CROSSBRIDGE
CAPITAL

Market Viewpoints

Manish Singh
November 2014

"The future is already here – it's just not evenly distributed."

- William Gibson

If Mr. Market were anxious about withdrawal symptoms after the end of the US Federal Reserve's Quantitative Easing (QE) program, it needn't have worried. The Bank of Japan (BoJ), in an almost perfectly synchronized move, followed with a JPY10 trillion increase (or about 2% of Japan's GDP) of its annual target for expansion of the money supply. In Europe last week, Mario Draghi, President of the European Central Bank (ECB), did a good job dissipating the confusion around the ECB's willingness to do more for the economy. He reiterated that the ECB was in a high state of preparedness to provide further stimulus, if required to do so. He also added that, contrary to speculation, the Governing Council was "unanimously" (he used the word "unanimous" five times during the press conference) behind the goal of expanding the balance sheet. The US mid-term elections saw Republicans seize control of the Senate from the Democrats. This result has arguably reduced President Barrack Obama to a "lame duck." His policies have been repudiated, and it's now up to him if he also gets "plucked." Should Obama choose to negotiate and broker a deal with the Republicans (rather than use executive orders to govern), many things could be achieved and this will be positive for the US economy as well as the US equity market. All is not lost with Republicans controlling both Houses of Congress in the US. The last time this happened was in 1994 under President Bill Clinton, when the S&P 500 Index gained +25% during the ensuing 12 months.

A trillion here, a trillion there...

In November 2008, as interest rates neared zero, it became clear that the US Federal Reserve's (Fed) traditional ammunition, cutting interest rates, was proving ineffective. Amid fears that the US, and the rest of the world, may be facing a 1930's like depression, the Fed embarked on a QE programme. The central bank began buying US Treasuries and mortgage securities and creating new money to pay for them. The rationale was to reduce both long and short term borrowing costs, boost asset prices, generate growth and consumption and reduce an unemployment rate which had reached over 10%. The policy was controversial, but fast forward 6 years, and it has worked incredibly well in averting a depression. US monetary policy has been vindicated and one has only to look at Europe to see what might have been, if QE had not been implemented. The US banks have been nursed to health, house prices and stock markets have rallied, corporate earnings have soared, unemployment levels have dropped to below 6% and GDP growth is at +3-3.5%. The QE program was never meant as an open-ended facility and the taps were finally turned off in October. In total, the Fed has added $3.7 trillion in assets to its balance sheet and, during this time, the S&P500 index (SPX) nearly trebled.

If Mr. Market were anxious about withdrawal symptoms after the end of the Fed's QE program, it needn't have worried. The Bank of Japan (BoJ) in an almost perfectly synchronized move, followed with a JPY10 trillion trillion increase (or about 2% of Japan's GDP) in its annual target for expansion of the money supply. If the recent sales tax increase is excluded, core inflation in Japan is still running at +1%, too close to deflation for comfort.

The second important news from Japan was the long awaited announcement of the rebalancing of the Government Pension Investment Fund (GPIF) away from Japanese Government Bonds (JGBs), into other assets. The holdings of domestic bonds will be reduced to 35% from 60%, domestic and foreign stocks will rise to 25% each from 12%, whilst foreign bonds will rise to 15% from 12%. Thus, the mid-point weight of foreign assets will rise to 40% from 23%, which equates to a JPY16 trillion ($140 billion) flow into foreign assets based on the current AUM of the GPIF.There is certainly plenty of liquidity to support Mr Market, and if the European Central Bank (ECB) were to act on its promise to increase its balance sheet by almost €1 trillion, more will certainly follow.

Lame duck, now what?

Market Viewpoints

Manish Singh
November 2014

The US mid-term election saw Republicans seize control of the Senate from the Democrats (Republicans already control the House of Representatives). The result has arguably reduced President Barrack Obama to a “lame duck”. The final tally - the Republican party holds 249 seats in the House (the most since a 270 majority in 1929), 54 seats in the Senate, controls 67/99 State Houses and Senates and 31 Governors mansions. President Obama’s policies have ben repudiated, and it’s now up to him if he also gets “plucked.”

Obama however doesn’t have to be a “lame duck,” if he plays the hand he has been dealt wisely. The new Senate Majority leader Mitch McConnell is a severe critic of Obama, but he is also the one who helped broker partisan deals that ended last year's government shutdown and twice averted a federal default. McConnell has, so far, spoken a conciliatory tone and ruled out any more shutdowns. Regardless of the political views, if Obama chooses to negotiate and broker a deal, a lot could be achieved and this will be very positive for the US economy as well as the US equity market.

An outbreak of bipartisan bickering will be an unpleasant surprise, but the two sides could find common ground on a number of issues. The three that immediately come to mind are.

- Granting the President a so-called “fast-track” authority to conclude trade agreements with Europe and with Asian countries
- The President approving the Keystone XL pipeline, which will create tens of thousands of jobs. The pipeline will allow Canadian crude oil to be transported to the US Gulf states and save the US refiners an estimated $2-3 a barrel for piping in the oil, rather than sending it across the country by rail
- A deal to allow back corporate cash lying overseas (repatriation holiday) by bringing in legislation to reduce or cut in half, the 35% tax levied on cash repatriated by US companies. The increased revenue to the Treasury would be used to fund infrastructure spending

All is not lost with Republicans controlling both Houses of Congress in the US. The last time this happened was in 1994 under President Bill Clinton, when the SPX Index gained +25% in the ensuing 12 months.

