Market Viewpoints

Manish Singh

May 2015

"Don't limit a child to your own learning, for he was born in another time."

- Rabindranath Tagore

If Greece couldn't manage the €750 million payment in May without raiding the reserve account at the IMF, it seems likely that they will struggle to make the even larger payments in June. No European help is forthcoming in the meantime. Therefore, either Greece agrees a deal and gets EU aid, or it defaults on its obligations come June. Even if Greece were to approve a deal, it is difficult to predict what becomes of the country in six month time. Would Greece reform and find itself on a path to renewed growth or would it sink further laboring under stringent measures and eventually decide to exit the Eurozone. The US recovery that began in Q3 2009 has seen US GDP expand at rate, well below that of previous recoveries. A slow recovery can be knocked off its perch very easily and the US Federal Reserve will be very cautious on signaling monetary tightening. The Q1 GDP print in Eurozone was at an encouraging +1.6% quarter-on-quarter, with stellar performances from France and Spain. In what is becoming a habit, last week China's People's Bank of China cut benchmark one-year interest rates once again and more measures to liberalise rates were announced. Equities are still a buy. If the Euro continues to appreciate, then moving from Eurozone overweight to equal weight will be required. Japan may take a breather, but there is more to come.

Greece: Syriza's boat has run aground

Greece is on the brink and not for the first time. This time however, the situation looks extremely precarious. In Greece, hospitals, universities and local authorities have been forced to transfer funds from their cash reserves to the central bank's "common fund," administered by the debt management agency. Last week, Greece came very close to defaulting on its €750m repayment to the International Monetary Fund (IMF). Ahead of the payment due date, Greek Prime minister Alexis Tsipras took the extraordinary step of writing a letter to the IMF chief Christine Lagarde, warning that he could not make the payment unless Greece was allowed by the European Central Bank (ECB) to issue more short-term debt. Greece ultimately managed to avoid a default and make the repayment by tapping into a rarely used reserve account of Greece at the IMF – i.e. using money at the IMF to pay the IMF. This raises the question – how close is Greece to bankruptcy?

Greece has over €1.5billion of repayments due to the IMF next month, of which €300 million is due on June 5. If Greece couldn't manage the €750 million payment in May without raiding the reserve account, it seems likely that they will struggle to make the even larger payments in June. No European (EU) help is forthcoming in the meantime. Therefore, either Greece agrees a deal and gets EU aid or it defaults on its obligations come June.

It's not just the Greek public finances that are in tatters, but the Greek banks are also living dangerously. Greek banks rely on the ECB for its funding and, for this, they need adequate amounts of collateral, which is being depleted rapidly. Cut away from ECB funding, Greek banks will see an acceleration in the outflow of deposits. The government is delaying billions of Euros in payments to its suppliers, and the damage caused from non-payment to Greek corporates will cause added misery and affect the broader Greek economy (my comments on Greece from a Bloomberg interview earlier this week.)

There is little sign of progress in the Greece-Troika (IMF, EU and the ECB) negotiations that would release €7.2 billion of assistance, withheld from Greece, due to its noncompliance in implementing reforms agreed at the time of the last bailout. Difficult issues such as pension cuts and VAT increases remain to be resolved. Besides, it's not just a matter of striking a deal. Given past experience, the EU insists that reforms must be legislated and implemented before the EU will release any cash.

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Syriza's leadership banked on the threat of a Greek default to bring the EU to the negotiating table. It seems they may have overplayed their hand. Early in the negotiations, Syriza's government used a primary budget surplus (+4% of GDP at the time) as a bargaining tool: Threatening to default and use the surplus for public spending, instead of making interest payments if Greece was not offered a new more favorable deal. I am sure you can guess what has happened since. As the Greek economy has struggled and the fiscal balance worsened, the primary surplus is almost gone. Syriza's boat has run aground and they have few bargaining chips left on the table. Had they defaulted early on, with a +4% primary surplus, they would have had the means, at the very least, to meet their domestic obligations for some time and continue negotiating. A default now would bear down immediately on the Greek people with cuts in services, wages and pensions. Meanwhile the EU is in no mood to compromise, nor will it expel Greece from the Eurozone, even if Greece were to default. It intends to keep a defaulted Greece in the Eurozone, and the absence of any financial aid would amount to a slow asphyxiation of the Greek economy. Perhaps this can be a lesson to other errant Eurozone economies who are considering going down the path of electing a populist government, and opposing the EU rules on fiscal prudence, structural reforms and better governance.

Having said this, there is still hope that Greece gets a deal from the EU, which the Greek parliament doesn't pass. It could lead to a referendum, where the Greek people would get the choice to approve the deal and stay in the Eurozone, or reject the deal, and precipitate a default and ultimately choose to leave the Eurozone. Even if the Greeks were to approve a deal, it is difficult to predict what becomes of the country in six month time. Would Greece reform and find itself on a path to renewed growth or would it sink further laboring under stringent measures and eventually decide to exit the Eurozone.

