



“ You should always be aware that your head creates your world ”
– Ken Keyes Jr

Bernanke's Jackson Hole Speech may have threaded the QE3 needle but it may be premature to conclude QE will be announced at the September FOMC meeting. In reality the Fed doesn't have to actually do a QE to keep asset prices from falling. The fear of any Fed action will be enough to keep the bears at bay. Only a worsening US Jobs report (less than 100k print) will make QE3 a sure bet. The macro data in Europe is not improving – manufacturing is down, unemployment is up, consumer confidence is down and the economy is still contracting. The ECB's bond buying plan is welcome but you can't wax a car and hope it fixes the engine. Europe needs structural changes. If the Euro is not to resemble a dead autumnal leaf floating on a pond, Europe and particularly Germany will have to agree "sharing is indeed caring" when it comes to normalizing the sovereign bond yields prevalent in the market today. At Thursday's ECB meeting - I expect 0.25% rate cut (a non-event rally), no clarification on the issue of "seniority" of bonds ECB purchases and a likely commitment to unlimited bond buying in the 2-3 year duration. The ECB will also assure the market that there is no challenge to such a policy and that this action does not contravene its mandate.

Bond (buying) to the rescue!

It is clear to all by now that another round of bond buying by the US Fed is on the horizon and at the Jackson Hole symposium last week, US Fed Chairman Ben Bernanke didn't say much to dampen this expectation. Bernanke's speech was more dovish than expected however and it may be premature to conclude Quantitative Easing (QE) will be announced at the next FOMC meeting September 12-13.

In reality the Fed doesn't have to actually conduct a QE to keep asset prices from falling. The fear of any Fed action will be enough to keep the bears at bay.

The upcoming FOMC meeting could still turn out to be significant if Bernanke decides to reduce to zero the 0.25% deposit rate that banks get paid on their reserves at the Fed. Such action could achieve the same result as QE by potentially increasing the velocity of money (as banks are forced to take their reserves out and lend them into real economy), which in turn would fuel asset price inflation and as a result reduce the need for more asset purchases by the Fed.

A US Presidential election and gasoline prices heading to \$4/gallon could also keep Bernanke squarely put even though the QE3 needle looks threaded. I say this because to an average American, gasoline prices hitting \$4/gallon (they are at \$3.7 now) is a breach of the pain barrier (in Europe we would happily accept the \$4/gallon price with glee and still see our energy bills reduced by a third). It is

also understood that the average American thinks it is the US President who sets the gasoline price. A QE that sends gas prices over \$4 could influence the election outcome and I don't think Bernanke (a registered Republican) would like the integrity of his decisions to be questioned.

Only a worsening US Jobs report will make QE3 a sure bet. The report is out this Friday and is keenly awaited. I suspect a number lower than +100k new jobs created will seal the deal for QE3 and anything above will postpone it for later. Market consensus expects the US to have added +125k jobs in August, with +163k jobs having been created in the month of July.

Whether we have it now or later, QE is definitely the tool of choice for central bankers in the UK, US, Europe and Japan even if it makes them look like the village doctor who treats everything with an ultrasound because it was the only machine at hand. At Jackson Hole, Bernanke vigorously defended QE and also emphasized the "grave concern" posed by the sluggish labor market, and "the enormous suffering and waste of human talent it entails."

ECB President Mario "whatever it takes" Draghi did not attend the Jackson Hole meeting of central bankers and academics due to "work load in the coming days". I hope it is really due to work load and not because he didn't want to hear others tell him how to do his job. We can draw our conclusions when we hear from him on Thursday this week.

The macroeconomic data in Europe is not improving – manufacturing is down, unemployment is up, consumer confidence is down, retail sales have shown a marginal improvement and the economy is still contracting. The Q2 GDP numbers in the Eurozone were as follows: Italy -0.7%, Spain -0.4%, France 0%, Holland +0.2%, Austria +0.2%, Germany +0.3% and -0.2% for the Eurozone as a whole. To draw any cheer from this data set is akin to watching ants race and excitedly saying: oh, look, that one's moving a little faster.

What we need in Europe is structural reform – labor laws reform, social security and pension reform. You can't wax a car and hope it fixes the engine. The ECB buying bond alone is not going to fix the problem or bring back growth, but it will put a floor for risk assets to rally from when growth does return.

“Calling the mare”

September coincides with the end of harvesting time and the ushering in of autumn. In medieval times there was a ritual (more of a contest really) called “calling the mare”. As the last of the crops were gathered in, the final stalks were shaped into a mare and this would be thrown into the field of a neighboring farm where reapers were still at work, to serve as a message for them to get a move on otherwise wild horses would be after their crops. Farmers would get the work done quickly before throwing the mare to another farm where reapers were still at work in the fields. The last farmer to finish had to keep the mare all year and have it on display as a trophy of having been the slowest farm to harvest, that year!

