



## Market Viewpoints

*Manish Singh*

October 2014

---

***“Courage is what it takes to stand up and speak. Courage is also what it takes to sit down and listen”***

**- Winston Churchill**

.....

From the European Central Bank (ECB) announcement last week, the market was left with the impression that the ECB Governing council has had a rethink and wants to see the impact of the existing policy initiatives before undertaking any fresh intervention. This however doesn't change my view that the ECB will eventually pull the trigger on sovereign debt Quantitative Easing (QE) sometime next year. In the absence of more supportive news from central banks, it is easy to see how we might enter a liquidity vacuum over next two weeks, until the US Federal Reserve meets on October 29. This is the period of anxiety for equity investors. However, given all the bearishness during the last few days, markets were left confounded this week as to whether the minutes released by the Fed were actually from its meeting in September. The minutes were more dovish than the statements and comments of three weeks ago. In the present circumstances, being bearish or bullish comes down to basically one argument. Given the debt dislocation, if governments have to choose between inflation and deflation, which would they choose? If you vote for deflation, then you should be a Bear and a buyer of bonds. If on the other hand, you think inflation will be tolerated (and perhaps encouraged), then you should be a buyer of nominal assets – equities, real estate and commodities. The current disinflationary spell may threaten to bring on deflation but deflation is unlikely to be tolerated by the G7 central banks and governments. On a medium to long term basis, I am firmly in the inflation camp and therefore a buyer of nominal assets.

.....

**The Truman Show**

Markets don't seem to be in good health: blowing hot one day and cold the next. There is not one clear overriding reason for this, as the news flow on average hasn't changed much compared to a month ago, three months ago or even over the last couple of years. The economic message remains the same: A disinflationary outlook with a steady recovery. As QE nears its conclusion in the US, bearish views abound and anxiety is growing. Is it right to be anxious? Yes. Is it right to be entirely bearish? Absolutely not.

There is always a big difference between the way things seem and the way they actually are. Nowhere is it more on display than in today's financial markets. Some have warned of a 'Truman Show' market. In this 1998 film, Jim Carrey's character (Truman Burbank) goes about his life oblivious that every aspect of his existence is being shown to an audience of millions. His hometown of Seahaven is carefully supported by a cast who are all in on the deception. In today's financial markets, central bankers are being viewed as the creators of a similarly artificial market environment for investors. The day will come when Mr Market, like Truman Burbank, will have to snap out of the dream and face reality. If that will be a rude awakening or one that Mr Market will handle with aplomb, is anybody's guess. For now though, the "Truman Show" is not over, and despite a few gyrations, the equity market will continue to be supported. The concern that QE has done more to create over-valued asset prices than assist an economic recovery, is debatable. What isn't debatable is that without such drastic monetary policy, we might not have had economic recoveries in the US, Japan and the UK.

From the ECB announcement last week, the market was left with the impression that the ECB Governing council has had a rethink and wants to see the impact of existing policy initiatives before undertaking any fresh intervention. This however doesn't change my view that the ECB will eventually pull the trigger on sovereign debt QE sometime next year. In the absence of more supportive news from central banks, it is easy to see how we might enter a liquidity vacuum over the next two weeks until the US Federal Reserve meets on October 29. This is the period of anxiety.

**Crossbridge Capital LLP**

9 South Street, London W1K 2XA, United Kingdom [www.crossbridgecapital.com](http://www.crossbridgecapital.com)

Registered in England and Wales no: OC348979 Registered office as above. Authorized and regulated by the Financial Conduct Authority



## Market Viewpoints

Manish Singh

October 2014

The International Monetary Fund's (IMF) World Economic Outlook, published early this week, talks of "*Legacies, Clouds, Uncertainties*". Two prior reports in July and April were titled "*An Uneven Global Recovery Continues*" and "*Recovery Strengthens, Remains Uneven*" respectively. As you can see, the titles, get gloomier with each edition. No surprise then that the IMF cut its forecast for global growth to +3.3% this year and +3.8% next year (vs. their July forecasts of +3.4% and +4% respectively). To be fair, it is the IMF's mandate to warn governments and encourage them to carry out reform. If the IMF didn't highlight the risks, it wouldn't be doing its job. The IMF forecast a stronger US economy, and a steady (albeit weak) Eurozone recovery as well as a slowdown in China. If the growth outlook is gloomy, surely the Fed will not be in hurry to raise interest rates. Therefore, the bearish expectations look premature to me.