US GDP growth: unsteady footing

For the second year in a row, economists have come into Q1 forecasting +3% GDP growth in the US. They have then lowered their forecasts as the quarter progressed to coalesce to +1% consensus, only to see the actual data print close to zero. It's likely this number will be revised down given a set of misses we have seen recently on the economic data front– retails sales, consumer confidence, industrial production, and personal spending. If Q1 growth were revised to a negative number, then it would be the third time during this recovery that the US economy has registered a quarterly contraction, and all three of these in the first quarter.

Going back to the 1980's, there has never been a quarterly contraction in GDP once the recovery had started. The recovery that began in Q3 2009 has seen US GDP expand at rate of +2.0-2.5%, well below the +3.5-4.5% of previous recoveries. A slow recovery can be knocked off its perch very easily and the US Federal Reserve will be very cautious on signaling monetary tightening. The Fed next meets on June 17, and it is safe to say a rate hike in June is now completely off the table.

Counter-intuitively, as US growth stumbled, the US government bond market witnessed a selloff. The US 10y yield increased from +1.86% in mid-April to a high of +2.29% by early May. The US bond selloff has been blamed on the selloff in the German bunds. The yield on 10y German bunds went from lows of 7 bps (basis points, 1 bps is 0.01%) on April 20 to 74bps in matter of two weeks. The yield on German Bunds is now back to where it was at the end of last year, when the ECB announced its intention to start a sovereign Quantitative Easing (QE).

Why this sell off in bonds?

Long European government bonds was a consensus trade waiting to be disrupted. By mid-April almost 35% of European bonds were trading at negative yields i.e. bond holders were paying for the privilege to lend money to the governments issuing the bonds. As the economic numbers in the Eurozone improved, expectations of higher nominal growth developed. Some panic selling ensued, and the resulting rise in volatility in the government bond market led to a further selloff in Bunds. The selloff was compounded by a lack of liquidity, as banks have scaled back on their market-making activities, in response to increased regulatory capital requirements. There is no saying that things have changed fundamentally for bond buyers and the selloff will continue. However, there is one clear lesson – bonds, in this

environment, are bought for yield and not capital gains. If you chase short term capital gains, then you may be opening yourself to potential capital losses.

Where to invest

The last two weeks have been a test of patience, as bond markets sold off, and chatter ("sell in May and go away") of an impending market correction increased. Nevertheless, despite all the volatility, the US equity market has proven resilient. The S&P 500 index (SPX) eked out gains both last week (+0.25%) and the week before (+0.37%). The big sell-off in bonds has perhaps provided a sneak peek at how bond markets would fare once the Fed begins to tighten. The narrative around the Fed still seem to be - despite the sluggish economic numbers - at least one hike on the board sooner rather than later. This means that the current market expectations (which don't anticipate tightening until December) are in for a surprise. However any Fed-driven downside will be shallow and one that will see a quick rebound in SPX levels to current levels or above. The SPX may continue to trade sideways until the next US jobs report on June 5. I still expect a Fed lift off in September this year.

The Q1 GDP print in Eurozone was at an encouraging +1.6% quarter-on-quarter, with stellar performances from France and Spain. Speaking in Washington, ECB President Mario Draghi reiterated his intent to continue the ECB QE program until September 2016. The Euro area should continue to do well in the remainder of 2015 given:

- A level of the FX rate that aids competitive position of the Eurozone economy
- A neutral to accommodative fiscal stance to go with easy monetary policy, and
- A rebound in credit origination

The risk to Eurozone growth and indeed European equities will be from a confidence shock (Greece) or lower world growth combined with a re-appreciation of the EUR currency.

In what is becoming a habit, last week China's People's Bank of China (PBoC) cut benchmark one-year interest rates once again by 0.25% to 5.10%. This move follows a similar reduction in February to "support the healthy development of the economy". In a further sign of increased rate liberalisation, the bank increased the maximum ceiling on benchmark deposit rates and will trial certificates of deposit (CDs) for individuals and companies this month. So far, CDs can be issued only in the interbank market among financial institutions. CDs for households and companies are considered a big step to interest-rate deregulation.

Equities are still a buy. 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. Japan may take a breather, but there is more to come. The SPX index will grind higher. Within the US sectors my preference is for – Healthcare (XLV), Technology (XLK) and Financials (XLF). US dollar weakness should help miners and gold.

Some of the stocks I favor – Citi (C US), JP Morgan (JPM US), Gilead Sciences (GILD US), Apple (AAPL US), Amazon (AMZN US), Cognisant Technology (CTSH US), Starbucks (SBUX 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).

Currencies

In the March Market Viewpoints, I highlighted that "the risk to EUR/USD is to the downside, but a rally back to 1.15 or beyond is not ruled out" and in last month's newsletter I added -"EUR/USD is capped for now, unless we see a robust Q1 GDP number in the meantime." We did get a good Q1 GDP number and EUR/USD got to nearly 1.15. Where to next? If

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the Fed continues to delay its interest rate increases, then EUR/USD could continue to overshoot. Of course the longer the Fed sits on the fence and delays tightening, the closer the ECB will be to “tapering” its QE program and thus the higher the trough in EUR/USD will be. Calls for 0.90 in EUR/USD will then be belied. My medium term (6 month) forecast for EUR/USD to trade at 1.05 still holds true.

Best wishes,

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