



## Market Viewpoints

Manish Singh

November 2013

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### **Despite a voluminous and often fervent literature on "income distribution," the cold fact is that most income is not distributed: It is earned. - Thomas Sowell**

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Despite a few "tricks"- tapering, an Emerging Market sell-off, and a US government shutdown, 2013 has largely been a "treat" for risk-taking investors. Inflows into equity mutual funds/ETFs in October were the third-largest on record. On the other hand, Bond funds have posted five consecutive monthly outflows, for the first time since 2003. You will recall my year-end target on the S&P 500 (SPX) is 1744 and this was obliterated two weeks ago amid the euphoria of a deal in the US Congress to avert a US default and an end of the US government shutdown. I am not tempted to raise my year-end target as I see very little upside from here. I would recommend you lock in your profits and look for more income-yielding strategies until the end of the year. I am however by no means bearish, and have a very constructive outlook for 2014. US inflation continues to come in on the soft side. Europe encountered its own scare of deflation with new data showing inflation well below the European Central Bank (ECB) target. The most anticipated political event of the year – the third plenum of China's ruling Communist party is set to take place this weekend. Recall, it was at the third plenum in 1978 that Deng Xiaoping announced the opening up of the Chinese economy: *The* move that triggered three decades of phenomenal growth.

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### **Squirrel away your returns**

If you have watched a squirrel carefully (remember Scrat from the movie *Ice Age*), you will have noticed that a squirrel will pick up a nut using its teeth, shake its head and either peel off the husk and eat it then and there, or hop off to find a place to bury it. Storing it away for harsh winter months. Squirrels collect and store nuts so they will have food to last through the winter.

Like any good squirrel, investors should also be protective of their prized possessions (i.e. their returns). It has been a great year for risk assets. US equities (SPX) are up +23%, Europe's Eurostoxx 50 is up +16%, although Emerging Markets are down -4.3% and Gold is down -21%. You will recall my year-end target on the SPX is 1744 and this was obliterated two weeks back amid euphoria of a deal in the Congress to avert a US default and the end of the US government shutdown. I am not tempted to raise the year-end target as I see very little upside from here.

Therefore, I prefer to be the squirrel. Lock in your profits and look for more income-generating strategies until the end of the year. I am by no means bearish and have a very constructive outlook for 2014, which I discuss later in the newsletter. But first to China, where a key event comes up this weekend.

### **Chinese whispers**

The most anticipated political event of the year – the third plenum of China's ruling Communist party is set to take place from November 9-12. It was at the third plenum in 1978 that Deng Xiaoping announced the opening up of the Chinese economy: *The* move that triggered three decades of growth. In 1980, at the beginning of this economic reform, China's GDP stood at \$301 billion, smaller than that of the UK. Since then, it has grown over twenty five times to \$8.2trillion and is now over three times the size of UK's GDP. In 2009, China overtook Japan to become the second biggest economy in the world. No wonder Warren Buffett argues- "The 19th century belonged to England, the 20th century belonged to the US, and the 21st century belongs to China. Invest accordingly."



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From Deng through to Jiang Zemin, Hu Jintao and now Xi Jinping, the liberalisation of the Chinese economy over the last three decades has been methodical. First, it was agriculture, then industrialisation and the next phase is going to be the liberalisation of financial markets. Industrialisation, and specifically the entry to WTO, marked the turning point in China's growth story, as exports increased from \$25bn/month in 2001 to highs of \$200bn/month in 2012.

Between 2000 and 2012, emerging economies grew at annual rate of +6% (while the US grew at +2%) as people shifted from rural to more productive urban jobs. It is fair to say that the easy gains from industrialisation have already been harvested and for the next wave of growth the emerging countries have to overhaul their economies to compete in high-end production and carry out structural reform.

In September this year, we received a glimpse of the financial reform, when China announced the setup of a Shanghai free trade zone – an eleven square mile zone where foreigners will find it easier to set up businesses; investors will be able to move capital into and out of the country with few restrictions; and banks (not the government), will set the interest rates on deposits. It is reminiscent of special economic zones created by Deng in the early 1980s, which heralded the broader opening of the Chinese economy.

Unfettered movement of capital out of China is as unlikely as any announcement related to full convertibility of the Renminbi. However, an overhaul of the heavily regulated financial system, which has led to misallocation of capital and excess local government debt, is on the cards. Chinese leaders are prepared to sacrifice quantity for quality – low but sustainable growth. So misunderstood is China that the market comments on China over last two years have now come full circle - "overheating", "hard landing", "soft landing" and now "renewed momentum" as data has held their own and in some cases improved. Reforms are the only way to avoid a systemic crisis; rebalancing the economy, and unleashing growth potential. China knows this more than anyone.

### Few tricks, many treats

Despite a few "tricks" - tapering, an Emerging Market sell-off, and a US government shutdown; 2013 has largely been a "treat" for risk taking investors.

So where do we go from here?

At its November meeting, the US Federal Open Market Committee (FOMC) made no changes to monetary policy and maintained the pace of the \$85 billion/month asset purchase program. The most recent Labour market data came in below expectations, but the US unemployment rate dropped a notch to +7.2%. The Fed noted some concerns in slowing housing data but remained fairly neutral, taking a wait-and-see stance to reducing the asset purchase program.

The US manufacturing Index rose for a fifth consecutive month in October, beating expectations and suggesting on-going improvement in the industry. The manufacturing data in Emerging Markets improved as well.

