



Market Viewpoints

Manish Singh

March 2014

"Nobody intends to put up a wall!"

- *Walter Ulbricht, Leader of the GDR, June 1961 - 2 months before the Berlin Wall was erected.*

"A wall is a hell of a lot better than a war."

- *John F. Kennedy, August 1961 - on the construction of the Berlin Wall.*

Crimea, the Peninsula on the Black Sea, has held a pivotal place in world history for over 150 years. After a relative peace of 24 years since the end of the Cold war, Crimea is back in focus as Putin looks to annexe it to Russia. The referendum in Crimea is scheduled for this Sunday and will be closely watched. All equity markets will get impacted from an escalation of the Russia-Ukraine crisis and we saw a preview of this earlier this month when the DAX in Germany fell over -3% in one day. On March 9, 2009 the S&P 500 Index (SPX) touched the lows of 666. Five years hence, the SPX is up +177% from these 2009 levels. The SPX Bull has run a good race. The only time the Bear came close to getting the Bull by its horns was in July 2011 when the SPX fell -18% over a two months period, as Europe teetered on the brink of a sovereign debt crisis. The S&P Bull at 5 is not old yet and far from running out of breath. When one talks of the corporate balance sheets now, one refers to the "cash" on it and not the "debt/leverage" ratio. Since the beginning of 2009 only \$132 billion has flowed into global equity funds, while \$1.2 trillion has flowed into global bond funds. The re-allocation from bonds to equities is far from over. The recent February US Jobs report indicated the US economy added 175,000 jobs. The data also indicated that the number of workers in February, who had a job but didn't work due to bad weather, was 601,000 compared to a ten-year average of 357,000. The number of workers who had reduced hours, due to weather, was 6.9 million compared to the ten-year average of 1.5 million. This is the highest reading for any February on record. It will not go amiss to say, if not for the poor weather, the job growth would have been even stronger in the US. The equity bull therefore has more legs, as the weather effect recedes.

Crimean and Cold War Jitters

Crimea, the Peninsula on the Black Sea, has held a pivotal place in world history. The Crimean War (1853-56) pitted the French and the British against Tsarist Russia and its plan to expand eastwards by occupying provinces of the weakened Ottoman Empire. This would have allowed the Russian navy direct access to the Mediterranean, a threat to French interests in the area and the route to British India through the Middle East.

Ninety years later, in February 1945, Crimea was again the scene of a historic event – the Yalta Conference. As World War II was grinding to a halt, the Allied leaders - Franklin D. Roosevelt, Winston Churchill and Joseph Stalin met to discuss the post-war world. The meeting took place in the Crimean resort of Yalta. The leaders sought to defeat Nazi Germany as quickly as possible, but they were also concerned about the future. Anticipating conflict with each other, they sought to establish a mutually acceptable post-war world order. What we got instead was the United States and the Soviet Union mistrust for each other over the issue of the status of Eastern Europe. Arguably, Yalta is where the "Cold War" began and engulfed the world for the next 45 years.

After a relative peace of 24 years, Crimea is back in focus as Putin looks to annexe it to Russia. A senior US Politician recently remarked – *Putin is playing Chess, Obama is playing marbles*. Russia has produced many chess grand masters and it seems Putin is playing his G8 compatriots on seven boards simultaneously. The West's chess pieces seem stuck behind layers of diplomacy and meetings. There is no guessing what end game Putin has in mind but a US-Russia direct confrontation seems very unlikely. When Russian tanks rolled into Budapest in 1956, President Dwight Eisenhower resorted to words not military confrontation.

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President Lyndon Johnson did the same when Soviet tanks rolled into Prague in 1968. When Soviets troops entered Poland in 1981, President Ronald Regan counselled negotiations. Only during the Cuban Missile crisis did the US really go head-to-head with Russia, but even then, President John F Kennedy defused the crisis by agreeing to withdraw American missiles from Turkey. Even the most hawkish of Republican Congressmen would admit a US-Russia war is highly unlikely.