### Inflation v Deflation

When the US economy slumped in 2007-08, budget deficits rocketed and the Fed began large-scale asset purchases. The *Inflationistas* argued - higher deficits and the resulting higher sovereign debts would drive interest rates higher and the money printing would bring about inflation/hyperinflation. The *Deflationistas* argued - demand destruction and deleveraging means yields would be driven lower and the money printed would just sit idle as there would be a lack of demand for credit. The *Deflationistas* had the right prognosis, but the *Inflationistas* shouldn't be discredited. Following a debt crisis, the path to higher inflation first travels through a disinflationary zone, and this is what we are witnessing now.

In the present circumstances, being bearish or bullish on the market comes down to basically one argument. Given the debt dislocation, if governments have to choose between inflation and deflation, which would they choose? If you vote for deflation, then you should be a Bear and a buyer of bonds. If on the other hand, you think inflation will be tolerated (and perhaps encouraged), then you should be a buyer of nominal assets – equities, real estate and commodities. The current disinflationary spell may threaten to bring on deflation, but deflation is unlikely to be tolerated by the G7 central banks and governments. On a medium to long term basis, I am firmly in the inflation camp and therefore a buyer of nominal assets.

In the days prior to 1933 and going back as far as the year 1200, years of deflation were as common as years of inflation. However, since 1933 there has not been a single year of global year-over-year fall in prices. How come?

We live in a world of paper money, where the lessons from the Great Depression have been learnt and another spell of global deflation is unlikely to be allowed to take hold again. To this end, the global currency links to precious metals were disabled and finally collapsed under President Nixon in the 1970s. The 1997 LTCM hedge fund crisis, the Dot-Com bust in 2000 and the 2007 subprime crisis are all cases where easy money policy was used to maintain nominal growth, ultimately leading to higher debt.

The International Centre for Monetary and Banking (ICMB) released the 16th Geneva Report on the world economy last week. Contrary to widely held beliefs, the world has not yet begun to de-lever. The global debt-to-GDP ratio is still growing (albeit at a slower rate). The total burden of world debt, private and public, has risen from 160% of national income in 2001 to almost 215% in 2013. Not surprisingly, the report predicts interest rates across the world will have to stay low for a "very, very long" time to enable households, companies and governments to service their debts and avoid another crash. The report advocates the ECB to carry out "a forceful intervention with outright purchases of sovereign bonds as well as private securities" to avert excessive downward pressure on inflation and fulfil the ECB mandate of price stability.

### Where to invest?

There are many red flags – a sell-off in high yield bonds, falling commodity prices, a flattening yield curve and a narrowing labour force participation rate. Geopolitics and the Ebola outbreak are also potentially significant tail risks, but the underlying equity backdrop is still constructive and supports the "buy the dips" message. We are facing low interest rates and low inflation, hand in hand with low GDP growth i.e. a Goldilocks economy.

### Crossbridge Capital LLP

9 South Street, London W1K 2XA, United Kingdom [www.crossbridgecapital.com](http://www.crossbridgecapital.com)

Registered in England and Wales no: OC348979 Registered office as above. Authorized and regulated by the Financial Conduct Authority



## Market Viewpoints

*Manish Singh*

October 2014

The Fed's QE program is coming to an end, but the US economy can walk without the crutches of QE, given a reliable +2% GDP growth rate. One cannot call the US recovery a "jobless" recovery anymore. A strong USD in response to sustained US growth, helps US consumer spending and by consequence global exports into the US.

