



Market Viewpoints

Manish Singh

January 2014

“I know not with what weapons World War III will be fought, but WW IV will be fought with sticks & stones”

– **Albert Einstein**

Last year saw improved economic activity and reduced monetary and fiscal risks. 2014 promises more of the same. There is no denying that the US Fed's easy money policy has helped greatly, but there have been real improvements in the US economy too. I believe that the Fed starting to pull away (albeit cautiously) will be viewed by the market as another step towards returning to normalcy. In 2014, around 40 countries go to the polls, representing 42% of the world's population and more than half of its GDP. The political landscape particularly in the Emerging Markets (EM) could be very different by the end of the year. Incoming Fed Chair Janet Yellen has been an ardent proponent of an easy money policy to address the cyclical shortfalls of the labour market. The Fed under her stewardship, is likely to play down the 6.5% unemployment threshold and may even go a step further and reduce it to 6% or lower in Q1 of this year. Therefore, equities will have support throughout the year. In 2013, three-fourths of the S&P500 (SPX) return came from Price-to-Earnings multiple expansion, rather than higher earnings. This year, another +29% gain on the SPX is very unlikely. The healing process in Europe is underway, and more remedial action is expected this year. The European recovery theme, which investors endorsed in 2013, will remain alive in 2014 too. Perhaps 2014 is finally the year of positive Earnings-per-Share (EPS) in Europe. Japanese equities are a buy, but be prepared for volatility in March/April, around the time of the increased consumption tax coming into effect.

Keep Calm and Carry On

As we begin 2014 and try to interpret the world economy together, first, a very Happy New Year to you.

Last year saw improved economic activity and reduced monetary and fiscal risks. The New Year promises more of the same – acceleration of GDP growth, loose monetary policy, a falling unemployment rate, and progress on structural reforms. 2014 promises to be calm and normal, just as was expected at this time 100 years ago. This year marks the 100th anniversary of the outbreak of the Great War and few Europeans could have imagined that just seven months later, their political and military leaders would plunge the world into a cataclysmic war, resulting in tens of millions of casualties over the next four years.

The last few weeks have seen tempers flare in China and Japan. China has asserted its claim to the disputed Senkaku/Diaoyu Island in late November when Beijing announced an Air defence identification zone (ADIZ) covering a large swathe of the East China Sea, including the disputed isles. All aircraft now entering the zone have to enter a flight plan and submit radio information – a clear assertion of sovereignty over the islands. The diplomatic row is also playing itself out in the British press. China's Ambassador to the UK, Liu Xiaoming, in an Op-ed for the *Daily Telegraph* criticised Japanese Prime Minister Shinzo Abe's visit to the Yasukuni Shrine - "If militarism is like the haunting Voldemort of Japan, the Yasukuni shrine in Tokyo is a kind of horcrux, representing the darkest parts of that nation's soul." The *Financial Times* in its January 1, 2014 editorial '[Reflections on the Great war](#)' noted - "One hundred years ago it was Germany seeking its place in the sun at the British Empire's expense. Now it is, increasingly, China and the US. Recent tensions in the East China Sea between Beijing and its neighbours, which rely on US support, recall Germany's strained relations with Britain, France and Russia before 1914."

There is little reason to fear the world in 2014 is on the edge of such a momentous disaster, therefore my advice is: Keep calm and carry on.

In 2014 around 40 countries go to the polls, representing 42% of the world's population and more than half of its GDP. Many of these elections will have wide repercussions, like those in India, Indonesia, Thailand, Turkey, South Africa, and Brazil. The politic landscape particularly in Emerging Markets (EM) could be very different by the end of the year. As I mentioned in my last newsletter, I am more bullish on Developed Markets vs EM for Q1 but I believe EM will present



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good opportunities into the second half of the year.

Year of the Horse; Stable returns

According to IMF projections, global growth is expected to increase from +2.9% in 2013 to +3.6% in 2014 driven largely by developed economies. In 2013, the S&P 500 Index (SPX) galloped to a +29.6% return. A similar performance this year is very unlikely. This will be a year for stable returns.

