CROSSBRIDGE
CAPITAL

Market Viewpoints

Manish Singh
September 2014

"It is never too late to be what you might have been"

- George Eliot

Last week, the European Central Bank (ECB) sent a strong and resolute message to fight dis-inflation by cutting its main lending rate, the deposit rate as well as pre-announcing the purchase of asset-backed securities. This could imply a potential expansion of €1 trillion in the ECB balance sheet, which could provide a boost to the outlook in the Eurozone for the next few months. ECB President Mario Draghi has once again bought time, and both European equities and bonds have responded positively. For much of the year, markets have been ignoring the referendum vote in Scotland, but not anymore! On Sunday, the complacency was broken, when the UK woke up to the shock news that the Yes campaign was now marginally ahead in the polls for the first time. A Yes vote in Scotland may have repercussions not just for the UK, but further afield as well. It could provide a catalyst to other discontented regions in continental Europe. The August sell-off in the equity markets was short-lived and the month ended with a new record high. Recent data in the US has surprised mostly to the upside. An improving geo-political picture in the Ukraine, accelerating US growth and the unveiling of a stimulus program in Europe, all keep me positive regarding equities. I would not rule out a short period of market weakness around the US Federal Reserve meeting later this month. However, any sell-off would be a buying opportunity. The drivers for positive movement in the equity markets are central banks and seasonality, which in my view, would see the risk asset rally to the end of the year.

I'll fetch what you wish and I'll fetch more

In Part II of Goethe's *Faust*, Mephistopheles, convinced that there has been too much deflation and financial distress due to the lack of money, talks to the Emperor and says: "In this world, what isn't lacking, somewhere, though? Sometimes it's this, or that: here's what's missing's gold". The Emperor troubled by financial distress responds: "I'm tired of the eternal 'if and when': We're short of gold, well fine, so fetch some then."

Mephistopheles replies: "I'll fetch what you wish, and I'll fetch more". However since there was no more gold until it was mined, Mephistopheles convinces the Emperor to print paper money and distribute it as legal tender. The measure proves a success. The soldiers are paid their salaries, the Chancellor can pay off all the debts and tailors and artisans get busy with their work. Mephistopheles stirs up the mood by saying: "Such paper's convenient, for rather than a lot of gold and silver; you know what you've got. You've no need of bartering and exchanging; just drown your needs in wine and love-making."

Last Thursday, ECB President Mario Draghi pulled a Mephistopheles - I'll fetch what you wish (printing money), I'll fetch more (printing more money), as he announced the firing of the printing presses to buy Asset Backed Securities (ABS) in the first round of Quantitative Easing (QE).

Some key takeaways from his press conference:

- As the Eurozone inflation reading for August came in at an annual +0.3%, Draghi noted: "In August, we see a worsening of the medium-term inflation outlook, a downward movement in all indicators of inflation expectations. Most, if not all, the data we got in August on GDP and inflation showed that the recovery was losing momentum"
- The ECB sent a strong and resolute message to fight dis-inflation by cutting its main lending rate (from +0.15% to +0.05%) and the deposit rate (from -0.1 to -0.2%). Draghi ruled out further interest rate cuts by saying - "Now

we are at the lower bound." i.e. if the ECB needs to do more, it would likely start buying a broader set of assets, including government bonds

- More significantly, Draghi pre-announced the ABS purchase program with the details to follow in October

All the various measures that the ECB has announced – the rate cut, the negative deposit rates, the targeted longer-term refinancing operations (TLTROs), and the ABS purchase; could imply a potential expension of €1 trillion in the ECB balance sheet, which could provide a boost to the Eurozone outlook for next few months. Draghi has once again bought time, and both European equities and bonds have responded positively. However, all these measure would be less effective to promote growth if the Eurozone member states fail to make structural reforms to their economies.

The (dis)United Kingdom

The United Kingdom, as a unified sovereign state, began in 1707 with the political union of the kingdoms of England and Scotland into a united kingdom called Great Britain. Historian Simon Schama has remarked - "What began as a hostile merger would end in a full partnership in the most powerful going concern in the world". This going concern is about to turn hostile again. There are less than ten days until the Scottish referendum on independence on September 18, when Scotland will vote whether or not to end the 307 year old union with the rest of the UK. For much of the year, markets have been ignoring the vote, largely because the No campaign has been consistently ahead. On Sunday, the complacency was broken when the UK woke up to the shock news that the Yes campaign was now marginally ahead in the polls the first time. In the space of four weeks, the No campaign has blown a 22-point lead. The UK could be heading for the history books. There is a chance that David Cameron's position as Prime Minister will be at risk. Much like in 1782, when Lord Frederick North the British Prime Minister was forced to resign after a vote of no confidence by the House of Commons. The vote came after a loss in the Battle of Yorktown and the loss of colonies in the American War of Independence.

