



## Market Viewpoints

Manish Singh

January 2015

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***“When things aren’t adding up in life, it is time to start subtracting”***

– Author Unknown

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By pegging its currency to a fixed EUR/CHF rate in 2011, Switzerland became an adjunct member of the Eurozone. This was the case until last Thursday, when it suddenly decided to cut loose. With Switzerland, we now have an insight into some of the risks that might emerge should a strong nation i.e. a budget surplus nation (Germany) leave the Eurozone. What we also saw last week, was a major western central bank going back on its pledge; a pledge it had reiterated to hold only a week before. It should serve as a reminder to all investors that unconventional policies will not last forever and cannot be taken for granted. At the heart of the Greek crisis is “debt sustainability.” This means that if the cost to service the debt becomes higher than the primary budget surplus, Greece will never be able to reduce its debt and will head towards a sovereign default. Greece has received €252bn in bailout money since 2010. However, astoundingly, 90% of this amount has gone to service debt and interest payments to creditors, many of whom are in the core Eurozone countries. Only 10% of the bailout money has gone into public spending. The Eurozone economy has weakened considerably and due to political wrangling, the European Central Bank’s (ECB) response so far has been more words than actions. The ECB is behind the curve. Fortunately, as inflation expectations have worsened, the consensus on the Council has grown. Even Bundesbank President Jens Weidmann seems to have shifted his focus from opposing a Quantitative Easing (QE) program, to influencing its design and implementation. The ECB Governing Council meets this Thursday, and I expect the meeting to result in the Council announcing a QE program to purchase Euro sovereign bonds. European stocks could rally significantly post the QE announcement. An ECB QE is not priced into European stocks.

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### Swiss Roll

If a Central Bank’s job is to calm the market, last week, the Swiss National Bank (SNB) achieved the exact opposite, as the Swiss Franc rocketed +30% and Swiss equities melted away like Swiss chocolate on a summer’s day. In a surprise move, the SNB decided to scrap the minimum exchange rate target of CHF1.20 against the Euro. The EUR/CHF dropped -30% to lows of CHF0.85 per Euro before settling above parity. The EUR/CHF floor of 1.20 was set up in 2011 in an effort to fend off safe-haven flows from the Eurozone leading to the relentless rise of CHF, which was crippling Swiss exporters. The answer as to why now may lie in actions due later this week from the ECB, which is poised to launch a QE program, in the hopes of stimulating the Eurozone’s struggling economy. That move would likely weaken the Euro further, and with the SNB committed to a stable CHF, it would have had to print, sell francs and buy Euros thus adding billions of Euros to its already bloated balance sheet. It seems that it dawned on the SNB that fighting the strengthening of their currency against a tsunami of Euro flows was a losing game, and the sooner it stops playing it, the better. Since December 2007, the SNB’s balance sheet has expanded from the equivalent of 20% of the Swiss GDP to 75% of GDP. For some perspective, over approximately the same time period, the US central bank’s QE programs expanded its balance sheet from 6% to 25% of US GDP.

By pegging its currency to a fixed EUR/CHF rate in 2011, Switzerland had become an adjunct member of the Eurozone. This was the case until last Thursday, when it suddenly decided to cut loose. While we are yet to witness what would happen if a weak nation leave the Eurozone, we now have insights into some of the risks that might emerge should a strong nation i.e. a budget surplus nation (Germany) leave the Eurozone. What we also saw last week was a major western central bank going back on its pledge, a pledge it had



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reiterated to hold only a week before. It should serve as a reminder to all investors that unconventional policies will not persist forever and cannot be taken for granted.

### How do you say *déjà vu* in Greek?

For faithful followers of European events, it feels like *déjà vu* all over again: The Greek government loses a vote in the parliament, elections are called, the left wing party leads in the polls and threatens to take the reins of the government in Athens, Greece exiting (Grexit) fans fears of Eurozone instability, German politicians play hardball and the Euro weakens.

In the last version of this “Greek tragedy” in May 2012, the writing was on the wall for Greece. One respected Wall Street Economist went as far as putting a date on Greece exiting the Euro – January 1, 2013. He noted, “...we assume Grexit occurs on January 1, 2013, with Greece staying in the EU and receiving external loan support (to mitigate risks of social unrest and collapse of civil society). Grexit will be followed by a series of policy responses aiming to prevent a domino-style collapse of the banking system and escalating economic disruption.”

Two years hence, Greece is still in the Eurozone and still on crutches. The Grexit comments highlight two things - first, the pitfalls of forecasting a political and macro event, and second, the complexity of the European Union which makes an exit very unlikely. The EU in that respect is a little like the Eagles classic *Hotel California*, where - you can check out anytime you like, but you can never leave.

