Alpha Value MANAGEMENT

Points of View

Analysis, Research and Texts
by AVM Market Analysis Unit

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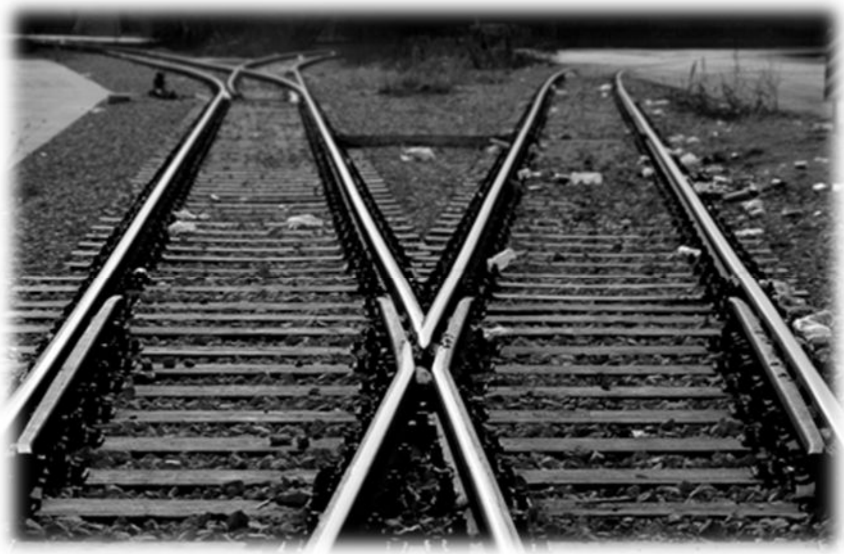
From the Editor

Portfolio Manager point of view

People say markets are created to surprise. What we are instead looking for is not to be surprised, as much as we can, even if the world is really changing very fast and what is true today will no more be true tomorrow or the day after tomorrow.
Practically, we are now keeping an upward forward guidance on stock markets for the short term and for the medium one, but we are still paying attention to the incoming horizon where stormy clouds may come...
I wish good "Points of View" to everybody.

Giorgio Saronne



Main scenario Hypothesis

Economic growth in the US is still strong, supported as it is by a monetary policy that is growth-oriented in terms of low interest rates, despite the Fed's ending of QE (Quantitative Easing). According to current consensus figures, growth is expected to come in at 3.2% in 2015 and 2.8% in 2016. The current consensus is that inflation will be 0.85% in 2015 and 2.8% in 2016, in line with the target of the Fed, which, just like the ECB, is aiming for inflation to come in slightly below 2%. US unemployment is expected to be 5.4% over the whole of 2015 and 5.1% in 2016. Over the last few years, during the season for earnings announcements, US companies have, on the whole, systematically beaten the consensus figures; as a result profits have grown steadily and share prices are still not overvalued. Thus the necessary conditions for stock indices to rise are still in place, at least over the first half of 2015. The crucial moment that is looming is when the interest rates that are fixed by the Fed begin to rise. The consensus view is that this will happen in the time window between mid-2015 and early 2016. Our personal perspective is centred on the third quarter of 2015.

Within the Eurozone the situation differs between its member countries, but overall prospects for growth remain uncertain. For 2015 the consensus on growth is currently at +1.1%, well below its full potential. For 2016 the expectation is for 1.6%. The definitive figure for inflation in 2014 was 0.44%, well below the ECB target of just under 2%. For 2015, expected inflation is 0.2%; it is then set to rise to 1.2% in 2016. Unemployment is still high: the expectation is for a level of 11.3% in 2015 and 11.1% in 2016. Besides the expected effects of the monetary stimulus measures announced in July 2014, there will be the impact of the much more substantial QE measures finally announced on January 22nd, together with the decision already taken for the buying of government bonds, starting in March. The announcement was surprising because of the size of ECB intervention that was announced, but also because of its duration. Both were greater than expected, but they were actually presented as being potentially unlimited if the objectives are not achieved by the planned deadline.

This QE by the ECB, as announced, will have a strong positive impact on financial markets, and will ensure the continuation of the rising trend in stock markets, at least over the next 6-12 months. On the other hand, its effects on the economic picture in the Eurozone and on assessments for the future will be at best uncertain, since the Eurozone has a growing need for urgent and drastic policy decisions in the single member nations, and for structural reforms, as Draghi has been repeating for years. If such reforms do not come soon, or if they are further postponed, QE will probably become no more than a futile attempt to buy time that will then be squandered by politicians and so fail to bring solutions to present problems. In that case the long-term scenario (i.e. thinking beyond the time horizon within which the positive outcomes of QE will take effect) would turn out to be far from ideal.