During the month of October, Ford sold 63,803 F-Series pickup trucks (a +12.9% increase from October 2012). Sales of pickup trucks are often a sign of strength or weakness in the small business sectors, which are the most common users of these vehicles.

US inflation continues to come in on the soft side. The headline number is now running +1.2% year-on-year. Given this softness, the Federal Reserve will be in no hurry to unwind the asset purchase program in place. Therefore "tapering" seems to be a topic more for Q1 2014. If inflation were to drop further in the coming months, it would set off alarm bells and talk of deflation would come to dominate.

Europe encountered its own scare of deflation with new data showing inflation at +0.7%, well below the +2% that the ECB targets. To make matters worse, Eurozone unemployment is stuck at +12.2%, with a range of +5% in Germany to +26% in Spain.



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In Europe, where the ECB meets this Thursday, the soft inflation data presents a challenge to policy makers. The Eurozone is out of recession, but not out of the woods yet. The ECB could cut interest rates, but with rates at 0.5%, cutting them anymore would have minimal impact (if any). Unfortunately, the ECB cannot go out and buy sovereign bonds in large measure and implement its own version of Quantitative Easing which has been used (effectively) in the US, UK and Japan. In Outright Monetary Transactions (OMT), the ECB has a similar program at its disposal, but it cannot use it unless asked to by a sovereign nation. The sovereign nation in return for this privilege will have to adhere to strict austerity conditions; viewed as political suicide by many an implicated government.

ECB President Mario Draghi's words have historically proven more powerful than the tools he has at hand. Therefore, I would expect nothing more than rhetoric this Thursday, to calm the markets.

### Where to invest

Reports continue to suggest strong inflows into the equity asset class, mostly at the expense of fixed income funds. Data from earlier in the week showed that flows into equity mutual funds/ETFs in October were the third-largest inflows on record. On the other hand, Bond funds have posted five consecutive monthly outflows, for the first time since 2003.

The year started with the SPX trading at 12.8x forward earnings and it is now at 14.4x. Can we go higher? 15x or even 16x (which would mean an SPX level of 1842 and 1964 respectively at the end of 2014)? To quote President Obama, which I am not too fond of doing: Yes we can! We have seen the SPX trade at 25.6x forward earnings in 2000 and again at 15.6x in 2007. Those valuations were at the top of the economic cycle. Currently, we are at best mid way in the expansionary cycle, with the US still struggling to get to a +3% GDP growth rate.

Therefore, at the current PE level of 14.4x we are not at risk of breaching a high valuation by any means. If earnings keep pace, and so far nothing suggests anything to the contrary, and macro calm prevails, the SPX will continue its upward climb during the next year.

European equities continue to outpace US equities and even more impressive yet, is the decline in European sovereign yields. What went from 7.6% to 4% bounced back to 5% and is now back at 4%? Spanish 10 year yields of course. Spanish bond yields are back at multi year lows.

I remain positive on US equities in the medium term, but today my preference is for European and Emerging Market Equities until the end of the year.

In the US, my preferred sectors are Energy (XLE), Financials (XLF) and Technology (XLK) followed by Basic Materials (XLB) and Industrials (XLI).

In our discretionary portfolio the allocation stands as follows: **Equities** 50% (US 24%, Europe 18%, Japan 4% and EM 4%), **Bonds** 20%, **Commodities** 6%, **Alternatives** (includes structured products and options strategies) 22%, and **Cash** 2%.

Some of the stocks I like – Apple, Google, Amazon, Schlumberger, Halliburton, Gilead Sciences, GE, United Technologies, Bank of America, JP Morgan, Lyondell Bassell Industries (LYB), Rio Tinto, Saint-Gobain, Danone, L'Oreal, Roche, Société Generale, Infineon Technologies, ASML Holding, BMW.

### Currencies and commodities

For the currency traders, the ECB's monetary policy decision this week is vital, perhaps more so than the US Jobs report due Friday. The EUR/USD dropped over -2% on the back of weak Eurozone data and less than the anticipated pessimism from the Fed statement. As noted above, the Eurozone inflation is soft, and if the ECB were to undertake a



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rate cut or signal more easing, EUR/USD could go all the way to 1.32. However, were Draghi to say that the drop in inflation is only temporary; EUR/USD will head back to the 1.38 level. A better-than-expected jobs report in the US would also send EUR/USD lower.

**GBP/USD** is likely to hold the 1.60 level for the time being. Manufacturing data indicate the UK economy is growing at a healthy clip of +3.5-4% p.a., if not more. This could force the Bank of England in the near future to consider its dovish stance and further support the currency.

**AUD/USD** is likely headed higher as data improves in China. The China trade balance data out this Friday will likely indicate a higher surplus as exports jumped higher. Australia's retail sales data out Monday was twice the expected value and manufacturing activity has also accelerated. This will keep the Reserve Bank of Australia on hold and the AUD currency bid.

**Gold** has traditionally had good second half of the year, but so far this year the yellow metal has not found favour with consumers or investors alike. The US default risk pushed gold higher, but since then it is back to testing the \$1,300 level. Despite delayed expectations of Fed tapering, USD strength against EUR falling inflation, the uptick in 10y US Treasuries and firmer equity markets have all set a difficult environment for Gold. Weaker-than-usual seasonal demand from India, due to an import ban on Gold, has also hurt the metal.

Best wishes,

Manish Singh, CFA