Greece has received €252bn in bailout money since 2010, however, astoundingly, 90% of this amount has gone to debt and interest repayments to creditors, many of whom are banks and hedge funds in the core Eurozone countries of Germany and France. Just 10% of the bailout money has gone into public spending. The crisis in Latin America in the 1980s saw American and British banks bailed out, now it's the turn of the German and French banks!

At the heart of the Greek crisis is “debt sustainability.” This means that if the cost to service the debt becomes higher than the primary budget surplus, Greece will never be able to reduce its debt and therefore will head towards a sovereign default. Greece's debt interest cost is 4.3% of GDP. Greece has to target a primary budget surplus of 4% of GDP on trend to reduce debt/GDP, and it is achieving only 2.4%, despite severe austerity.

The elections are on January 25. Failure to form a government will lead to a second election in March, which prolongs the uncertainty. The new government will also have to quickly prove a strong commitment to reach an agreement with the Troika (The European Commission, the IMF and the ECB) to buy time and allow the ECB to continue funding the Greek banks. Greece's debt restructuring, Private Sector Involvement (PSI) in 2012 and progress in fiscal consolidation have provided it with more negotiating power this time around. More than 80% of Greece's sovereign debt is with the official sector. European banks have very little or no exposure to Greek assets post-PSI. In a recent report, the IMF admits the need for an official sector involvement (OSI) in Greece, in other words: debt relief. €35bn in the base case scenario and €110bn in the worst case scenario. A primary budget surplus will be the target and focus of the negotiation's between Greece and the Troika, which will then determine everything else.

I believe the probability of a Grexit is a very low. Greece will carry out more reform in return for renegotiating its debt and extending the maturity (perhaps as far out as 50 years). Undoubtedly, it will be an

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acknowledgement that the current approach to debt sustainability in the Eurozone is imperfect, which I think we all know is true.

### **The Agony and the Ecstasy**

The festive discounts and Boxing Day sales are over but prices continue to fall. The agony (German opposition) and the ecstasy (ECB President Mario Draghi's relentless push for QE) have now come to a conclusion, as deflation has come knocking on the doors of the Eurozone. In December, we received the first negative inflation print (-0.2%) since 2009. The ECB's legal mandate is price stability, defined as inflation "below but close to 2%" in the medium term. A Japan-style deflationary slump in the Eurozone beckons, if nothing is done to arrest the fall in prices. A short period of deflation is not a bad thing, however, when growth is weak and some Eurozone countries are in recession or barely avoiding it, falling prices are not harmless and indicate a deeper malaise.

The Eurozone economy has weakened considerably and due to political wrangling, the ECB's response so far has been more words than actions. The ECB is behind the curve. Fortunately, as inflation expectations have worsened, consensus on the ECB Governing council has grown. Even Bundesbank President Jens Weidmann seems to have shifted his focus from opposing the QE program to influencing its design and defining its implementation.

The ECB Governing Council meets this Thursday, and I expect the meeting to result in the Council finalizing and announcing a QE program to purchase Euro sovereign bonds. The likely reluctance of the members of the Council to pre-commit to size and Draghi's aim to maximize Council "Yes" votes means QE1 will likely be smaller than what Draghi intended, and there will be QE2, QE3 etc. to achieve the target of expanding the ECB balance sheet.

Indications are that the ECB will announce a €500bn government bond purchase program to be implemented over a one year period. Those expecting a €1 Trillion QE programs may feel underwhelmed, but they shouldn't be. If you compare the US and Eurozone QE program as a percentage of the respective regions' gross annual debt issuances, the ECB's €500bn announcement looks very significant. The US Fed's QE program absorbed 16% of gross issuance of US Treasuries; by contrast the ECB's €500bn program would absorb 62% of gross issuance.

QE is not the silver bullet, structural reform of the Eurozone is. However, the ECB's mandate is price stability and, with inflation in negative territory, the ECB cannot wait for structural reforms in the Eurozone. QE is an important monetary policy tool. With interest rates at zero, QE is the monetary stimulus to keep real rates positive. If real rates go negative, it would amount to monetary tightening, which is not the outcome the ECB wants or intends, and one that the Eurozone can afford. QE supports debt sustainability in the Eurozone by keeping interest rates low for a longer period of time.

The 3Q-earning season in Europe ended well. For instance the Eurostoxx 50 (SX5E) earnings rose +16% despite only a marginal +2% rise in revenues. Yet, stocks have hardly responded due to the macro overhang of Greece, the oil price slide and fears of deflation. The continued weakness of EUR/USD should help earnings further. European stocks could rally significantly post the QE announcement. An ECB QE is not priced into European stocks.