Considering now the effects of the European QE, and of the other monetary stimulus measures enacted by the ECB, together with the persistent growth seen in the American economy and stock markets, plus the conditions of objective underestimation of future prospects for European companies, if the situation remains stable, we can confirm our medium-term view (let's say, lasting at least to this summer) for European and worldwide stock markets. Our assessment of the long-term outlook is a different matter.

Monetary Policy

With its aim of implementing a growth-oriented monetary policy worldwide, the ECB continues to pick up where the Fed left off. While the Fed is still withdrawing from a monetary policy of expansion that had lasted for years, the ECB, motivated by a general situation that is far from its objectives, is continuing to introduce conventional and non-conventional measures.

To sum up, the Fed's monetary policy is still growth-oriented, but its bias – its future orientation – is towards tightening.

The ECB's monetary policy is strongly growth-oriented and shows a growth-directed bias.

Stefano Bagnoli
Market Analysis Unit

FED's monetary policy is still expansive,
with restrictive bias.
ECB's monetary policy is still strongly expansive,
with expansive bias.

Hypothesis for the Revision of Long-Term Forward Guidance

A stock market acts as a model for discounting expected future profits. By 'discounting' we mean bringing those profits forward to the present, while incorporating a correction to include the risk factor. It is worth bearing in mind the basic formula for calculating the fair value of a stock:

$$\frac{U_x}{i_{10} + R}$$

We are currently in the topping phase of the American economic cycle – at peak growth after the prolonged efforts made by the Fed – but also, within the Eurozone, in the middle of the maximum push towards growth being undertaken by the BCE. In this phase it is only normal that profits should be expressing a positive dynamic.

The two Western economic areas we have in mind, the USA and the Eurozone, are showing a decoupling situation, as there are radical differences between their respective economic cycles and, above all, between their monetary policies. While the Fed is carrying out a progressive withdrawal from its growth-oriented monetary policy, which had lasted for years, within the Eurozone the BCE, responding to a general situation that is far from its objectives, has already initiated and is now applying conventional and unconventional measures. The Fed's monetary policy is still growth-oriented, but it is now showing a tightening bias (future orientation). The ECB's monetary policy is strongly directed towards growth, but its bias likewise points in that same direction, favourable to growth.

Compared with the historic mean, the risk level ("R") is high, especially regarding 'geopolitical risks' and, in the medium term, those risks are tending to rise further.

Interest rates close to zero are making a strong contribution to sustaining the value and the fair value of American corporate stocks, and are helping to keep Eurozone stocks at historically acceptable levels. The discount rates to be applied to future profits are closely dependent on the yield curve, which, in its turn, is strongly influenced by the benchmark interest rates that are decided by the central banks. The interest rates fixed by the Fed are still close to zero, but the situation is different in its case. In the conventional rhetoric used by the central banks, in the late phases of expansive monetary policies, announcements resort to the ritual phrase: "Interest rates are close to and will stay close to zero [or: 'will stay at low levels'] for a long time". As long as that continues, using the standard time interval for models of economic analysis (usually six months), interest rates will be assumed to be, and will be modelled on, minimal levels. In this situation, monetary policy has an official growth-oriented bias (orientation). This bias, partly on the basis of pure mathematics, has a positive impact on the fair value of stocks.

It should be kept in mind that holding interest rates at such a low level for such a long time is an absolutely exceptional situation, which was only adopted to combat a systemic economic and financial crisis – a crisis that even affected Western culture, demographics and society – in a way that is unparalleled in modern history. As soon as the system starts to provide indications of normality – supposing that agreement can be reached on what 'normality' actually implies – interest rates will move upwards from their current levels. There is no doubt that 'normal' interest rates will, in the short term, stay much lower than they were 10-15 years ago, but they will still be higher than their current levels. In Janet Yellen's speech held on Wednesday, January 28th, she was careful to say that she would not be in a hurry to raise interest rates. There is, in fact, no reason for her to be in a hurry, as long as the price of crude oil stays near its historic lows, alongside robust economic growth and low inflation. So far, so good. But there was also a ritual phrase that she left out: "Interest rates are and will stay close to zero for a prolonged period". That must be taken to mean that the beginning of a phase of interest rate rises is already being targeted. In the Federal Open Market Committee this is already under discussion, and the first increase will happen within 6-9 months. It could no longer be called a surprise – so much so that it is by now practically the consensus view of the analysts, and my own personal view. What had been a hypothesis has become a near-certainty, and the most likely timing can now be calculated. Markets must now officially acknowledge this tough reality, which had not previously been included in the mathematical models (which always take account of different degrees of probability). Those markets will, during the next twelve months at most, search for new equilibria between share prices and

