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Market Viewpoints

Manish Singh
February 2014

"The reasonable man adapts himself to the world; the unreasonable one persists in trying to adapt the world to himself. Therefore all progress depends on the unreasonable man."
– *George Bernard Shaw*

In January, the US Manufacturing Index suffered its steepest decline in two decades, dropping to its lowest level in eight months. There is no denying that the weather had a role to play in the bad data, but it is difficult to conclude that weather alone is the sole guilty party and the February data is keenly awaited. Nevertheless, a good showing in the US Jobs report this Friday is key to keeping the equity markets supported. The equity sell-off in Emerging Markets (EM) is being exacerbated by the inability of central banks to halt the decline of their currencies, despite the bold hikes in overnight interest rates and currency interventions. I have repeatedly advised to stay away from EM equities and to stay short EM currencies vs. USD, and I continue to do so. In my last newsletter I wrote "keep calm and carry on." I reiterate this view and assure you it has not changed to "freak out and panic now." It is advisable to look for stocks and indices that now have good upside potential in view of the sell-off. Monetary policy in the US, Europe and Japan is still on track to encourage economic expansion and growth expectations for the Developed Markets (DM) remain sound. The European Central Bank (ECB) might be right in thinking that deflation is not a threat, but at low levels of inflation the bigger risk is one of measurement error. At normal levels of inflation, overestimation of inflation may be less of a problem. At low levels of inflation however, overestimation might mean that the zone is in deflation without anyone realizing it. Later today, the ECB could cut policy rates again and/or strengthen their "forward guidance" timeline. In any case, falling inflation has to get the ECB to act with more urgency which could weaken the Euro. A weaker Euro could add some buffer back into forward inflation expectations.

Icy January

As the Australian Tennis Open suffered from an extreme heat, North America was under the grasp of a deep freeze which brought dangerously icy weather of -60 degree Fahrenheit to the US. Not even Mr. Market could escape the chill.

In January, the US Manufacturing Index (ISM) suffered its steepest decline (56.5 to 51.3) in two decades, dropping to its lowest level in eight months. "We have experienced many late deliveries during the past week due to the weather shutting down truck lines," was one factory's response to the survey. Some respondents also mentioned that the government shutdown in October had some lagged effects on delivery and inventory levels.

Looking into the ISM index components:

- Production dropped to 54.8 from 61.7 (a negative)
- The new orders index plunged to 51.2 from 64.4 (a negative signalling softer forward-looking demand)
- Inventories receded to 44.0 from 47.0 (reduction in inventory a positive)
- The employment component decreased to 52.3 from 55.8 (reflecting a slower pace of hiring)

There is no denying that the weather had a role to play in the bad manufacturing data, but it is difficult to conclude that weather alone is the sole guilty party from just one reading and the February data is keenly awaited. Nevertheless, a good showing in the US Jobs report this Friday is key to keeping the equity markets supported.

Last week, the Central Bank of the Republic of Turkey (CBRT) and the South African Reserve Bank made bold-but-ultimately-futile attempts to stem excess weakening of their currencies. In a shock policy response, the CBRT raised overnight rates by 425bps (4.25%), but the ensuing rally in the Turkish Lira vs. USD lasted less than half a day.

For the EMs, all the pieces are there - competitive labour costs, a rising middle class, rising productivity, huge improvements in the communications and transport, yet, EM growth seems to have hit a bric(k) wall. Why?

Well, as mentioned in my December note, EMs (particularly India, Turkey, Brazil, Indonesia, South Africa) have missed a crucial opportunity to reform their economies and exploit their advantages for growth as the developed market went through a credit crisis. EM growth will not accelerate without the development of rules for efficient allocation of capital, legal infrastructure, limited government, and erosion of a culture of corruption. The EMs have had several years to reform and most have failed miserably. Now we have another crisis and another period of likely stagnation.

Doubts about China's shadow banking systems is another reason for EM weariness. Over the past decade, China's economy has grown ever more reliant on financing from outside the formal banking system. Bank loans, which used to account for more than 90% of total credit, fell to little more than half of new financings last year. According to JP Morgan, lending by shadow banks now totals Rmb47 trillion (US$7.5 trillion), or 84% of China's GDP. Of this gross amount, Wealth Management Products (WMP) represents half. WMPs were sold to investors under the guise that they were risk-free products (i.e. guaranteed by the issuer). The funds however went into anything but risk free projects, such as - miners, property developers and local governments – which regulators have now deemed too risky for banks to hold. Around US$660 billion of WMPs are up for repayment or refinancing this year, according to Bank of America Merrill Lynch. One WMP default was recently averted. If and when a default occurs, this could drastically slow down lending in China, and in turn cause a further slowdown in its GDP growth.

O Inflation, Where Art Thou?

Inflation in the Eurozone fell to +0.7% in January, down from +0.8% in December and further below the European Central Bank's (ECB) +2% target. This has raised the spectre of deflation risk in the Eurozone, which could lead to the price of goods and assets locked in long-term decline, hitting corporate profits, wage growth, and tempting consumers to delay purchases in the hope of further falls in price. The Eurozone unemployment rate remains unchanged at 12%.

At the World Economic Forum in Davos, Christine Lagarde, head of the International Monetary Fund cautioned that Eurozone inflation was "way below" target and that the risks to the bloc's fragile economic recovery should not be ignored.

