ECOGNOSIS ADVISORY LTD

From the Greek: ΟΙΚΟΝΟΜΙΚΗ ΓΝΩΣΙΣ (Ekonomiki Gnosis, Knowledge of Economics). Ecognosis is global financial and economic advisory service covering, economic and financial developments, equities, fixed income, forex and commodities as well as portfolio investments.

Econotes is a free research publication available on request. It is not a solicitation for business. It is devised and written by Dr. Andrew F. Freris based on 46 years of market experience which included senior positions with GT Capital, Salomon Brothers, Bank of America and BNP Paribas as well as senior academic posts with universities in London and Hong Kong

8/F, 2 Exchange Square, 8 Connaught Place, Central, Hong Kong. Tel: 852 3167 4591, Mob 852 9738 0944
Email: afreris@ecognosisadvisory.com Website: www.ecognosisadvisory.com

ECONOTE No. 11 **11/8/2014**

THE USA: AN IVESTOR'S CHEAT SHEET

Summary	Investment Conclusions
The trends in the economy continue to favor a possibly earlier than later increase in Fed's short term rates. The Fed, however, and rightly so, stays cautious and so it is very unlikely to hike rates in 2014.As usual with all economic releases, there is always a "but" to be said. Employment, a crucial issue for the Fed, is full of "buts" especially with the issue of low labour participation which can distort the level and rate of unemployment, as well as the question of long term unemployment. There is also the management of expectations of the markets as to the timing of the first hike. In all a tricky period to yearend 014.	Clearly rates in the US will rise, but when ? And when they rise, will the markets have priced the hikes in and, hence, will the impact on equities be mild? And what about junk bonds which have been giving danger signals, but then they are junk and ,hence, riskier. To add to the uncertainty, since the start of 2014 the 2YUST bond yields have been rising while the 10Y falling, thus flattening the curve, a sign of impending tighter monetary policy. Which leaves the equities still doing relatively well with the backing of the economy. Bottom line, stick to US equities, avoid UST and prefer the USD

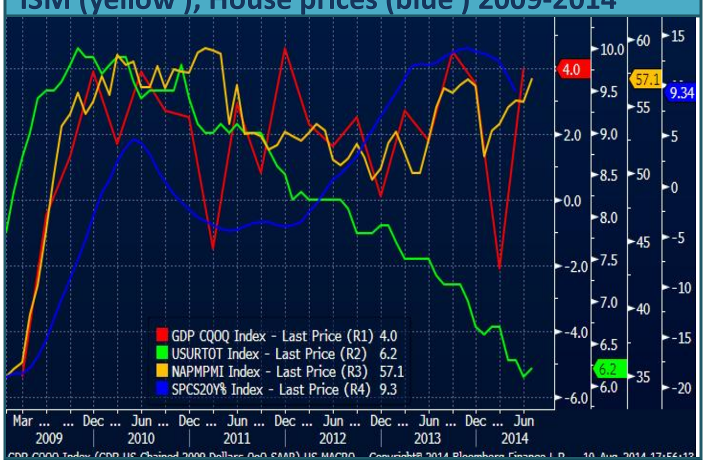
Macro trends: A lot to choose from !

The basic indicator, GDP growth, took a steep drop in 1Q.14 because of the bad weather effect, and then recovered strongly in 2Q.14 giving, nonetheless, pause for thought. (Red line in Chart 1).

As hinted in our introduction, the situation in the labor market is not as straightforward as the th green line in Chart 1 shows, namely a continuous fall in the rate of unemployment, because of the deep- seated structural issues in the labor markets. If fewer people stay in the market to seek jobs, then the number of unemployed goes down and may also reduce the unemployment rate. But then participation in the labor force becomes crucial in understanding the dynamics of unemployment, and if this is combined with lengthening periods of out of work, then it shows that the economic recovery lacks dynamism. Hence the continuous references by the Fed on the labor markets and the necessity to pay close attention not just to the unemployment rate.

The ISM index of expectations and confidence in business (yellow line if Chart 1) has been staying firmly over the 50 mark, the level above which expectations are positive. More importantly, however, house prices have grown at positive rates since the middle of 2012 and have stayed in the positive side (Charft 1 blue line).The index,however, has peaked House prices continue to be a suportive development in present circumstances.It can be easily forgotten that the 2008-9 crisis in he US was a property bust.All the blame on derivatives and "greedy" bankers does not remove the truth that banks overlent on homes and paid the price, as did the "greedy" borrowers.It takes two to tango !

Chart 1:US : GDP (red) Unemployment(green), ISM (yellow), House prices (blue) 2009-2014



Source: Bloomberg

The "I know you know that I know" game

The recent peaking of the S&P 500 after a spectacular run raised the, justified, question whether that was the end of the bull run. Blame it on the Fed for bringing neared the date of higher rates. Geopolitics such as Gaza, Ukraine, Russia and Iraq did not help. Neither did the dire state of the EU economy with Italy slipping into a statistical recession, and with Portugal having to rescue its biggest bank. However, the question still remains as to what will the market reaction be when the tapering is over by autumn and the Fed stops adding (but does not subtract) liquidity while the short end of curve keeps going up. Ideally the economy in three months' time should be strong enough to keep supporting the equities markets and the flattening of the yield curve should not matter greatly. Ideally, yes, but it very likely that the official hike in the rates will cause equities to fall for a while and may impact the 10Y UST yield.

In the middle of all this the Chinese must be, quietly, biting their fingernails as they (and the Japanese) will have most to lose in mark-to-market pricing

when the Fed shift to rising from zero/flat rates.

All this leaves the outlook for the USD strong, as USD rates will rise while EU and Japanese will not move for several more quarters, which is a polite way of say "years", The G3 central banks have totally diverting credit and monetary policies.

FACTOBOX: Who owns it all ?

In July 2014 the US public debt stood at USD 17,670 bl of which the US government itself held USD 5,009 bl (28% of grand total) while the public in general, including the US Fed, held USD 12,660 bl (72 %)

Of the publicly held debt, foreigners held USD 5,976 bl (47% of this total, or 34% of the grand total). China, the biggest foreign holder, held USD 1,270 bl (10% of the debt held by the public or 7% of the grand total or 21% of debt held by foreigners).The next biggest foreign holder was Japan with USD 1,220 bl and then Belgium (yes you read that right !) with USD 362 bl. So China, basically still a poor country, funds uncle Sam and help keep rates low.

Chart 2: US, S&P 500 (red), 50MAVG (green) 12M forward P/E (yellow),RSI (white),2013-2014

Source: Bloomberg

Investment implications

As Chart 2 shows, the S&P 500 seem to have peaked after its unbroken bull run. However a combination of metrics and macros argues for still favoring the US equities markets. The index is now below its moving average and the forward P/E have cheapened but are bottoming, leaving the S&P 500 fairly close to the P/Es of outperforming smaller Asians. In a portfolio which contains EU and Japanese shares, US shares mertit an overweight position.

It is easy to remain bearish on the UST as a flattening yield curve may translate, as we have indicated, into a stepping curve.

We remain bullish in the USD and US equities and stay cautious on government bonds-an advice which the Chinese should be now taking seriously, and incidentally, have been doing so as their holdings of UST have been modestly decreasing for several months now.

(Wring completed 11/8/2014)