Talk of “tapering” by the US Fed dominated most of 2013 and contrary to my expectations, we did get some tapering before the year ended. However, in line with my expectations, Mr. Market shrugged off the announcement and continued its record climb. The Federal Open Market Committee (FOMC) moved to begin reducing the pace of its asset purchases by \$10bn/month and enhanced its forward guidance at its December meeting. The FOMC minutes out later this week will provide clarity on how much of a consensus there was for the decision to start tapering. The minutes will also tell us if the Committee laid out any details about the strategy for tapering in coming months. With 1.3 million Americans losing their unemployment insurance (were it not extended) at the start of the year, the labor market is still a legitimate headache for the Fed and future policy in this regard will be data dependent. My guess is the complete unwind of Quantitative Easing (QE) will be spread through to the end of 2014 and any interest rate rise will not occur until or after mid-2015.

We also get the all-important US Jobs report this Friday. The monthly gain in non-farm payrolls has been at or above +200K in three of the past four months, pointing to some pick-up in labour market momentum. This week’s non-manufacturing ISM report indicated a slowdown, but the employment component of the report jumped to 55.8 from 52.5. I expect a +200K plus number this Friday, which would be consistent with this data and the previous set of good data at the end of 2013, including the sharp +4.1% increase in 3Q GDP.

In Europe, the reforms both at the EU and national levels are moving at a glacial rate. Hardly surprising if you know how Europe works, hence the GDP growth rate of +0.1% has semblance of a rounding error than a measurable rate of growth of an economy the size of Europe. However, the European Central Bank (ECB) has the back of the Eurozone. The ECB meets this Thursday. I do not expect any change to its rate policy but I do expect ECB President Mario Draghi to continue to emphasise that the ECB is ready, if required, with a number of tools available in its arsenal (without singling out any as he has done so far).

The Bank of Japan (BoJ) will hold its Monetary Policy Meeting on Thursday and Friday. The bank upgraded its economic assessment following the solid outcome of the Q4 Tankan Survey – an indicator of business sentiment. The core CPI inflation rate rose to around +1%, making the BoJ more confident that CPI is tracking the trajectory toward 2%. The BoJ quantitative and qualitative easing (QQE) policy started on April 4, 2013 with the target of increasing the monetary base. The trajectory of the monetary base and the BoJ’s balance sheet is in line with its projection. The consumption tax rate hike, effective in April, is expected to create a drag and contract GDP notably in Q2 2014. The BoJ will very likely take additional easing measures in April as a result. The Nikkei is a buy in my view, with expectation that it will be over 18,000 by the end of the year.

Back in 1997, it was a consumption tax hike which was widely blamed for plunging Japan back into recession. Mr Abe will take heed of this and try to avoid a similar fate. To this end, an economic stimulus program comprising of public infrastructure spending and incentives for business investment on fiscal side, and further monetary stimulus from the BoJ, will be needed to offset the tax hike.

Where to Invest

Last year, begrudgingly, even the most ardent of bears accepted that we were in a bull run, even if some attributed it all down to the Fed’s measures. There is no denying that the Fed’s easy money policy has helped greatly, but there have been real improvements in the economy too. Some say that with the Fed starting to withdraw the support, the Bull Run (the S&P 500 Index is now up +173% from its March 2009 low) may come to an end. I believe that the Fed starting to pull away (albeit cautiously) will be viewed by the market as another step towards returning to normalcy.

Incoming Fed Chair Janet Yellen has been an ardent proponent of an easy money policy to address the cyclical

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shortfalls of the labour market. The Fed under her stewardship is likely to play down the 6.5% unemployment threshold and may even go a step further and reduce it to 6% or lower in Q1 this year. Therefore, equities will have support throughout the year.

In 2013, three-quarters of the SPX return came from P/E multiple expansion (12 month forward P/E rising from 12.6 at the start of the year to 15.4 at the end of the year) rather than higher earnings. Earnings in the same period increased by only +6-7%. Investors willingness to pay a higher price multiple for the same EPS gradually increased through the year, keeping with the growing consumer and economic confidence. This year, another +29% gain on the SPX is very unlikely. However, US equities continue to be a good long trade.