Mario Draghi, president of the ECB, has said that although inflation was "subdued, and expected to remain subdued" for about two years, he was confident that it would return to target. The ECB may be right in thinking that deflation is not a threat, but at low levels of inflation the bigger risk is that of measurement error. At normal levels of inflation, overestimation of inflation is less of a problem. At low levels of inflation, overestimation might mean that the Eurozone falls into deflation without anyone realizing it.

If inflation continues to fall, there is a risk that the ECB overestimates inflation through 2014 and is slow to respond. This can lend itself to weaker inflation expectations and can reignite the sovereign crisis dynamics. The lower the average Euro area inflation, the more the peripheral countries have to deflate to achieve rebalancing. Deflation with high levels of debt begets a debt-deflation spiral.

As if to add to the ECB's challenge, the stresses in EMs have the potential to compound the deflation threat. These include: Lower commodity prices; a higher EUR; and a hit to bank capital (European banks have loaned in excess of $3 trillion to EMs, more than four times US banks).

Later today, the ECB could cut policy rates again and/or strengthen their 'forward guidance' timeline. In any case, falling inflation has to get the ECB to act with more urgency, which could weaken the Euro. A weaker Euro could add some buffer back into the forward inflation expectations.

Where to invest

You will recall that I have repeatedly advised you to stay away from the EM equities and to stay short EM currencies vs. USD. The EM equity sell-off is being exacerbated by the inability of central banks to halt the decline of their currencies, despite the bold hikes in overnight interest rates and currency interventions.
In my last newsletter I wrote "keep calm and carry on". I reiterate this view and assure you it has not changed to "freak out and panic now." It is advisable to look for stocks and indices that now have good upside potential due to the sell-off. Monetary policy in the US, Europe and Japan is still on track to encourage economic expansion and DM growth expectations remain sound.

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You will also recall that I forecasted 2014 to be one of modest returns, offering +5-8% upside on the Standard and Poor's Index (SPX). However, picking a low point to enter the market could double this return and I suggest using sell-off opportunities to add to cyclical long positions.

The sell-off in EMs is a concern, but it is worth noting that only 5% of SPX company sales come from the EMs. Goldman Sachs analysts estimate in an EM sell-off, the SPX falls by half as much as an equivalent EM index.

The indices in Europe with high sales exposure to the Emerging Markets are as follows:

Country Equity Index	Company sales exposure to EM
Spain IBEX	42%
UK FTSE 100	38%
Italy MIB 40	35%
Europe Eurostoxx 50	33%
Switzerland SMI	32%
France CAC 40	31%
Germany DAX	28%

I still recommend long position in US, Europe and Japan. The Nikkei (NKY) is down -13% for the year and is particularly attractive. The sectors I prefer are Technology, Finance and Healthcare. Consumer Discretionary (XLY) is down over -7.5% for the year and getting attractive again as a cyclical bet.

The US stocks and ETFs I like –
Google, Amazon, Apple, Citigroup, JP Morgan, Pfizer, Schlumberger, Freeport McMoran (FCX), General Electric, P&G, Gilead Sciences, Chevron, , Philip Morris, CBS Corp, General Motors, Healthcare ETF (XLH), Technology ETF (XLK), Financial ETF (XLF), Energy (XLE).

The Europe stocks and ETFs -
UBS, BNP, Deutsche Bank, Anheuser Busch, L'Oreal, Novartis, Royal Dutch Shell, Nestle, SAP, Danone, Kering (KER FP), British American Tobacco, Richemont, EUFN (European financials ETF).

EMB (USD Emerging Markets Bond ETF) and EMLC (Emerging Markets Local Currency Bond ETF) both have fallen by more than -12% since June last year and present a good entry point for bond investors. Both ETFs have over 80% invested in EM Sovereign debt.

Currencies & Commodities

USD/JPY has been hit hard by risk reversion as the NKY slid more than -10%. I have pointed out in the past that USD/JPY has a very high correlation to rising UST 10Y yields. No surprise then as the UST 10y has fallen from 3.02% to 2.62% over the last five weeks; USD/JPY has dropped from 105 to 100. The direction of US and Japanese monetary policy supports a rally in USD/JPY over the next 3 months with a pause in the near term.

EUR/USD is prone to weakness due to anticipated ECB actions and the weakness in the EMs as explained in the previous sections. I see EUR/USD capped at 1.37 on the upside with the downside limited to 1.30/32 over the next month.

GBP/USD has failed several attempts to break the 1.66 level on the upside and I see that as a cap on cable. The rally in cable may be running out of steam, however a sharp downside is not in the offing. There is a slight concern however that UK growth may have peaked in Q4 last year. Cable has limited downside from here and should stay above 1.58/60 level.

AUD/USD has held on as the Reserve Bank of Australia (RBA) stepped back from cutting rates due to rising inflation. At +2.7%, the annualized inflation growth rate is near the top of the RBA's +2-3% range, making it difficult for it to ease.

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However, the slowdown in China will come to bear, and I would still look to sell rallies in AUD/USD.

Gold may see some short term rallies in response to risk aversion but being long Gold is not a trade for Q1 until we see signs of inflation. Brent is likely to be range bound hugging the $105 level, with downside to $100 if EM weakness continues.

One final note

Crossbridge Capital has been nominated in the 2014 London Wealth Management Awards in the category 'Best Market Newsletter'. We would really appreciate your vote: http://wealthmanagementguideuk.com/voting-2014/

Best wishes,

Manish Singh

Manish Singh, CFA

Crossbridge Capital LLP

9 South Street, London W1K 2XA, United Kingdom www.crossbridgecapital.com