In Europe, the UK is experiencing the best growth among G7 nations, with a +3% plus growth rate. The Eurozone is gliding into a "bad data is good news" phase and weak data brings weaker EUR/USD and increases the probability of QE from the ECB.

There were interesting comments this week from "Bond King" Bill Gross. When asked why interest rates would remain low, he remarked – "The Fed has said that the appropriate interest rate long-term to keep the economy in balance is 3.75% to 4%. I say it's 2%. If the Fed follows through by raising the Federal Funds Rate to 4% in the next few years, there will be Bear markets for all assets."

Given all the bearishness during the last few days, markets were left confounded this week as to whether the minutes released by the Fed were actually from its meeting in September. The minutes were more dovish than the statements and comments of three weeks ago. Indeed, on the committee a number of participants said growth "might be slower than they expected if foreign economic growth came in weaker than anticipated," and that "some participants expressed concern that the persistent shortfall of economic growth and inflation in the Euro area could lead to a further appreciation of the dollar and have adverse effects on the U.S. external sector." This doesn't sound like a committee ready to raise rates.

Being overweight Europe is proving tricky, but Germany and Spain remain attractive. Germany will be chief beneficiary of a weaker Euro. Japan and the US are still good Longs and dips in Emerging Markets are another opportunity to enter Long trades if you missed the rally earlier this year. Luxury goods, energy stocks and mining stocks have seen the biggest move on the downside recently and present a good buying opportunity.

My sector preferences in the US are Financials (XLF), Technology (XLK).

Some of the other stocks I hold/like to hold in our discretionary portfolio: Amazon (AMZN), Google (GOOG), Apple (AAPL US), Citigroup (C), JP Morgan (JPM), Bank of America (BAC), Standard Chartered (STAN LN), Barclays (BARC LN), UBS (UBSN VX), Halliburton (HAL), Total (FP FP), Freeport McMoran (FCX), 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), Petrobras (PBR US)

### Currencies

The **EUR/USD** seems to have shrugged off the negatives and found a modicum of support and is back near 1.27. However this is only a temporary move. The economic data from the Eurozone is horrid. The news is only likely to embolden ECB President Mario Draghi to expand credit and stimulate the economy. The EUR/USD pair remains a sell on rallies, as the divergence between US and Eurozone growth only seems to be widening.

The Bank of England (BoE) is becoming increasingly reluctant to raise rates and **GBP/USD** has suffered. The BoE is however keen to reign in the rally in house prices, which would further distort (the already distorted) London property market. Macro prudential measures - ceilings on the amount of mortgage debt a borrower can take on and increases in the amount of capital banks have to hold against risky loans - have been put in place. Such measures are no substitute for monetary policy however, when it comes to the currency view. Of the G7 central banks, the BoE is still very likely to be the "first to hike." GBP/USD is unlikely to stay below 1.62 and I expect it trade in the 1.60-1.65 range for the rest of the year.

### Crossbridge Capital LLP

9 South Street, London W1K 2XA, United Kingdom [www.crossbridgecapital.com](http://www.crossbridgecapital.com)

Registered in England and Wales no: OC348979 Registered office as above. Authorized and regulated by the Financial Conduct Authority



## Market Viewpoints

*Manish Singh*

October 2014

---

**USD/JPY** is a very tough call. Regular readers of this newsletter will recall my year-end target on USD/JPY of 110, and we nearly got there earlier this month (with a high of 109.76 on October 3), much sooner than I had envisaged. The move so far, is in accordance with the Japanese government's announced policies. However, a race to 120 would be damaging. A nation needs a weak currency not a continuously weakening currency, which could be sign of a larger problem. My year-end target is still 110 on USD/JPY and I expect it to trade down to the 105 level in the interim.

Best wishes,

Manish Singh, CFA