If the current world economy were a medieval farm and Governments the farmers doing the harvesting, I suspect Europe would have to display ‘the mare’ this year again. The UK, US, Japan and China have all shown more eagerness and action in deploying and harvesting the QE/ Stimulus “crop” than Europe.

The short term yields on Italian and Spanish bonds have fallen by over 300 basis points since Draghi's “whatever it takes” speech, and as is typical of political process, Spain's leadership is reluctant to ask for a bailout; in fact they are attaching conditions to ask for a bailout. Would that be the case had Draghi not verbally intervened in July and the short-term yield had continued to rocket past 7%? Perhaps not.

The German's Bundesbank's opposition meant that Mr. Draghi's July comments were in danger of looking like a proverbial wet firecracker. However, recent comments

from Chancellor Angela Merkel and Germany's representative on the ECB, Joerg Asmussen have (mostly) allayed these concerns. Draghi could go ahead with bond buying without the approval of the Bundesbank but that wouldn't instill too much confidence in the Euro. If the Euro is not to resemble a dead autumnal leaf floating on a pond, Europe will have to decide if they want to keep the Euro and agree that sharing is indeed caring when it comes to normalizing the bond yields prevalent in the market today.

The ideal outcome on Thursday would be to get a clear framework on the ECB's bond buying; allay the fears of current bond investors losing “seniority” to the ECB and to show the willingness of the ECB to commit unlimited amounts to bond buying.

What we are more likely to get is – 0.25% rate cut (a non-event rally), no clarification on the issue of “seniority”, a likely commitment to unlimited bond buying in the 2-3 year duration aiming to bring the targeted yields within a “fixed range” of German Bunds of the same duration. This “range” however is unlikely to be defined upfront. The ECB will also assure the market that there is no challenge to this policy and this action does not contravene its mandate.

I also expect Draghi to hint that the ECB will start purchasing short-dated Portuguese bonds very soon. Portugal has already asked for a bailout, has been granted one and their budget is subject to conditions imposed by the bailout program. Their yield curve remains elevated from 5.3% to 9.3% over 2 to 10 years. Therefore Portugal seems to be a perfect candidate for the ECB to try out its plan. Of course, any such implementation cannot take place unless the question of seniority of bonds purchased by ECB is not fully clarified. Failure to address this issue will, in my view, massively detract from whatever else he says on bond buying.

The German Constitutional Court decision concerning the European Stability Mechanism (ESM) is not due until September 12 and some press reports have suggested Draghi is reluctant to give details ahead of this ruling. Will there be disappointment on Thursday? Remember, whatever it takes...

Equities

If you look at the equity market gains in Italy and Spain (over 24% since the last week of July), you would say: crisis what crisis? However, put in context for the year, Italy is up a mere +1.5% and Spain is in fact down -11%,

whereby the S&P 500 is up +13.5%, the DAX +19% and CAC +7.2% during the same period.

Investing in peripheral European stocks comes with its own volatility, with all gains wiped out in matter of weeks if the promised ECB actions are not carried out or reports surface of problems in implementation. Therefore, my preference has been and continues to be large cap stocks in core Europe (Germany and France) and the US, with stocks such as Total (FP FP); Sanofi (SAN FP); L'Oreal (OR FP); Danone (BN FP); Siemens (SIE GY); Syngenta (SYNN VX); Anheuser Busch (ABI BB) as top picks.

The US economy grew +1.9% in the first half of the year. In four of the past five years, GDP growth has come in higher in the second half of the year. Will it be the same this year? This will depend in large part on the consumer (who accounts for 71% of total output) and this in turn will depend on the labor market (The unemployment rate rose to 8.3% in July, well above the long term average of 5.8%). The recovery in the US housing market is on but the manufacturing sector is still stuck below the critical level of 50, signaling contraction.

The US Jobs report out this Friday takes on added significance because it will be the last key economic release before the September 12-13 FOMC meeting. As I have said before, QE looks unlikely this time but “verbal easing” will continue, which should be positive for US equities.

A higher level on the S&P can be driven either by higher earnings or expansion of P/E multiples. Continued strength in earnings has made stocks look cheap by conventional valuation measures (S&P 500 Index 10 year average P/E 16.78; current P/E 14.26) If the ECB's bond buying program is successful, it will have the additional effect of getting China and Emerging Market (EM) exports to Europe going again. I would not rule out a multiple expansion in equities in such a case.

