Alpha Value MANAGEMENT

Points of View

Analysis, Research and Texts by AVM Market Analysis Unit

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Year II – N. 5

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From the Editor

Portfolio Manager point of view

May and June have been months characterised by Grexit uncertainties, especially linked to the complex dynamics involved in finding out an agreement between the Greek government and the creditors (mainly IFM, ECB) to avoid Greece to default and a possible exit of the country from the Euro. International institutions are going to offer the deferral of the payment only getting important structural reforms that should involve the entire country. Volatility is increasing in markets and this may continue also in next weeks.

I wish good "Points of View" to everybody.

Gianluigi Montagner

Main scenario Hypothesis

Markets: X-Ray of an Inversion

As mentioned previously, in 2015 the driver and nodal point of our forward guidance on markets and on the whole economic and financial picture has been and will continue to be the price of crude oil. The longer-dated WTI crude oil contracts clearly show the bullish dynamic that will prevail in the near future; in addition, the central banks have said the same thing almost explicitly.

In a 'normal' scenario, our estimates are for the price of WTI crude oil to rise to at least $65-70 per barrel. (A 'normal'' scenario is one in which a known cause produces a known effect with a high degree of probability: a greater or lesser knowledge of the cause allows a greater or lesser degree of precision in forecasting the effect.) That dynamic will have a bullish impact on American inflation, which will quickly rise above the 2% fixed by the Fed as its target. At that point the Fed will immediately begin its new cycle of interest rate rises. That would imply a monthly rate rise of 25 basis points, for several months, in a dynamic search for the equilibrium desired by the Fed itself and by policy makers. The benchmark interest rate will remain at much lower levels than those seen in the most recent cycles; it should not rise above 3%, compared with the peak rate of 5.25% seen in 2006 and the peak rate of 6.25% seen in 2000. It may be noted that the analysts have coverged on a consensus view that the initial interest rate rise will be an isolated event; stock prices are, therefore, not discounting a series of rises, but, rather, one single rise not followed by others.

In formulating an overall assessment, besides the beginning of interest rate rises on the initiative of the Fed, other elements need to be considered.

The year-on-year rise in profits reported by American and Eurozone companies is still steady, and under present conditions stock prices are still not overvalued, but, as we had foreseen over the last few months, a negative scenario is gradually taking shape that will make the continuation of the current uptrend in stock market prices much less likely. On one hand there is the Greek crisis, with its unforeseeable consequences on the stability of the Eurozone system, but, more importantly, there is also the increasingly negative context of geopolitical risks, ranging from the explosive situation in Ukraine to chaos in the Middle East and in North Africa, and comprising many other war-torn zones worldwide, together with a greater risk of terrorist attacks. These factors keep the risk level R high, and have introduced many critical elements into the picture.

A spark in any of the contexts just listed would detonate a series of effects, in a kind of chain reaction,

which would be able to hit all the parts of the system, *including* stock markets, so halting the rising trend of the latter and leading to a medium-term bearish inversion.

By 'medium term' we mean a time window lasting 1-3 years.

Considering all these new elements, it must be concluded that our previous bullish medium-term view of world stock markets, which has lasted for as long as 5 years, has now formally entered into a critical phase.

As the American system is still in a good condition, unlike the Eurozone system, and its parameters are stable, unlike those of the emerging nations, it can be deduced that the negative effects of all these factors will lead to more serious outcomes on the stock markets of the Eurozone and the emerging countries.

In the absence of serious or extreme degenerations and negative predicaments on the geopolitical front, which, however, at the present moment, is indicating a scenario of that type with a probability that is anything but insignificant, the new downtrend should last for 2-3 years. That time frame will allow the economic cycle to run its course, so leading to the inception of a new cycle of interest rate cuts (whereas the interest rates fixed by the ECB will not rise). That turn of events will bring stock markets back to their original excellent state, predisposing a new bullish trend (that should cover the last few years of this decade).

In the downtrend that is now to be expected, all the systemic variables that are currently out of control should return to normal. It is possible – more exactly, it must be hoped – that some form of agreement can be reached between the Russian-Chinese axis and the Atlantic Alliance (NATO), even if that might only be attained after probable moments of great tension and circumscribed conflict scenarios. The risk of terror attacks will rise. The action of armed movements with an Islamic matrix will persist, and there will certainly be conflicts initiated by NATO forces to limit their advance. So too the Greek crisis will, in the meantime, have found a solution, which may be drastic but will anyway be definitive.

Conversely, in the (less probable) case of further complications and degenerations in the already wide spectrum of critical situations on the geopolitical front, taking the form of conflicts that would no longer be marginal, but that would directly involve the superpowers, it would be impossible to make any forecasts, but we would certainly be facing an evolution towards an extremely negative scenario.

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.

