equities

As mentioned before, the economic data so far is still pointing to more upside in US equities and the strong manufacturing data out Tuesday reiterated the growing strength of the US economy. Such strength, can easily justify an S&P 500 at 1470-80 (if I were to take cue from my ISM versus y-o-y S&P return regression spreadsheet), which is a good 6% above current levels.

Therefore I wouldn't follow the adage of 'sell in May and go away'. In fact , this year, I would definitely stick around.

Writing out-of-money calls on good-named stocks you own is a good way of enhancing yield in what is likely to be a slow grind-up market, barring any quick ECB action in Europe.

I believe that the ECB will play a larger role sooner than later and therefore I am turning more positive on European stocks. With QE in the US and LTRO in the Europe, we have already seen what central bank liquidity measures can do for risky asset. However, I would still stick to large cap names only, and would seek more proof of the ECB's action before turning positive on European financials, which will be key beneficiary of ECB actions. The ECB is the only reliable fire brigade Europe has and not using it to fight the fire of the sovereign debt crisis is madness.

I am still wary of Emerging Market stocks given the better risk reward profile in the US and in Europe. People too easily jump to the conclusion that the US is losing its leadership and dominant position to China. In fact, it is likely with the Natural Gas finds and exploration that it is undertaking, the US could, if anything, be firming its dominant global position and playing a lead energy exporter role.

Bonds

Sovereign concerns have resurfaced after a two-notch downgrade of Spain's rating (negative outlook) by the S&P as the unemployment rate in Spain climbed to a new record high of 24.4%.

I recommend focusing on short-duration exposure and to have an overweight allocation to corporate credits over government bonds. Also recommended, is a continued focus on investment grade names and selective holdings of lower rated bonds – Tier 1 European financials and Insurance sector bonds.

By the same reasoning of a larger role for the ECB, a trade shorting German Bunds would be a good one. The 10Y German Bund is at a record low yield of 1.67%. If nominal growth and tolerance for inflation returns to Europe, one of the biggest casualties would be the German Bunds. Now, I don't think it will happen tomorrow, but a 1.67% yield level is a good time to start building the Shorts using futures.

Oil

With US growth grinding up slowly but surely and the risk of Iran-Israel tension latent but present, Brent Oil should stay the course and remain in the $120 price range. Brent markets are likely to trade sideways but we should see a trend up over the summer, when demand for Oil increases.

Gold

I maintain my bullish view on Gold. Gold is not just a weak US dollar play, but a play against paper currencies of any color. The US dollar has been in a down trend so Gold versus dollar often comes up in conversation, but Gold should do well against the Euro too.

If the ECB is allowed to play the role of lender of last resort and therefore engage in printing Euros to support banks and sovereigns directly, this should give a further boost to the precious metal.

EUR-USD

The narrow range that the EURUSD has traded over last couple of months has been a source a frustration. It seems the macro reality of Europe has passed by the EURUSD without as much as a whiff and it is down to relative interest rate trends alone. With the ECB and the Fed both on hold with respect to more QE (Quantitative Easing) it is not surprising that there is no big move to either side.

The portfolio flow data show Eurozone residents shedding over EUR 100bn in foreign assets since the end of 2010, whereas foreigners have bought EUR264bn of Eurozone equities and bonds. This has been one clear area of support for the Euro currency. Should conditions worsen in Europe and a reverse capital flight ensue, a selloff in the Euro is likely. However, as I have indicated in sections above, a larger role for the ECB will be the key reason for the Euro to sell-off, even without a capital flight from Europe.

Best wishes,

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