fair values, at different levels from before, most probably lower ones.
Monetary policy centred on growth – especially that of the Fed – has been the real force behind the rise in stock prices seen over the last six years, with a consequent positive impact on the economy. It follows that the removal of monetary stimulus is likely to have a decisive negative impact on markets. This is true especially if that removal of stimulus is combined with the many sources of geopolitical tension (wars and terrorism are set to increase in the near future), and if it also takes into account the structural weakness of the Eurozone, which, plausibly, will receive no significant help from the policies of national governments, which should be acting to support the courageous QE decided by the ECB. To sum up, considering all the diverse forces that interact uninterruptedly, and often in conflict, to determine market direction, they are likely to set up the preconditions for a long-term downard reversal of the current trend.
Our long-term working hypothesis must now be that the current hefty growth of the US economy will be progressively discounted by rising stock prices, until the point is reached where interest rate rises will create resistance. Increases in company profits will lose their momentum at exactly the same time when the stock price vs, profit ratio will be very high and become unsustainable. On the other side of the Atlantic, the positive effects of QE will mainly affect stock markets, and only marginally the economy – in any case for no longer than a year.
For all these reasons our long-term guidance must officially be revised. Our current view of an upward trend for markets for twelve months might, at the end of 2015, no longer be supported by the fundamental factors that have given rise to it so far. That does not mean that stocks markets have to fall immediately. It is, in fact, likely that the falls observed in the first few sessions after the three events occurring between January 22nd and 28th (the ECB meeting, the Fed meeting and Greek general election) had an emotional element and contained a phase of overshooting – that is, those falls went too far too fast. The most probable scenario for the next few months is a distributive trading range close to the market maxima. The new situation is that, for the first time in many years, and taking a long-term view, there are no longer any significant or incisive new reasons (i.e. reasons not included in current prices) for expecting new rises in share prices. Thus, at some time during the next 1-2 years, we must expect reasons that will produce – or will probably produce – a long-lasting phase of falls in stock prices.

Stefano Bagnoli
Market Analysis Unit

Markets

After the ‘easy month’ of January, in which our forward guidance was realised perfectly in all respects, our periodic analytical review leads to a forecast pattern that is, all things considered, clear for the next few months. For the medium term the risk-on attitude will continue to be dominant. Stock markets will continue to rise at least till June, then we will see. The S&P and the Dax are ready to test the all-time highs, and the Ftse Mib is the strongest of all the indices. The sectors to be preferred are Italian banking and American technology, and also, for the near term, the crude oil industry, which we had dropped a few months ago, and which we still prefer to leave alone for the medium and long term. The bond spreads continue to grow narrower, which means that there is value to be found in peripheral bonds, probably mostly in the medium- and the long-term segments of the curves, but, over the short term too, corporate bonds and high yield bonds (if chosen appropriately) merit attention. In any case, considering the strongly risk-on attitude that marks this phase, investment in stocks deserves more attention than investment in bonds; I mention this without wishing to upset the personal choices that are embedded in every portfolio.Now that we have gone beyond the second half of 2014, where the main driving force and the simplest operative theme was the short position on the euro-dollar spread (where we took our position as early as May), for the first half of 2015 the leading theme will be the recovery in crude oil, which will reach a price of around $70 in the next few months, and the rouble, too. Over the short term, the euro-dollar cross-rate will stabilise, as has become necessary after the sharp downward acceleration of the past few months, but quite soon (starting in March, as our hypothesis) it will resume its downward decline towards 1:1 (parity), and it will then head towards bolder targets..Investors will need to pay attention to the deliria of Syriza and the Greek government. It is true that they have both shed light on the less-than-transparent aspects of the relationships between the financial milieu and Greece during the past few years, but, even so, both seem to have completely lost sight of logic and reality. The ‘Greek front’ seems to be leading the system into instability, so threatening the hypothesis of a medium-term rise in share prices that we have formulated. During the next few months there will be further accelerations in geopolitical risks in Greece and Israel, or even Iran (though Iran is less probable in the current phase), besides other neglected war fronts, such as Syria, Libya and Isis. Regrettably, terrorist attacks will become more frequent, as is only natural in this phase of the cycle. The world is changing rapidly, and what is on view today will have disappeared the day after tomorrow. The rise in geopolitical risks will lead to occasional phases of high volatility. These, however, will not immediately threaten the underlying rising trend of stock markets in the period under consideration (the medium term).For the long term, however, things will become a bit more complicated...