Japanese equities are a buy, but be prepared for volatility in March/April around the time of the increased consumption tax coming into effect.

The healing process in Europe is underway, and more remedial action is expected this year. The European recovery theme, which investors endorsed in 2013, will remain alive in 2014 too. Bottom up estimates suggest EPS are expected to grow +8-10% this year. Similar positive estimates last year turned out to be -4% in reality, however the MSCI Europe Index still rose +15.8%. Historically, corporate earnings tend to follow the direction of equity prices, with a slight time lag. However, we've now seen over two years of rising equity prices against a backdrop of consistently falling EPS in Europe. Perhaps 2014 is finally the year of positive EPS in Europe.

As mentioned previously, my preference is DM over EM, with a positive view on US, Japanese, and Eurozone stocks.

In the US, the sectors I would overweight are Technology (XLK) and Financials (XLF).

Some of the stocks I like: Amazon (AMZN), Google (GOOG), Salesforce (CRM), CBS Corp (CBS), Pepsi (PEP), Philip Morris (PM), Schlumberger (SLB), Gilead Sciences (GILD), Citi (C), JP Morgan (JPM), United technologies (UTX), Boeing (BA US), Dupont (DD), Pfizer (PFE), UnitedHealth (UNH), Simon property Group (SPG), DR Horton (DHI).

In Europe: Roche (ROG VX), British American Tobacco (BATS LN), Burberry (BRY LN), UBS, Lloyds (LLOY LN), Nestle (NESN VX), Anheuser Busch (ABI BB), L'Oreal (OR FP), BMW, SIEMENS (SIE GY), SAP, EADS, Total (FP FP), Volkswagen (VOW GY).

Commodities and Currencies

USD strength seems to be the consensus view, yet the USD strength recently has been hard to come by. If the FOMC minutes show that there was overwhelming support for tapering before the end of the 2013, their enthusiasm will revive the rally in the USD particularly in USD/JPY, and drive it back above 105.

I do not expect any new announcement from the ECB and the spread tightening in peripheral country bonds has persisted into the New Year. The Irish/German spread is now only at +136 bps, the narrowest in almost 4 years. In mid-2011, the spread was at +1,200 bps. Therefore, with the absence of bad news from Europe, any further near-term drop in EUR/USD will likely have to come from the USD leg. A good non-farm payroll number this Friday (say above +250K) in the US, will move the currency pair down, otherwise there is unlikely to be much change from the current 1.35-36 levels for now.

The turnaround in the U.K. economy in 2013 was the envy of the world and the two Eds – Ed Miliband and Ed Balls. From flat-lining zero growth in 2012 to +1.6% growth in 2013, driven largely by the government's responsive fiscal policies and the Bank of England's (BoE) pledge to keep interest rates low. The UK is expected to grow at +2.4% in 2014. GBP/USD will be well supported in 1.64-1.66 range near term, with little downside. As with EUR/USD, any downward move in GBP/USD will be more a USD story.

My prognosis for Gold hasn't changed and I expect Gold prices to remain soft and have further downside in the medium term as the economy improves and inflation remains benign. Despite the \$650 correction in Gold prices from highs of

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\$1,900, Gold at \$1226, is +60% higher than its inflation-adjusted, post-Bretton Woods average of \$768/ounce and well above its marginal production cash cost of approximately \$950 per ounce (GS estimates).

Chinese GDP growth has halved from +14.2% in 2007 to around +7.5% now and the Chinese government is determined to carry out more reforms which could depress GDP growth to maybe +7%. Besides the shale gas extraction technology is impacting the supply side. According to GS estimates, extracting US oil shale on a profitable basis requires Brent oil prices of approximately \$80 per barrel, while less developed international projects can require prices exceeding \$90 per barrel. Saudi Arabia has already stated a preference for prices of around \$100 per barrel and is in a position to cut production to support those prices. I therefore see the Brent stabilising in the \$95-\$105 range.

Best wishes,

Manish Singh, CFA