Market Viewpoints

Manish Singh
October 2015

"Have no fear of perfection – you'll never reach it."

- Salvador Dali

The European Central Bank's ultra-dovish comments last week came as a bit of a surprise. Yet, the Euro's appreciation of over 10% from its March lows is a big burden for the Eurozone's exporters to carry (particularly Italian and German), at a time when China is slowing down and world trade is contracting. As inflation remains moribund and "negative rates" become mainstream, sooner or later the US Federal Reserve (Fed) is likely to go down this path as well. What if negative deposit rates don't bring back growth and inflation? Will central banks send cheques in the post directly to the people? Strangely enough a "cheque in the post" policy may do more to bring back growth and inflation than anything done so far by the central banks. Therefore, monetary policy is going to remain accommodative for quite some time, and in such a case equities will remain bid due to the lack of a substitute asset class with a better risk-reward trade-off. It's likely we will see a new high on the S&P 500 Index (SPX) before snow arrives. As for next year, one argument is that the SPX has never been up seven years in a row. This is true, but neither have we seen every major central bank easing at the same time, taking rates to zero and buying assets.

Cash to the people: By helicopter or by cheque?

Last week, European Central Bank (ECB) President Mario Draghi went as close as imaginable to pre-committing to a December policy easing. He signalled that the bank is prepared to embark on another round of stimulus and is open to cutting deposit rates further (which currently stand at -0.2%), to counter lacklustre growth and falling inflation. This is significant because, for almost a year now, Draghi and his ECB Governing Council colleagues have stated a number of times that interest rates have reached their "effective lower bound." The ECB's Benoît Coeuré went as far as to deliver a full speech on this issue last May. However, it now seems that this "lower bound" is not so binding. Are we therefore entering a new era of monetary policy? Are negative deposit rates the tool of choice for monetary policy going forward?

The ECB's ultra-dovish comments came as a bit of surprise. Yet, the Eurozone's falling inflation, an unemployment rate at 11.1% and the Euro's appreciation of over 10% from its near 12-year low in March, must have sent alarm bells ringing at the ECB. The Euro's appreciation is a big burden for the Eurozone's exporters to carry (particularly Italian and German), at a time when China is slowing down and world trade is contracting.

As inflation remains moribund and "negative rates" become mainstream, sooner or later the US Federal Reserve (Fed) is likely to go down this path as well. Let's go a step further. What if negative deposit rates don't bring back growth and inflation? Will central banks send cheques in the post directly to the people?

Strangely enough a "cheque in the post" policy may do more to bring back growth and inflation than anything done so far by the central banks. The concept of direct cash transfer is not new. In the 1930s, economist John Maynard Keynes proposed burying bottles of bank notes in old coalmines; once unearthed (like gold); he suggested, the cash would create new wealth and spur spending. Fellow economist Milton Friedman also endorsed direct money transfers, which he likened to dropping cash out of a helicopter.

In December 1998, a Princeton economics professor (and future Fed Chairman) named Ben Bernanke diagnosed the stagnation facing Japan. At that time, Japan was essentially suffering from a deficiency of demand: Interest rates were low, but the consumers were not buying. Firms were not borrowing and inflation was not picking up. Sound familiar? Pessimism about the economy was preventing a recovery. Bernanke argued that the Bank of Japan needed to act more aggressively and suggested it consider an unconventional approach: Give Japanese households cash directly. "A large enough helicopter drop must raise the price level. The real wealth of the population would grow without bound, as they are flooded with gifts of money from the government. Surely at some point the public would attempt to convert its increased real wealth into goods and services, spending that would increase aggregate demand and prices."

I strongly believe that we may be heading towards direct cash transfer in the not too distant future. Japan never heeded Bernanke's advice and suffered two decades of further stagnation. I hope the US and Europe will learn from Japan and not repeat the same mistake. Now, whether it's by helicopter or by cheque, I would not discriminate, and would accept either happily.

Will China succeed where the Soviet Union failed?

In 1953, taking cues from their Soviet advisers, Chinese leaders launched their first five-year plan (FYP). This week is the start of the fifth plenum, which sees China drafting its 13th such document. The Soviet Union collapsed before it was able to see its 13th FYP to completion. China seems set to do better than the Soviet Union. The ultimate demise of Communism in the Soviet Union was a failure to adapt to the times. Like someone once said - "Communism doesn't work because people like to own stuff."

The Communist Party in China has been able to adapt by putting economic reform ahead of political reform. This foresight of Chinese leader Deng Xiaoping (and successive leadership) is arguably what has kept the Communist Party rule in China. The 13th FYP document will outline the Chinese government's economic objectives and policy approaches which are expected to be more market friendly and relinquish yet more "controls".

The world has, rightly, come to focus more on China. In a single generation, a nation that did not appear on any of the international league tables, has vaulted into their top ranks. In 1980, China's economy was smaller than that of the Netherlands. Last year, the increment of growth in China's GDP was roughly equal to the entire Dutch economy. As Singapore's late leader, Lee Kuan Yew observed, "the size of China's displacement of the world balance is such that the world must find a new balance. It is not possible to pretend that this is just another big player. This is the biggest player in the history of the world."