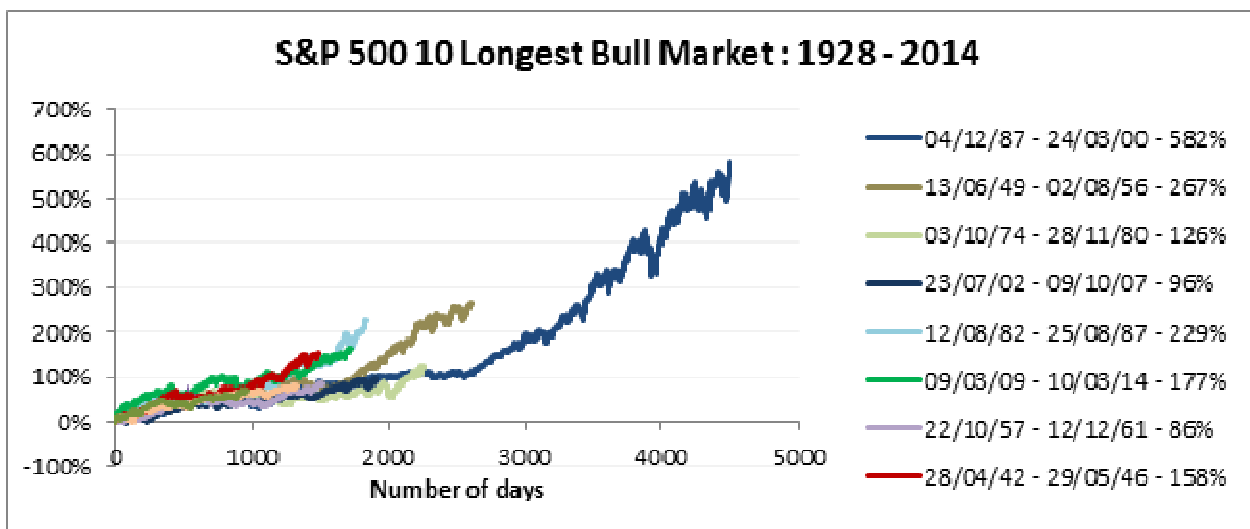
The referendum in Crimea is scheduled for this Sunday and will be closely watched. If polls are to be believed, the US and Western Europe are going to have a new neighbour very soon.

All equity markets will get impacted from an escalation of the Russia-Ukraine crisis and we saw a preview of this earlier this month. On Monday March 3, the day after Russian forces entered Crimea, Russian stocks fell by more than -10%, the Eurostoxx 50 (SX5E) fell by -2.1%, and Germany's DAX was down more than -3%. The FTSE(100) in the UK, which is less dependent on Russian gas in comparison to Germany, fared better. Gold, Oil, Natural Gas and Grain prices firmed up. The Japanese Yen and Swiss Franc strengthened versus the USD and USD strengthened versus all other currencies including the EUR and the GBP. So we have the template for asset price reaction, should the crisis escalate.

This Bull still has legs

On March 9th 2009, the S&P 500 Index (SPX) touched the lows of 666. Newswires at the time were abuzz with stories of US Automakers on the verge of bankruptcy, the possibility for a nationalization of the largest US banks and a "Lost Decade" for the economy.

Five years hence, the SPX is at 1871 (+177% from the March 9, 2009 low). The SPX Bull has run a good race. The only time the Bear came close to getting the Bull by its horns was in July 2011 when SPX fell -18% over a two month period, as Europe teetered on the brink of a sovereign debt crisis. Below is a table detailing all the longest Bull runs since 1928.



