Global Macro Report – 23rd Sept 2013

Snapshot

- *Taper Twist*: **Markets surprised by Fed decision to refrain from a reduction in stimulus. Global markets rally. Questions over missed opportunity and future credibility.**
- *Catching up with 'the can'*: **Clarity over German federal elections, means spotlight will return to Euro and Greek woes.**
- *Washington Wrangling*: **US govt moves closer to potential shutdown, with a heavily politicised debate over debt ceiling and Obamacare with lots of moving parts.**

Macro Environment

Taper Twist

US & European stock markets up 1.5%, EM markets up 5%, Rupiah up 4% and a rate hike from the RBI.

Not bad, considering some polls showed a 52:48 split amongst economists *against* any tapering this month, indicating markets were clearly pricing in at least some reduction in Asset Purchases for September. The rally was short lived however, as the prospect of Bad News once again meaning Bad News, crept back into the market.

So where now for the markets? The key points:

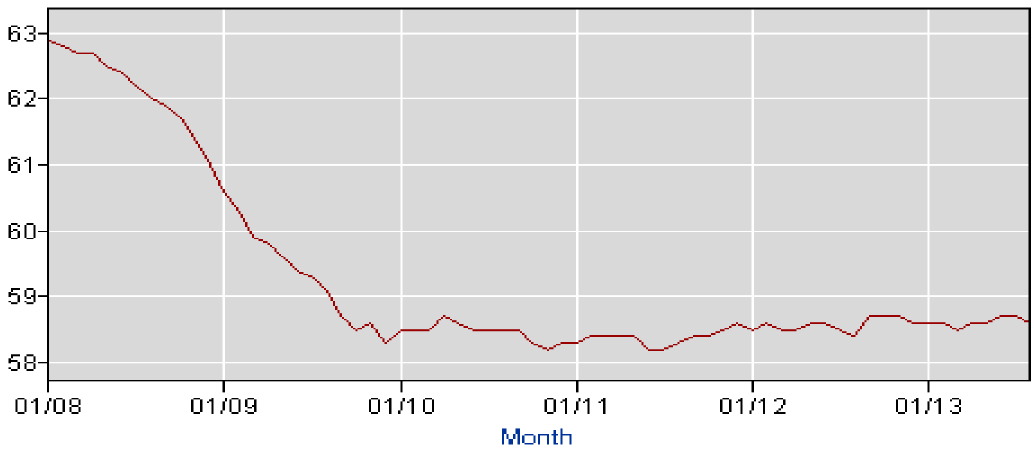
1) Whereas we have quantitative guidance on a trigger for an increase in the Fed Funds Rate *"at least as long as the unemployment rate remains above 6.5%" (FOMC Dec 2012),* we have the much more ambiguous *"until the outlook for the labor market has improved substantially" (FOMC Mar 2013)* in terms of QE/Tapering guidance.

   If the fall from 7.6% to 7.3% (Apr to Sept) in Unemployment is not *'Substantial'* enough for Bernanke, then what is? Well, we could take guidance from the 6.5% threshold for the Fed Funds Rate, but it is unlikely that two policy tools would be used simultaneously. Rhetoric from St Louis Fed President Bullard suggesting the decision was *"borderline"* and that *"revisions to past data, strong jobs reports….could accumulate to a decision to taper.",* combined with the necessity for Bernanke to 'finish what he started' with QE3 before he leaves office, suggests tapering could start in Q4 2013.

2) *A missed opportunity?* This is one of the biggest concerns over the Fed decision, which appears to have been a rather last minute one, influenced by low inflation and sticky unemployment. The Fed had been telegraphing the strong possibility of a taper in September since the summer and the markets had clearly priced in at least a $10bln reduction in Asset Purchases. With a balance sheet approaching $4 Trillion, the withdrawal of stimulus has always been considered the hardest part of QE and the Fed will not get another chance to frontload the reaction in the markets. This may be key in forcing their hand in either Oct / Dec.

3) Much has been made recently, of the fall in the Unemployment Rate and how the figure is misleading due to a decline in the participation rate. However if we use an employment-to-population ratio instead, this has held steady at around 58.5% since 2010 (**Fig 1**) , this combined with the fact we have averaged 182k net new jobs for the past 12 months and crucially Long Term Unemployment has fallen from 40.5 % to 36.9% YoY to July 2013, suggest the employment picture *is* improving.

Fig.1 US Employment-to-Population %



What's the Trade?

For as long as Bernanke keeps the printing presses running, money will be put to work and asset prices will rise. However timing is key and much of the move is likely to have passed already, with a 15bps move on the US 10yr seen in one day. Investors should look to book profits ahead of the taper and bond investors should look for visuals on future interest rate rises (see ***Rates*** below).

Catching up with '*the can*'

Despite Five different possible outcomes this weekend, it is not the potential makeup of a new coalition that surprised, so much as the manner of the personal victory for Angela Merkel.

