Market Viewpoints

Manish Singh

June 2015

"In the end, more than freedom, they wanted security. They wanted a comfortable life, and they lost it all – security, comfort, and freedom. When the Athenians finally wanted not to give to society but for society to give to them, when the freedom they wished for most was freedom from responsibility, then Athens ceased to be free and was never free again."

- Margaret Thatcher

For those who think Greece cannot be reformed, *Grexit* is an easy solution to propose, but not one without consequences for the Eurozone. It is right to say that *Grexit* is not a problem in the short term (indeed Greece is only 2% of the Eurozone's economy), but it's the medium term implications that worry Germany, the biggest beneficiary of the creation of the European Monetary Union (EMU). If a Grexit does happen, it will change the nature of the EMU forever and make the Euro unstable. EMU will not be a monetary union anymore but will become a fixed rate system like the Bretton Woods. The Bretton Woods system collapsed as it was a fixed rate system, and it came under increasing pressure in the late 1960s and early 1970s as policies pursued by the United States diverged from policies preferred by other member countries. An erosion of the EMU will be a bad outcome for Germany. Of course Germany will not do a deal at any price, but the cost right now is not too high to pay in exchange for guaranteeing the stability of the EMU. Therefore, I continue to believe there will be a deal. Greece, in turn, will be subject to severe reform, for its own good. Athens is finally accepting that raising revenue and cutting spending is its only route to survival.

Goodbye Greece? Not so fast…

Sovereign defaults have been with us for almost as long as sovereign borrowing. The dubious distinction of history's first recorded sovereign default belongs to Greece (oh, the irony). In the 4th century B.C, 10 of the 13 Greek municipalities in the Attic Maritime Association defaulted on their loans to the Delos Temple. Learning from this, Delos subsequently chose to lend to private borrowers in preference to public authorities.

Twenty four centuries hence and many defaults later, Greece is faced with another default. The creditors this time – the IMF (€32bn), the European Central Bank (€20bn) and European nations (Germany €58bn, France €43bn, Italy €38bn, Spain €25bn and so on) stand to lose over €350bn - five times the size of Argentina's $95 billion default in 2001. Apart from the €1.6bn due to the IMF next week, Greece has to redeem almost €7bn worth of bonds at the ECB in July and August and the country clearly does not have the money to do so. The talks to find a solution continue.

This Greek credit crisis began five years ago, but the origins of it can be found many years ago in Greece's deep-rooted culture of tax evasion. According the one estimate, 3-4% of Greece's GDP is lost to tax evasion. Greece's tax evasion culture dates back to the country's centuries-long occupation by the Ottomans, when people evaded taxes as a form of resistance and patriotism. Over the last three decades, that distrust extended to focus on the Greek government of the day, who Greeks saw as corrupt, inefficient and unreliable.

For those who think Greece cannot be reformed, *Grexit* is an easy solution to propose, but not one without consequences for the Eurozone. It's right to say that *Grexit* is not a problem in the short term (indeed Greece is only 2% of the Eurozone's economy), but it's the medium term implications that worry Germany, the biggest beneficiary of the creation of the European Monetary Union (EMU). If a *Grexit* does happen (and it can only happen if Greece voluntarily decided to leave), it will change the nature of the EMU forever and make the Euro unstable. EMU will not be a monetary union anymore but will become a fixed rate system like the Bretton Woods union which came out of the Second World War. Under that system, a country left the union when it became untenable to pursue the single monetary policy of the union. The Bretton Woods system collapsed as it was a fixed rate system, and it came under increasing pressure in the late 1960s and early 1970s as policies pursued by the United States diverged from policies preferred by other member countries. Faced with rising unemployment and an increasing current account deficit, the US responded with an expansionary monetary policy which was at odds with the policy stance required for the smooth maintenance of the fixed exchange rate arrangement.

An erosion of the EMU will be a bad outcome for Germany. In the future, when another EMU country gets into trouble or a radical government comes into power, markets will recall what happened with Greece, conclude another exit from the EMU and the Euro’s stability will put into question. German Chancellor Angela Merkel and her economic adviser, know this and they want to use the Greek crisis to assure everyone that the stability of the EMU is paramount and they will do everything to preserve and fortify the architecture of the EMU. Never let a crisis go to waste, as they say, and Germany will use this crisis to strengthen the monetary union and not cut Greece loose. There will be a Greece-Troika deal, not because Greece so desperately wants it, or deserves it, but because Germany wants it and it desperately wants to keep monetary union going. For it is Germany that has and stands to benefit the most from keeping the EMU together.

Of course Germany will not do a deal at any price, but the cost right now is not too high to pay in exchange for guaranteeing the stability of the EMU. Therefore I continue to believe there will be a deal. Greece, in turn, will be subject to severe reform, for its own good. Athens is finally accepting that raising revenue and cutting spending is its only route to survival and an overwhelming number of Greeks (70% or more) want to stay in Europe.

Ready, set, stay!

Last week, at its June policy meeting, the US Federal Open Market Committee (FOMC) pondered for two days if the time was right to raise interest rates from near zero (where they currently stand). They concluded that it was not. Fed Chair Janet Yellen remarked “Economic conditions are currently anticipated to evolve in a manner that will warrant only gradual increases in the target federal-funds rate.” The Fed officials emphasised an even more cautious and dovish outlook than the one they had laid out at their March meeting. While the median expectation for two interest rate hikes this year remained unchanged, seven participants now saw fewer than two hikes this year, up from three participants in March.