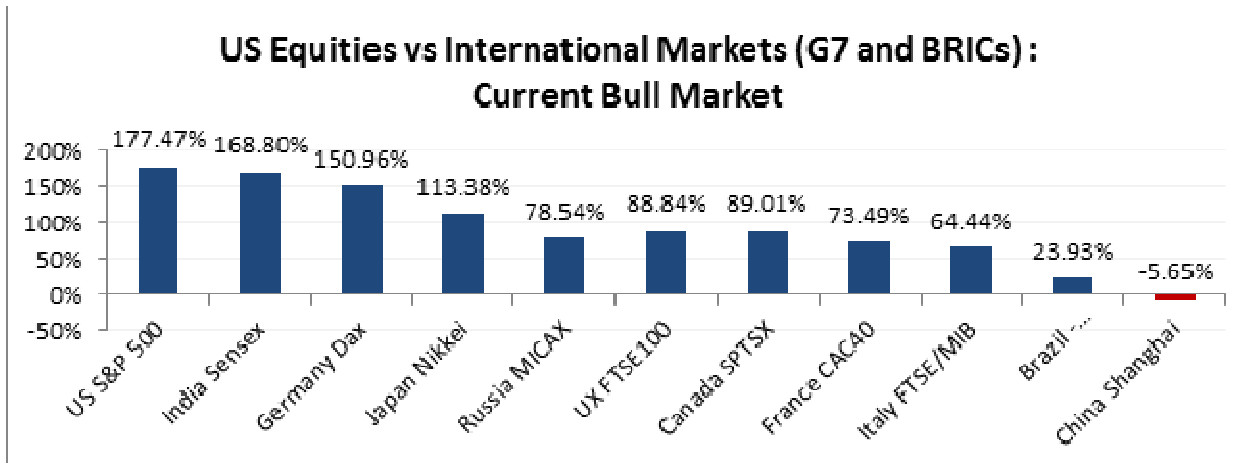


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How has international equity markets fared (compared to the SPX) during the current Bull market?



So from here on out, do we see a Bounce or a Trounce?

Pessimists will point to the 2002-2007 Bull run that lasted exactly 5 years before the decline in SPX started in October 2007. The S&P Bull at 5 is not old yet and far from running out of breath. Unlike 2007,

- When one talks of the corporate balance sheet now, one refers to the "cash" on it and not the "debt/leverage" concern.
- The key central banks remain resolved to doing "whatever it takes" to keep the economy from breaking down.
- Importantly, since the beginning of 2009 only \$132 billion has flowed into global equity funds, while \$1.2 trillion has flowed into global bond funds. The re-allocation from bonds to equities is far from over.

This Bull has more legs to run.

Where to Invest

The February US Jobs report out last week indicated that the US economy added 175,000 jobs and the prior two months' numbers were revised. The unemployment rate ticked up from 6.6% to 6.7%, the first increase since December 2012. This increase, however, does have a silver lining:

- The data indicated that the number of workers in February, who had a job but didn't work due to bad weather, was 601,000 compared to a ten-year average of 357,000.
- The number of workers who had reduced hours, due to weather, was 6.9 million, compared to the ten-year average of 1.5 million. This was the highest reading for any February on record.

It will not go amiss to say that if not for the poor weather, the job growth would have been even stronger, suggesting healthy underlying momentum in the economy. Better growth in the US should be good for the world economy and particularly so for Emerging Markets (EM) that still rely on the growth in the US and

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Europe to sell their products and services.

In Europe, European Central Bank (ECB) President Mario Draghi indicated last week that all is well with the Eurozone economy and didn't indicate any shift in policy to get more accommodative. Draghi seemed very comfortable with the outlook for growth and inflation and there was no sign of "verbal easing" as witnessed in the previous month's ECB press conference. This stance sent EUR/USD rallying, although equities have not followed as quickly.

In the UK, the economy is still on an upswing and expectations of rate hike are gradually shifting forward. The first rate hike, thus far anticipated in Q1 2015, could actually come two quarters sooner. It is becoming clear that the Bank of England (BOE) will be the first central bank to tighten, although it will be in small steps.