The German election was used as an excuse by officials in Brussels, to hold fire on any significant decision making, testament in itself to the power Ms Merkel already had over European Policy. Now that her position has been confirmed and her power galvanised, the global spotlight will return once more to the problems that had pushed out on the calendar in Europe.

A policy of 'consolidate & reform' rather than the blunt instrument of 'austerity', seems to be the new tack coming from European policy makers. However the severity of this reform and move away from austerity, depends much on the concessions given by Merkel to her likely SPD coalition partners.

Here are a number of possible outcomes and scenarios that markets need to watch for.

1) Schauble, who is likely to keep his post as finance minister, will be reluctant to accept any of the 'concessions' given to the SPD by Merkel such as a 'Transaction Tax' favoured by the left. This could lead to a turbulent government and possibly stymie future decision making.

2) Merkel's first priority will likely be to fast track the creation of a 'European Resolution Authority', a measure favoured by Mr Draghi. This will be the first step on the road to a full Banking Union and crucially could prove a headwind for Eurozone banks that may be forced to speed up their capitalization plans.

3) Greece has a final €1bln of aid due soon (from the 2nd bailout) then the focus will turn to the possibility of a 3rd bailout. This conversation will likely prove incendiary as Europe is divided with Mario Draghi saying bailout talk was "premature" and on the otherside Wolfgang Schauble saying "there will have to be another program" Factoring in the improving Eurozone economy and the lack of appetite for austerity, a 3rd bailout is unlikely for now.

Washington Wrangling

The situation here is complex and hugely politicised but here I describe the most likely outcome.

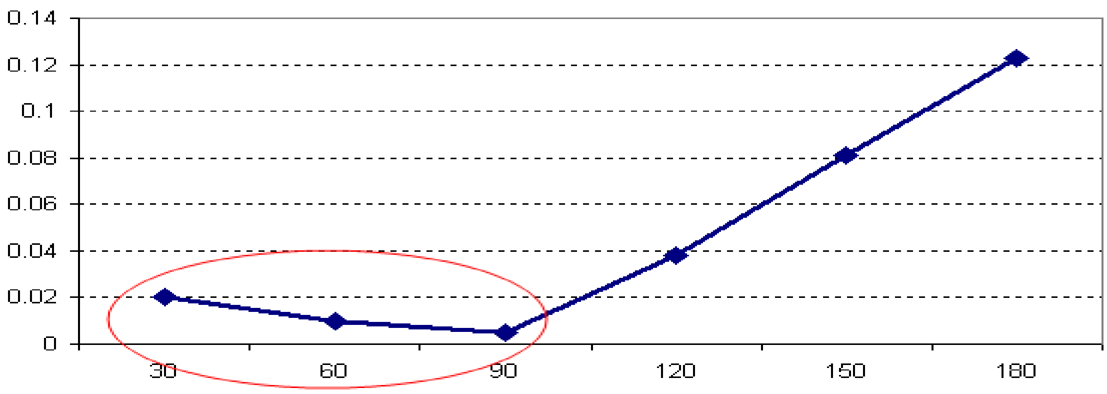
1) The 'Defunding' of 'Obamacare' is added to the Continuing Resolution (CR) and passed over to the Senate –
2) Harry Reid will kick out the 'Defunding' part of the CR (having said "any bill that defunds Obamacare is dead") and the CR, now void of the 'defunding will pass back to the House of Reps.
3) Possibility that Ted Cruz will Filibuster, which will delay proceedings but not prevent 'defunding from being stripped out of the CR (this is as much about Republican posturing as it the CR itself).
4) The House / Senate back-and-forth will continue until Speaker Boehner accepts the CR but with a new 'Sequester' for the 2014 year. Meaning a government spending cut.
5) Alternatively, Obamacare goes through but a 12 month delay on the Debt Ceiling is passes by way of compromise.

With lots of moving parts and infighting amongst the Republican Party, the likely outcome on Obamacare is further opining from the Republicans, until no more political capital can be gained (80% of the legislation if appropriated anyway and so can't be changed) and an eventual passing of a vote in the House. On the Debt Ceiling, a use of the 14th amendment section 4 (the President unilaterally raising the limit) is likely to be ruled out and quite simply a US default wouldn't serve the interest of the Tea Party or anyone else. But don't expect a resolution until the 11th hour in mid October.

What's the Trade?

Expect a selloff (and possible curve inversion) at the short end of the US yield Curve with **1-month bills** selling off in price as this is the nearest paper to the 17th Oct Debt Ceiling deadline. This would be similar to the liquidity squeeze we saw back in 2008 (**Fig.2**).