More promises, buys more time

Early last week, ahead of the ECB press conference, a *Reuters* report titled “Central bankers to challenge Draghi on ECB leadership style” spread like wild fire in the market. The report painted ECB President Mario Draghi as acting like a lone ranger. It claimed that the ECB Governing Council members were angered that at the last ECB press conference, Draghi effectively set a target for increasing the ECB's balance sheet, even as the policy-making Governing Council explicitly agreed **not** to make any figure public. Draghi was described as “secretive”, “less collegial” and that the Governors “sometimes feel kept in the dark”. Understandably, it made the market anxious about the ECB’s commitment to its announced expansionary monetary policies.

With this backdrop set, the press conference got off to a predictable start and Draghi didn’t disappoint. He went straight into assuring the audience, and indeed the market, that there was no discord within the ECB Governing Council and it was not operating in a state of paralysis at the Eurozone’s hour of greatest need. Draghi stressed that Council disagreements were “normal,” and like those of any other central bank committees. “When we differ in our views and in our policies, there is no drawing a line between North and South,” he said. “There is no coalition, not at all.” He also reiterated that the ECB was in a high state of preparedness to provide further stimulus if required to do so. Draghi also added that contrary to speculation, the Council was “unanimously” (and he used the word “unanimous” five times during the press conference) behind the goal of expanding the balance sheet “towards” its early 2012 size (in March 2012, the ECB’s balance sheet was €2.93 trillion, it now stands at €2 trillion)

Mr Draghi did a good job dissipating the confusion surrounding the ECB’s willingness to do more. As a result, European stocks headed higher and the EUR/USD lower. If the ECB adds €1 trillion into the market, then it has to go somewhere! With bond yeilds at record low and the ECB’s policy objective of encouraging inflation, there is a strong likelihood that equities will benefit the most from this ECB largesse. New ECB staff forecasts on economic growth and inflation are to be released in December and these may open the door to further action.

Where to invest?

US employment growth is showing remarkable progress. The unemployment rate is now at 5.8% (a level last seen in July 2008) and fast approaching the Fed's Q4 2015 forecast, one year ahead of expectations. The current expansion in the US Job market (as measured by consecutive months of increases in nonfarm payrolls) is now in its 49th month and is the longest since World War II. This eclipses the 48 month streak achieved in the 4 years ending in June 1990.

The BOJ move into QE has led to a weaker Yen, which is very positive for the Japanese manufacturing sector and indeed the Japanese equity market. Korea and Taiwan are the main losers as a result. Long Japan equities is still the trade to be in.

Europe on a relative basis, looks far more attractive than the US. Germany (EWG US, -15% YTD) is trailing the SPX (SPY US, +10%) by 25% this year. Of the other European equity markets, France (EWQ US) trails the US by -21%, Italy (EWI US) by -19% and Spain (EWP US) by -16%.

My equity longs, in order of preference are, Japan, Europe and the US. Sector wise I favor Financials, Technology, Industrials, Consumer Discretionary and Energy.

Some of the other stocks I hold/like to hold in our discretionary portfolio are: Amazon (AMZN), Google (GOOG), Apple (AAPLUS), Citigroup (C), JP Morgan (JPM), Bank of America (BAC), KKR (KKR US), Barclays (BARC LN), UBS (UBSN VX), Halliburton (HAL), Glencore (GLEN LN), Rio Tinto (RIO LN), Nestle (NESN VX), Philip Morris (PM), Pepsi (PEP), Roche (ROG VX), Pfizer (PFE), Volkswagen (VOW GY), Inditex (ITX), Cognisant (CTSH), Vinci (DG FP), Sanpaolo Intesa (ISP IM), Anheuser Busch (ABI BB), Starbucks (SBUX), McDonalds (MCD US), Caterpillar (CAT US), General Dynamics (GD US), United Technologies (UTX), Richemont (CFR VX), and Petrobras (PBR US)

Currencies

Given large short positions in EUR/USD, the currency pair is always vulnerable to a short squeeze should US data disappoint, but the trade in EUR/USD is still for one of a weaker Euro. Draghi's comments indicated a likely downward revision in Eurozone data, likely keeping the ECB in an easing mode. Further ECB action hinges on two contingencies - a decision that current action is not enough and forward looking inflation & growth expectations that are weakening. I now expect EUR/USD to trade in 1.22-1.26 range.

The USD/JPY took ten months to go from 105 to 110 but less than a month to go through the next 5 big figures to 115. The overshoot from 110 came as the BOJ went into liquidity-infusion mode. Japan imports more than 90% of its energy needs and the recent collapse of oil prices has acted as a massive price deflator for Japan's economy, at the time when policymakers are already fighting years of deflation of their own making. USD/JPY is headed to 120, albeit not at the same pace as the last month.

In the UK, the economic news is not nearly as positive as the Bank of England (BoE) had anticipated. Consumer demand and retail sales weakness have made the BoE more dovish. GBP/USD is likely to hug the 1.60 level and not move much further away on either side of it for the foreseeable future.

Best wishes,

CROSSBRIDGE
CAPITAL

Market Viewpoints

Manish Singh
November 2014

Manish Singh

Manish Singh, CFA

Crossbridge Capital LLP
9 South Street, London W1K 2XA, United Kingdom www.crossbridgecapital.com