Market Analysis Unit

Medium Term Focus

The trend of medium-term in the equity markets remains bullish, and the flows ranging from no risk to the risk, and then from the bond, from the areas no risk and defensive currencies (as JPY and CHF), to the stock, areas and growth-sensitive currencies (such as AUD and GBP).

Short Term Focus

The short term trend has returned bullish. The flows ranging from no-risk to the risk, and then from the bond risk free to the stock, and from the defensive currencies towards the growth sensitive.

Economic Highlights

USA

	2007	2008	2009	2010	2011	2012	2013	*2014*	*2015*	*2016*
REAL GDP (YoY)	1,80	-0,30	-2,80	2,50	1,60	2,30	2,20	2,40	*3,20*	*2,80*
INFLATION (YoY)	2,87	3,85	-0,35	1,63	3,17	2,08	1,48	1,63	*0,85*	*2,20*
UNEMPLOYEMENT RATE (%)	4,62	5,80	9,28	9,63	8,93	8,08	7,35	6,15	*5,40*	*5,10*
FED FUNDS RATE (%)	4,25	0,25	0,25	0,25	0,25	0,25	0,25	*0,25*	*0,70*	-

Eurozone

	2007	2008	2009	2010	2011	2012	2013	*2014*	*2015*	*2016*
REAL GDP (YoY)	2,90	0,40	-4,40	2,00	1,60	-0,70	-0,40	0,80	*1,10*	*1,60*
INFLATION (YoY)	2,13	3,28	0,30	1,61	2,70	2,50	1,34	0,44	*0,20*	*1,20*
UNEMPLOYEMENT RATE (%)	7,53	7,58	9,55	10,10	10,12	11,30	11,95	11,58	*11,30*	*11,10*
ECB RATE (%)	4,00	2,50	1,00	1,00	1,00	0,75	0,25	0,05	*0,05*	-

Italy

	2007	2008	2009	2010	2011	2012	2013	*2014*	*2015*	*2016*
REAL GDP (YoY)	1,70	-1,20	-5,50	1,70	0,40	-2,40	-1,90	-0,40	*0,40*	*1,00*
INFLATION (YoY)	2,04	3,49	0,77	1,64	2,91	3,31	1,31	0,2-1	*0,10*	*0,90*
UNEMPLOYEMENT RATE (%)	6,11	6,78	7,82	8,42	8,41	10,68	12,21	12,81	*12,80*	*12,55*
ECB RATE (%)	4,00	2,50	1,00	1,00	1,00	0,75	0,25	0-,05	*0,05*	-

World

	2007	2008	2009	2010	2011	2012	2013	*2014*	*2015*	*2016*
REAL GDP (YoY)	3,94	1,55	-2,32	3,99	2,96	2,08	2,16	2,43	*2,75*	*3,05*
UNEMPLOYEMENT RATE (%)	6,11	6,36	8,18	8,24	7,88	7,82	7,88	-	*7,13*	*6,97*

Global Market Overview

	Last Price*	Last Month Variation	Year to Date
	Stock Indexes		
FTSE Mib	-	15,06%	9,13%
DAX	10972,14	15,87%	12,37%
S&P 500	2020,85	0,91%	-1,81%
Nasdaq 100	4188,59	1,89%	-0,98%
Eurostoxx 50	3423,04	13,80%	9,03%
Nikkei	17335,85	2,68%	-0,42%
MSCI Emerging Markets	963,80	3,11%	1,06%
MSCI World Index	1694,35	2,42%	-0,61%
Global Hedge Fund Index	1214,91	0,51%	-0,30%
	Benchmark Stocks		
Microsoft Corp.	41,28	-9,57%	-11,72%
Apple Inc.	118,63	11,64%	8,51%
Facebook	74,99	-1,52%	-4,41%
Google	532,20	5,05%	0,50%
Alibaba	90,13	-12,77%	-13,00%
Intesa San Paolo	2,62	15,03%	6,68%
Fiat Christler	12,06	25,43%	24,65%
	Forex and Commodities		
€/£	0,75	-3,99%	-3,65%
€/$	1,13	-4,97%	-5,60%
CRB Index	422,81	-2,69%	-3,38%
Gold	1283,60	5,47%	8,01%
Brent	4135,00	-14,44%	-16,92%
WTI	51,03	6,47%	-3,15%
	Yield curves		
T-Bond 10 years	1,67	1,94	2,11
Bund 10 years	0,31	0,45	0,50
BTP 10 years	1,62	1,86	1,74
Spread Btp BUND	131,1	-	-

*Data refer to Tuesday the 3rd February, at 11,30. For closed markets last price refers to 2nd February close price.

Contacts

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