Fig.2 Inverted Bill Curve



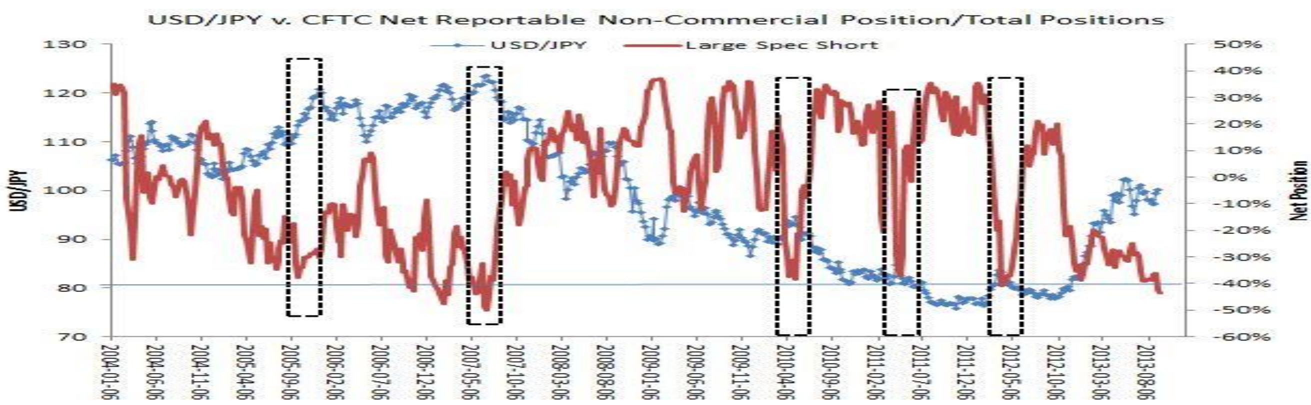
Market Opportunities

Currencies

-Short $ / ¥ (Short Term) Target 95

This is a short term speculative trade, based on historical technical patterns. The highlighted areas in **Fig.3** show that when the proportion of Net Short Yen positions (as a proportion of open interest) approaches the 40% level, we see a subsequent decline in $ / ¥. If the Japanese economic picture picks up and the spectre of inflation and interest rates appear then we could see a short term move lower in the dollar. The risk to this trade is the expected Oct / Dec fed QE tapering announcement which would see the dollar spike higher. So a short term, short lived move down to 95 could provide an entry point for those wanting a longer term Yen weakness trade (see below).

Fig.3 Net Non-Commercial - to - Outstanding Contracts Vs Dollar/Yen



Long $ / ¥ (Medium Term) Target 110

The obvious trade that carried Dollar / Yen from the 70 level through to the current 100 level was driven by the triple pronged attack by Shinzo Abe to bring inflation up to 2%. While many were sceptical, it appears that the '20 years too late' recovery in Japan is actually gathering traction, with core CPI up 0.7% YoY, Unemployment back to 2008 lows and PMI's back above 50. So, despite the possibility of a short term technical rise in Yen as described earlier, the BOJ are likely to do whatever it takes, to make the recent gains stick and that means heavy money printing and with vast amounts of outstanding JGB's to be purchased from the domestic market (Y604 trillion), the political appetite should be there for Mr Abe. When you combine this with the now imminent tapering from the Fed, this move higher in $ / ¥ is supported from both sides of the trade, a rarity in FX markets.

Commodities

Nat Gas – Crude Oil Spread – In order to analyse the spread between the two energy inputs, we need to standardise the units of measurement - One barrel of crude = 5.8mmBTU (British Thermal Units) - So at today's prices of $108 for North Sea Crude, we would have an $18.62mmBTU Energy Equivalent Price.

A seasonal trade could be to take advantage of the reduction in the oil premium during the winter months, where demand for Nat Gas increases (winter maintenance of oil plants and increased demand for heating account for this contraction).

Long Nat Gas on 1 Sept [58 Contracts] **– Sell in Dec & Short Crude on 1 Sept** [10 Futures] **– Sell in Dec**

Historically, between 1994 and 2008 this arbitrage trade would have been in profit 11 out of 14 years, with a PnL ratio of 3.4 to 1.

Buy Brent / WTI Spread Target $15 – Prior to 2011 the spread between the two contracts was range bound between + / - $5. In 2011 that all changed and the spread remained consistently above the $15 level until mid 2013 when it started its decline to today's $5. To under the reasoning behind this move, we need to breakdown the Brent premium into its various components.

- On the WTI side we had counterintuitive declines throughout the summer of 2012. These declines were caused when the Seaway pipeline opened and shale oil production increased.
- On the Brent side, the Geopolitical risk premium (which remains today) combined with the seasonal maintenance and fall in output at the Buzzard field, all off which pushed Brent prices higher.

We will see the spread widen again due to the following factors.

- Increased capacity (in 2014) in the Seaway pipeline from 150 to 850 tb/d will increase the flows from Cushing to the Gulf Coast, this will temporarily reduce the 34.8mb stockpile at Cushing but ultimately mean greater supply over the next 12 months.