Talking about China, for nine month now, China's manufacturing index has stayed below the critical mark of 50, indicating contraction. The Shanghai Composite Index is down -17% since May and down -20% over the last ten months. Such weakness will continue as long as China's leadership and the PBoC (People's bank of China) want it to be so. They certainly have the resources to turn the situation around, but do they want to? Is China managing its contraction and approaching this correction as a necessary evil? Perhaps, especially if you read the recent opinion piece published in the Chinese Communist Party's flagship newspaper, The People's Daily.

It urges officials - to save pro-growth ammunition for the future arguing against more impetus now to stimulate the economy; to build up an inventory of policy measures that could be used to rekindle growth; and to use the downturn to first address long-standing ills such as economic imbalances and industrial overcapacity.

China's top leadership may not be in a rush to roll out aggressive easing or other policies to prop-up growth given the leadership change is this October. However, this also makes the case for strong growth when China does embark on its stimulus program, which may be inevitable if the slide continues. I would suggest very selectively building up EM equity positions [ETF Tickers: AAXJ US, VWO US, EWZ US, and FXI US] since any improvement in Europe will drive EM equities even if China's stimulus is not immediate.

Bonds

EUR high yield names did better in August than their USD counterparts. On YTD basis USD High yield is +8.8% [Ticker: IHYU LN] and EUR High Yield is +14.84% [IHYG LN] and EM USD bonds are +12.2% [EMB US]. These are still the assets I would recommend investing in for bond investors. Investment grades bonds offer less than half the high yield returns but at considerably reduced volatility and so may be a safer bet for the more risk-averse investor. [ETF Tickers: LQDE LN, IBCX LN]

Credit still benefits from a benign default rate and investor appetite for yielding assets in a moderate growth environment which has reduced investment opportunity of capital growth.

Commodities

The Gold market rally (and subsequent correction) has confounded the wisest of investors and the precious metals sector has been re-invigorated over the past three weeks by the possibility of further QE. In this election year, some in the US have suggested returning to the Gold standard - which I must say is a crazy proposal. Returning to the Gold standard will see a hyperbolic rise in Gold price, (a cheer for Gold bugs like me) but a catastrophic move for the world economy. The Gold standard restricts money supply and credit and this will cause more frequent recessions, defaults and depressions than we have seen over last forty years. Just what the doctor ordered.

As I have mentioned in the past, Gold is a play on the debasement of money – be it due to higher inflation or to the breakup of currencies. Both these risks still remain and therefore Gold will continue to catch a bid and every fall will find a floor, as we have seen many times this year. You can never be entirely sure about the future but as things stand, money printing is just as certain as Prince Harry appearing fully clothed in all his future engagements, private or public.

Crude Oil has been strong and may go to \$120 but like I have said earlier, \$4/gallon is the threshold for gasoline in the US and for Oil to go higher and stay there the geo-political situation in Middle East has to get (even) scarier.

Iron ore has been among the biggest casualties across the industrial metals reflecting its vulnerability to a slowdown in Chinese activity. Iron ore is likely to remain soft until China decides to stimulate its economy.

EUR-USD

A rally in the Euro was anticipated following Draghi's big announcement and it has come true. Euro shorts have been reduced and perhaps more than two-thirds have been covered as the EUR/USD has reached 1.26.

On Monday this week, Draghi told an EU parliament committee that purchases of sovereign bonds up to a duration of 3 years by the ECB is not state aid and lawmakers agreed. ECB buying bonds out to 3 years is Euro-positive in the short term.

There is no doubt USD will strengthen if the Fed fails to announce a new round of asset purchase on September 13. My view is the Euro will trade all the way down to 1.20 before the month ends. The ECB may be willing to buy Spanish bonds but for this to materialize Spain has to ask for a bailout and subject its economy to bailout conditions and this remained a very political decision.

Market Viewpoints turns 1

This month, our newsletter is one year old. I hope you enjoy reading it as much as I enjoy writing it. In the coming months, I hope to share with you – the election of a new President in the US; more summits and more tete-a-tete meetings of European leaders to save the Euro; and the bursting of the bond bubble in Treasuries and Bunds which will send Equities soaring to new highs, contrary to current expectations. Have you ever wondered why the negative headlines are more dramatic and quantified – “billions wiped of stock market as Euro crisis grows”; and positive ones are less so – “S&P rallies 2% as Euro breakup fears ease”, when this 2% is actually in billions too. Negative headlines are an easier sell than positive ones and perhaps we are more wired and receptive to negatives than positives. Therefore the quote at the top of the newsletter serves as a good reminder – it's all in the head. Change your head and things will change (but make sure that change is based on real data and not empty rhetoric).

Best wishes,



Manish Singh, CFA

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