Three key elements to look out for the 13th FYP:

- This is the first FYP to be produced under President Xi Jinping's leadership at a time when China's growth is slowing. China will be looking to manage international expectations by providing a new and credible GDP growth target for 2016-2020, these could be +6.5%, down from the +7% set out in the 12th FYP and the +7.5% in the 11th FYP. GDP growth targets matter for both structural and psychological reasons
- The focus will be on the future of Xi Jinping's anti-corruption campaign. Chinese state media recently reported, that the Wang Qishan-led Central Commission for Discipline Inspection (CCDI) would "expand its inspections into more state entities this year, with its sight set on major financial institutions including the central bank, securities regulators and state-owned banks." Intensification of the anti-corruption campaign is good but it comes with its own risk. Ending cronyism and embezzlement bodes well for China and for investors doing business with China
- Since the Yuan's surprise devaluation in August, the market has become obsessed with where the Yuan is heading next. The 13th FYP could shed some light. It's likely we get that "market forces" will be allowed to play a more important role in setting the Yuan exchange rate, particularly since the International Monetary Fund (IMF) it seems, is set to green light China joining its currency basket

One final comment on China. The People's Bank of China (PBoC) cut interest rates last week on October 23. The two previous rate cuts were on June 27 and August 25. Spot a pattern? June 27, August 25, October 23. If you do, the next PBoC rate cut will be on December 21.

Market Viewpoints

Manish Singh
October 2015

Where to invest?

If you had turned off your computer on August 19, gone on a two-month break, and returned last Friday, you wouldn't have noticed any change in the S&P 500 Index (SPX) when you switched your PC back on. The SPX was at 2,079 on that date and there it was again at 2075 last Friday. After a massive move down to a low of 1867 in August (-11%), it's hard to believe that the SPX is back up 200 points to where it was in August. As they say, the more things change, the more they stay the same!

The Federal Open Market Committee (FOMC) meets this week. There is little expectation of a rate rise. As for the December FOMC meeting, the last opportunity for the Fed to raise rates this year, it doesn't look promising either.

Why do I say that? While technology stocks have cheered this earnings season, the quarterly earnings and revenue at big railroad, industrial, energy and manufacturing companies in the US are poised to decline for the first time since the recession of 2008. Some industrial firms warn of a pullback in spending and a protracted slowdown in production, sales and employment that will spill into next year. For the economy as a whole, I see Q3 US GDP growth of approximately +1% or below. The Fed may say they will raise rates this year but such talk is not convincing anyone. The New York Fed's William Dudley recently said he would favor a 2015 lift-off, if his forecast were met. It's like saying there will be a Brexit if the "Out" vote wins. We are none the wiser and uncertainty looms.

As I have said in the past, in my opinion, the Fed missed an opportunity to raise rates in September and it may not get another opportunity until Q1 2016. In fact, instead of blowing "hawk" and "dove" with each data it would be useful if the Fed were to say something to the effect - we are not going to raise interest rates until we have seen two quarters of price increases that are visibly and measurably above the +2% target. That would bring relief and an end to imminent rate rise anxiety.

Therefore, monetary policy is going to remain accommodative for quite sometime. In such a case, equities will remain bid due to lack of a substitute asset class with better risk-reward trade-off. It's likely we will see a new high on the SPX before snow arrives. In Europe, Draghi is hinting at further stimulus and that is because growth and inflation are forecast to be weak in the Eurozone.

Looking ahead to 2016, pessimistic views regarding equities already abound. One argument is that the SPX has never been up seven years in a row. This is true, but neither have we seen every major central bank easing at the same time, taking rates to zero and buying assets. Meanwhile, staying with this year here is an encouraging piece of news. A *Gallup* survey carried out from October 7 to October 11 showed that US consumer Christmas spending intentions are at the highest level since 2007. US consumers don't worry about the things we worry about – recessionary fears, deflation, China hard landing etc. US consumers, who make up 70% of US GDP are ready to spend and consume this Christmas. Equities will perform better into the year-end, with the Eurozone remaining particularly attractive due to the summer sell-off and the ECB easing ahead.

Besides a Eurozone overweight, I continue to like Japan (DXJ US) and India (INDY US). Some of the stocks I hold/recommend holding – Disney (DIS US), Starbucks (SBUX US), Citi (C US), JP Morgan (JPM US), Bank of America (BAC US), Gilead Sciences (GILD US), Allergen (AGN), Apple (AAPL US), Google (GOOG US), Amazon (AMZN US), Microsoft (MSFT), Facebook (FB US), Anheuser Busch (ABI BB), Pepsi (PEP 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), Rio Tinto (RIO LN), Alcoa (AA US), FreeportMcMoran (FCX), Michael Kors (KORS US), Halliburton (HAL US), Caterpillar (CAT US), Intel (INTC US), Walgreen Boots (WBA US), Home Depot (HD UN), Intesa Sanpaolo (ISP), Inditex (ITX), CBS Corp (CBS US), Alibaba (BABA US), Baidu (BIDU US).

Currencies

CROSSBRIDGE
CAPITAL

Market Viewpoints

Manish Singh
October 2015

With US interest rates still set to increase next year and the ECB ready to increase stimulus at its December meeting, the prospect of a substantial divergence of monetary policy between the Eurozone and the US implies downside risks for the EUR/USD. It will be interesting to see how the EUR/USD acts if the Fed strongly hints this week (not my base case), of a possible hike in December. That will perhaps see EUR/USD trade down to the 1.05 level. If the data in China gets better, it may just open the window for the US to raise rates in December (again not my base case, since the forward looking data for the US is not particularly promising). The risk for a short euro view is that the majority of the dollar run has been based on improving data and lift-off expectations, which now seem to be much more questionable.

Best wishes,

Manish Singh

Manish Singh, CFA