- This has an impact on the Brent side as well, as rival imported grades will be hurt, which should reduce the Brent premium, however we will likely see OPEC reducing supply to maintain premiums .
- Increase in capacity out of the Permian Basin (via West Texas Gulf pipeline) will increase flow of crude to the Gulf Coast (which can currently only reach Cushing via pipeline), thus suppressing WTI prices.

A price target of $15 on the spread is well supported from a technical analysis point of view and from the forward futures curve trend.

<u>Rates</u>

Sell US 10yr Target 4%

One of the biggest questions around the future of Fed Asset Purchases is how the current makeup of $45bln of treasuries and $40bln of MBS will look moving forward. This week we have been given a golden opportunity, ahead of any tapering announcement' to take advantage of the fall in yield and short the 10yr at a 2.62% yield. With the 10yr historically above 4% pre-Lehman (Fig.4), this leaves a nice amount of downside (*in price*) potential for any traders going short. When the tapering of Asset Purchases is combined with a strengthening US economy (*as per recent PMI, Employment, Housing starts, etc*) the case for higher yields is compelling.

Fig.4 US 10yr

<u>Equities</u>

Buy AAPL Target $600

Analysts recently have been lamenting the passing of Apple's status as an innovator and a 'products' company and have subsequently downgraded the stock. However from an investor's point of view, whether or not this structural shift in the firm's outlook is true or not, is completely irrelevant (at least short term). The real story here is the balance sheet & valuation. At near $150bln in cash, with a forceful investor like Icahn and cheap borrowing rates, a significant buyback or dividend is a no-brainer (less, a suitable M&A deal). Add to this, a simple S&P 500 market multiple of 16 and you get a conservative $600 price target, even without an accelerated earnings growth.

Sell BBRY Target $7.50

The story here is a simple one and a terminal one. Blackberry has $2.6bln cash on the balance sheet and a burn rate of $500mln (from the previous quarter). This leaves two options. 1) They continue at a high burn rate and run out of cash within months. This would mean the break up and sell off of their valuable patents and services division. 2) Or the most likely option, a shotgun sale of the business as a whole (the company is in receipt of a $4.7bln offer from Fairfax Financial). The current price of around $9 provides a good shorting opportunity, with any upside move capped by the sum-of-the-parts value in a sell off.

My Key Themes for 2014

Macro Themes

Fed Liquidity to fuel 1,970 target on S&P 500 by End of QE:

- During 2013 every 100bln of QE = 42pts on the S&P 500. With 315bln left to come in 2014, this gives a 1,970 target to the end of the current QE programme, just from Fed liquidity.

- Corporate profits and cash dividends at all time high, plus cheap financing/ strong balance sheets to allow for buyback and special dividends. This provides a fundamental 'bid' under equity markets.

EM to continue to struggle with capital flows:

- Carry trade &Fund flows to continue out of EM (with key exceptions) and into developed markets inc Europe, due to drawdown of Asset Purchases by the Fed and terminal pricing of US Interest Rate hike during 2015.

No 'Hard Landing' in China':

- China to stick to 25 year plan and not worry about 12 month GDP or stock market performance, whilst maintaining a tight grip on credit expansion and money supply. Fears of a 'hard landing' completely overblown, China is executing well on its multi-decade plan to return back to its 19th century share of global GDP.

- China have learnt the recent lessons of the west and are not interested in an economic boom fuelled by credit expansion and liquidity. Instead they are focused on a much broader and diversified growth strategy, with infrastructure, education, energy supply and controlled credit supplies (albeit with the likelihood of defaults in the shadow banking system).

ECB to join 'race to the bottom':

- With the Fed, BoJ and BoE all adopting monetary stimulus, the Euro is likely to strengthen into the early part of 2014 back up to the 1.40 EUR/USD level, before falling as Draghi has his hand forced. Outright QE will be difficult though, as unlike the US programme which was delivered through the Capital Markets, the ECB will have to go through the banks (which raises legality and efficacy issues). Currency wars to continue.

Sectoral Themes

- Consolidation, capacity control, positive operating leverage & pricing power within **US Airlines**.

- Accommodative regulation, continued Tax Inversions, movement from prescription to OTC, and strong pipeline for large cap **Pharma**.

- Rotation out of Italian banks into **Spanish Banks** as balance sheet repair spreads across the periphery.

- **Tech Security** to be strong, with high earnings capacity for large players and takeover potential for smaller firms. Partly driven by recent, high profile cyber attacks on consumers' details.

- US **Home Builders** to benefit from restricted supply, price discounts relative to peaks, huge build up in household formation potential and low interest rates.

- Unloved **Miners** to perform well due to peak in cap ex, huge improvements in cost control and pick up in global demand.