### **Where to invest**

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It's been a volatile start to the year. The general view is that there is a growth concern and this is exacerbated by the problems in the commodities market and the Eurozone. This has manifested itself in the following.

- Extremely low yields in the bond market, particularly in Europe, where the short end of German government bonds trade at a negative yield.
- Bid appetite for all USD assets, which has led to the strengthening of USD, and
- Selling of anything commodity-related - either hard assets or commodity currencies (RUB, BRL, MXN )

Could USD strengthen more? Yes. However, in my view, USD strength and the rush for USD assets, risk being overdone. Once the Greece election is out of the way and the ECB has announced its QE program, I expect European equities and Emerging Market equities to catch a bid and perform well.

With negative interest rates for deposits at the ECB, one thing is clear, the liquidity generated from QE will find its way to the markets, as investors look for positives returns. This did not happen in the case of the US QE, where most, if not all the liquidity, was deposited back at the Fed. The deposit rate paid by the Fed was +0.25%.

I see Emerging Market sovereign and corporate debt, Emerging Market equities and European equities benefiting from the ECB QE. I also see a relief rally in commodities on the back of an ECB QE and the selling off in US Treasuries as well as weakness of USD. The US 30Y Bond hit a new low and yields are now as rich as in 2012. A move up in yields would not be a surprise.

Besides battered oil stocks and miners are my favourite pick, as low oil prices (input cost to miners) give a boost to their earnings. China is not applying brakes and over next few quarters, you will see more Reserve Rate Requirement (RRR) cuts from the People's Bank of China (PBoC). In a move towards a more market-driven economy, China has stopped regular foreign-currency purchases and is freeing up restrictions on the flow of money in and out of the country. Reduced FX market intervention offers the PBoC more room and time to pursue monetary policies that are directed towards domestic growth objectives. A slowdown in China yes, but a spike in domestic demands is also in the offing.

It's abundantly clear than Janet Yellen is reluctant to raise rates and she has the Fed committee on her side. Therefore, equities are still the asset class to be in, and volatility is the price you pay for holding equities. When the first US rate rise comes in due course, it will likely be a token increase. As for Europe, Japan, the UK, China, none is looking to raise rates. It is therefore not in the US Fed's interest to increase the rate differential between the US Dollar and other currencies and make USD so strong that it begets a growth problem in the US economy.

My equity longs, in order of preference are: Europe, Emerging Markets, US and Japan.

Some of the stocks I like

Some of the stocks I hold/like to hold in our discretionary portfolio are: Amazon (AMZN), Google (GOOG), Apple (AAPL), Citigroup (C), JP Morgan (JPM), Bank of America (BAC), Barclays (BARC LN), UBS (UBSN VX), Syngenta (SYNN VX), Glencore (GLEN LN), Rio Tinto (RIO LN), Nestle (NESN VX), Pepsi

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(PEP), Roche (ROG VX), Gilead Sciences (GILD US), Twitter (TWTR US), Volkswagen (VOW GY), Inditex (ITX), Cognisant (CTSH), Vinci (DG FP), Sanpaolo Intesa (ISP IM), Anheuser Busch (ABI BB), Starbucks (SBUX), United Technologies (UTX), Richemont (CFR VX), and Petrobras (PBR US)

### Currencies

The EUR/USD fell to a fresh 9-year low and is below its inception rate of 1.1745. This move was in response to a key decision by an adviser to the European Court of Justice (ECJ) regarding the ECB's Outright Market Transaction (OMT) program. The adviser concluded that the ECB did not overstep its power when it launched the OMT program in 2012. This validates its legality. While the decision is not binding, it could affect the formal decision made by the Court in the middle of this year. Supporting the legality of OMT has smoothed the path to ECB's QE program. The prospect of QE has and should continue to keep the Euro under pressure with EUR/USD reaching lows of 1.15. At 1.10, I would be a buyer of EUR and not a seller.

In the UK, price levels have collapsed further as declines in energy costs, food and clothing all had a negative impact on inflation. The headline inflation rate now stands at +0.5%, a far cry from +3% a few years ago. This news only serves to reinforce the weakness of GBP/USD. For now, the key 1.50 level continues to hold, but it is likely to be just a matter of time before the currency pushes lower. Cable at 1.45 is a distinct possibility, even as inaction in the US over interest rates, will give the currency pair some support during Q1 of this year.

Best wishes,

Manish Singh, CFA