The Japanese equity market is still down -6.55% YTD. The sales tax hike is weighing on the Nikkei. Japan has committed itself to a two-step plan to increase sales taxes as a way to fund its ever-increasing social welfare programs and to ease the nation's dire fiscal state. Japan will put the first part of the plan, raising the sales tax from 5% to 8%, into practice this April. The second phase, raising the sales tax to 10% is slated for October 2015. The success of the first part will determine if Prime Minister Shinzo Abe will have the political will to push the sales tax to 10%. According to one estimate – lacking a stimulus from the Bank of Japan (BoJ) or any sort of fiscal respite, the economy is forecast to shrink at annualised rate of -3.9% in the quarter starting April, when the sales tax will rise to 8%. I firmly believe the BoJ will respond with additional stimulus and Abe with fiscal tax breaks in other parts of the economy.

Therefore, I stay bullish on US, Japan and European equities and I am starting to get bullish on the Emerging Markets. I am fully aware that April could be a difficult month as US data will lag and perhaps Japan market volatility will increase. However, looking beyond that, the case for equities remains positive.

- My sector preferences in the US are Financials (XLF), Technology (XLK), Consumer Discretionary (XLY) and Energy (XLE).
- Biotech stocks have started to remind investors of the 'tech bubble' in 2000. It is not to say there will not be correction given the phenomenal rally we have seen since June 2012, with some stocks up 200%. However, as long as you stick to the large cap names: Gilead Sciences (GILD), Amgen (AMGN), and Celgene (CELG) you have less to worry about.
- Some of the other stocks I hold/like to hold in our discretionary portfolio:

Google (GOOG), Amazon (AMZN), Apple (AAPL), Salesforce (CRM), Citigroup (C), JP Morgan (JPM), Pfizer (PFE), Schlumberger (SLB), Freeport McMoran (FCX), General Electric (GE), P&G (PG), Rio Tinto (RIO LN), Glencore (GLEN LN), Nestle (NESN VX), UBS (UBSN VX), BNP (BNP FP), Philip Morris (PM), L'Oreal (OR FP) and Pepsi (PEP). I added Roche (ROG VX) and Volkswagen (VOW GY) to the portfolio after their recent price correction. Gazprom (OGZPY US) and Standard Chartered (STAN LN) are other two stocks I am looking to add using limit orders.

Currencies and Commodities

The EUR/USD has been driven higher by the relatively hawkish ECB press conference of last week which came on the back of better than expected inflation data the Friday before. The general tone was that the slowly-but-surely improving economic activity offset any need to ease further. Draghi attributed the low price levels in the EU, in large part, to lower energy costs and higher EUR/USD exchange rates. The slightly worse than forecast data from the US - skewed by the bad weather - has provided a base for the rally not

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only in the Euro, but also in the GBP/USD and even the AUD/USD.

Given the ECB's cautious and less accommodative approach, the Euro leg is moribund and we will need the US leg to propel EUR/USD lower. If, for example, the expectations of rate hike in the US were to be brought forward, EUR/USD would trend down. I don't see a weakness in EUR/USD until after April's set of US data, which may again be weak due to weather.

The BoJ should feel the pressure as the sales tax hike comes into effect early next month. This will hurt Japanese demand and threaten the stabilisation of higher inflation, which is a cherished aim of central bank Governor Haruhiko Kuroda and Abe. This comes on the back of a weak Japanese Q4 GDP print which came in below expectations. I feel the pre-emptive BoJ easing action could keep USD/JPY bid going into next month's sales tax rise. Of course, any escalation in Ukraine will promptly see USD/JPY heading down to the 100 level.

For months now, I have indicated Gold is not an asset I would like to be structurally long. Gold at \$1350 is at the top of my price range and I would be a seller at this level. Brent has stayed in the 105-110 range and is likely to stay here.

Best wishes,

Manish Singh, CFA