If the Yes campaign wins, we can expect the GBP/USD to suffer yet more losses, as the market prices out a rate rise for a long time to come. I would forecast a GBP/USD heading down to 1.55/1.54 level (a No vote on the other hand, would see it bounce back to the 1.66 level). The protracted and perhaps heated negotiation that would follow before Scotland actually became independent (2016 at the earliest) would cause concerns, as the UK national debt is apportioned, pension and bank assets rationalised and not least, the UK's defence spending would present heightened strain on the UK budget due to the loss of Scotland's contribution. Scottish independence might also reduce the impact of the UK on the world stage. However, with a Yes vote, in the medium term, markets would eventually like the fact that UK *sans* Scotland would likely have centre right, market friendly governments in the future (if Scotland's seats were taken away, the current Conservative government would have a majority of 20 seats).

A Yes vote in Scotland may have repercussions further afield as well. It could provide fuel to other discontented regions in continental Europe. The Catalans and Basques in Spain, the Venetians in Italy and perhaps even the Flemish in Belgium will be watching carefully. Will a Scottish Yes vote start a re-organisation of nation sates in Europe? Only time will tell.

Those who want to save the union will draw some comfort from the turnaround that took place in the final hours of the Quebec independence referendum in 1995. With five days to go before the Quebec vote, the Yes campaign was six points ahead. Seven days before the poll, a massive unity rally in Montreal was organised by a Minister acting on his own initiative to plead with the voters to stay in Canada. On polling day, with a 93% turnout, Quebec narrowly voted 50.5% to 49.5% to remain a Canadian province.

Where to invest

As anticipated in the last newsletter, the August month market sell-off proved to be shortlived and the month ended with a new record high and a +3.7% rally for the S&P 500 (SPX) Index, for its best August since 2000.

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The SPX has scaled the 2000 level and this bull market run (which started in March 2009) is now just over 2000 days old. During this time, the SPX has gained an astonishing +196%. Despite 2000 days and +196%, this iteration of the bull run for the SPX is in fact, less than half - both in terms of the gains and the number of days - the record bull run in the SPX between December 1987 and March 2000. During that period of 4,494 days, the SPX rose +582%.

Recent US data (GDP, Durable goods, consumer sentiment, manufacturing and non-manufacturing) have all surprised to the upside. The jobs report however came in below expectations (estimate of +230,000; actual +142,000 jobs created). Despite this the US is still on track for a +3% growth in Q4, suggesting a solid rebound in the second half of the year. An improving geo-political picture in the Ukraine, accelerating US growth and the unveiling of a stimulus program in Europe, keep me positive regarding equities. I would not rule out a short period of market weakness around the US Federal Reserve meeting later this month. However any sell-off will be a buying opportunity into the year end. The drivers for positive movements in equity markets are central banks as well as seasonality, which would see the risk asset rally to the end of the year.

My preferred equity Longs are Europe, Japan, the US, and Emerging Markets, in that order. In Europe, the European Banks (SX7P) are attractive and I am overweight India (INDY US) in the Emerging Markets.

My sector preferences in the US are Financials (XLF), Technology (XLK), and with US growth accelerating, I would also go overweight Consumer Discretionary (XLY) as we head into Q4.

Some of the other stocks I hold/like to hold in our discretionary portfolio: Amazon (AMZN), Google (GOOG), 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), BHP Billiton (BHP US), 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).

Currencies

As discussed in the sections above, GBP/USD is exposed to event risk ahead of the Scottish referendum vote. Trading at the 1.61 level, the currency pair could tumble to 1.60 or below as investors liquidate positions ahead of the September vote. A Yes vote could take it to the 1.55 level and a No vote could see a massive short covering rally in the currency to the 1.66 level. The volatility in the currency pair will continue to rise as we get various sets of opinion polls over the next ten days.

The EUR/USD pair is deeply sold but even a US non-farm payroll miss on Friday wasn't enough to see a bounce. If anything, a dead cat bounce will see more sellers of EUR/USD, given the significance of last week's ECB announcement. With the one two punch of pre-announcing ABS purchases and cutting interest rates, the ECB has sent a strong message that it is very concerned about Eurozone growth. A weaker currency may not be a policy target, but it is one that will be well received in Frankfurt and other Eurozone capitals. The next support level for EUR/USD is at 1.2750.

Best wishes,

Manish Singh

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