In the US, growth momentum continues to build and labour markets continue to tighten. The Fed is getting set to raise rates later this year and I expect it to be announced at the September FOMC meeting. I forecast an increase in rates of 0.25% and that will be it for the year. Unless we see a 300K plus print on the US jobs report in the next quarter, two hikes this year are highly unlikely.

There have been widespread improvements in the U.S. economy - job growth rose strongly in May and consumer spending has rebounded. Retails sales increased +1.2% in May and excluding autos, the gain was a solid +1%. The US Economy seems to be getting on a firmer footing after a weak start to the year. Quarterly GDP growth is set to bounce back to roughly +3%. A rate rise, when it comes, will be an affirmation that the US economy is doing well. A slow and limited hiking cycle is no reason to be bearish US equities. US stocks will continue to inch higher and are on track to be above 2200 by the end of the year.

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Where to invest

There is increased optimism this week that a Greek deal is imminent. Even if the deal were to be delayed or in fact comes after an episode of capital controls in Greece, the risk of contagion from Greece is minimal. Everything in the Eurozone changed early this year when the ECB announced its Quantitative Easing (QE) program. The ECB's newfound ability to print money, essentially without limit, to support both banks and governments, has dealt a blow to those contemplating cornering the vulnerable Eurozone sovereigns. On top of that, last week came the ruling from European court of Justice (ECJ) on Outright Monetary Transactions (OMT), that opens the door to a more targeted QE by the ECB if it so desires. For instance, in the future, if short sellers target Portugal's sovereign bonds, and if the ECB judges that the country's bond yields have increased to an unjustifiable level so as to threaten contagion, I sense another "whatever it takes" pledge from the ECB and the undertaking of a targeted bond purchase of that sovereign to overwhelm the short sellers. The ECB is now a true lender of last resort and market participants will be wise to acknowledge and remember this.

Bearing this in mind as well as the improving growth parameters in the US economy, there is little reason to be bearish equities. In Europe, the ECB QE is having its desired effect, as the Eurozone economy grew by +0.4% during of the first quarter of this year, its fastest growth since 2013. Spain and Italy appear to be staging strong recoveries, benefitting in particular from impressive export performances. The ECB's recent actions have put Europe on a firmer footing.

This month, the Japanese Yen hit 125, its weakest level versus the USD in 13 years. It's no surprise that the Bank of Japan (BOJ) looks contented with the Yen's decline. However, BOJ Governor Haruhiko Kuroda's recent comments that the country's real effective exchange rate was weak, has no bearing on monetary policy at all and, last week, we did not see any change of tone from the BOJ. The Japanese economy is performing well and inflation is on the rise. However, the BOJ is in no position to unwind QE as inflation remains very low. Therefore, while the BOJ and Kuroda may be satisfied with the Yen's decline, there's nothing that they can or will do to jeopardise the recovery.

If the Euro continues to appreciate then moving from Eurozone overweight to equal weight will be required, with a preference for the Eurostoxx 50 Index over the German DAX Index. For now, Europe overweight suits well. Japan will grind higher. The S&P 500 Index in the US will likely be over 2200 by the end of the year. Within the US sectors my preference is for – Healthcare (XLV), Technology (XLK) and Financials (XLF).

Some of the stocks I hold or recommend one holds in an equities portfolio: – Citi (C US), JP Morgan (JPM US), Gilead Sciences (GILD US), Apple (AAPL US), Amazon (AMZN US), Cognisant Technology (CTSH US), Anheuser Busch (ABI BB), Pepsi (PEP US), P&G (PG US),UBS (UBSN VX), Richemont (CFR VX), Volkswagen (VOW GY), Airbus (AIR FP), United Technologies (UTX), Barclays (BARC), Societe Generale (GLE FP), Roche (ROG VX), Novartis (NOVN VX), Vinci (DG FP), Salesforce (CRM US), Rio Tinto (RIO LN) , Glencore (GLEN LN) , Alcoa (AA US), Michael Kors (KORS US), Petrobras (PBR US), SLM Coup (SLM US), Nordstrom (JWN US), Bank of America (BAC US), Caterpillar (CAT US), Intel (INTC US), Sandisk (SNDK US), Twitter (TWTR US), Walgreen Boots (WBA US), Union Pacific Corp (UNP US)

Currencies

The June FOMC disappointed the USD longs and a great many EUR/USD shorts have been lifted. According to Citi, net EUR/USD positioning now stands at -1.35 standard deviations from its historical mean,

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a significant reduction from the -3.81 standard deviations seen at the end of March. The unwinding of 74,000 contracts over the last 2 weeks, is the biggest 2 week move since the EUR/USD high in May 2014.

The risk to EUR/USD is to the upside, with a possibility that it gets above 1.15, perhaps even 1.17, as news flow in Europe improves and a Greek deal is struck. If it gets to the 1.20 level however, bearing in mind that the Fed will raise rates later this year, a short position in EUR/USD should be considered.

Best wishes,

Manish Singh

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