Markets

Euro against US Dollar

The Euro vs Dollar cross-rate will continue its medium- to long-term trend towards a target of 1:1 and, after that, move still lower to other, more ambitious levels.

Immediately after the creation of the Euro as a single currency, its exchange rate stayed for some time around 0.90, touching a minimum of 0.8490 in June 2001. At that time, the systemic conditions were less favourable to the dollar and less unfavourable to the Euro than they are now. The difference between the growth rate in the US and that in the Eurozone was less marked than it is today, and there was not the huge divergence in the direction of monetary policy currently being implemented by the Fed and the ECB. The Fed is now removing its monetary stimulus, and is close to the moment when it will raise interest rates, whereas the ECB has kept and will continue to keep interest rates close to zero for a prolonged period of time. Not long ago began its own QE, so that it is by now committed to its effort to bring the greatest possible acceleration to its expansionary monetary policies.

The divergence between the expected benchmark interest rates to be set by the ECB and the Fed (the current ones have been brought down to a level close to zero in both cases) and, therefore, all the other interest rates on the yield curve is therefore the first argument in favour of a further strengthening of the dollar against the euro. The thoroughgoing expansionary monetary policy now being applied by the ECB differs from the restrictive bias of the Fed, so causing a divergence in expected interest rates in favour of the American ones, while shifting money flows towards US Treasury Bonds and towards the dollar.

The divergence in growth between American and European companies continues and will remain a structural feature in favour

of the former, further shifting major money flows towards American stock markets and towards the dollar.

In the present and the near future there are two rather new features that are weakening the absolute nature of the downward trend in the Euro/Dollar ratio.

Factors driving money-flows and leading to correlations. The prevailing correlation (though it is not stable) between the euro/dollar ratio and stock markets is based on an enduring, direct correlation between the US dollar and and the level of stock markets. Up till now stock markets have been rising, which as a result of the correlation just noted, led to further downward pressure on the euro/dollar ratio. At least for now, the decline that has begun in equity markets, and which we hypo theize is likely to continue, has pushed (and will go on pushing) the euro up against the dollar for a few weeks.

Risk factors. In the new map of correlations, changes in perceptions of risk are directly correlated with movements in the euro: the increasingly strong perception of risk is associated with the euro and helps to strengthen it. Conversely, any fall in the perception of risk is associated with and induces a weakening of the euro: "When our analysis is focused on geopolitical risk, the euro strengthens against the dollar, because risk-free bonds issued in the Eurozone are seen as a safe haven, and, therefore, as a defensive asset. On the other hand, the euro weakens against the dollar when systemic risks of a geopolitical type diminish, because the wish for risk-taking resumes, and people go back to searching for risk-on investments, because they expect them to give a better return" (from Stefano Bagnoli, La teoria generale dei flussi).

Market Analysis Unit

Medium Term Focus

After taking a bullish view for over five years, our medium-term view of the stock markets has become bearish. Money flows will gradually move from being risk-on towards being risk-off, from equities to risk-free bonds, and from growth-sensitive value towards defensive value.

Short Term Focus

Our short-term view of the stock markets has become bearish. Money flows will go from risk-on towards risk-off, from the equity market towards risk-free bonds, and from growth-sensitive value towards defensive value.

Economic Highlights

USA

	2007	2008	2009	2010	2011	2012	2013	*2014*	*2015*	*2016*	*2017*
Real GDP (YoY)	1,80	-0,30	-2,80	2,50	1,60	2,30	2,20	2,40	*2,20*	*2,80*	*2,70*
Inflation (YoY)	2,87	3,85	-0,35	1,63	3,17	2,08	1,48	1,63	*0,30*	*2,20*	*2,20*
Unemployement Rate (%)	4,62	5,80	9,28	9,63	8,93	8,08	7,35	6,15	*5,40*	*5,00*	*4,90*
FED FUND 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*	*2017*
Real GDP (YoY)	2,90	0,40	-4,40	2,00	1,60	-0,70	-0,40	0,90	*1,50*	*1,70*	*1,50*
Inflation (YoY)	2,13	3,28	0,30	1,61	2,70	2,50	1,34	0,44	*0,20*	*1,30*	*1,60*
Unemployement Rate (%)	7,53	7,58	9,55	10,10	10,12	11,30	11,95	11,58	*11,10*	*10,60*	*10,30*
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*	*2017*
Real GDP (YoY)	1,70	-1,20	-5,50	1,70	0,40	-2,40	-1,90	-0,40	*0,60*	*1,10*	0,90
Inflation (YoY)	2,04	3,49	0,77	1,64	2,91	3,31	1,31	0,21	*0,20*	*1,00*	*1,20*
Unemployement Rate (%)	6,11	6,78	7,82	8,42	8,41	10,68	12,21	12,69	*12,60*	*12,30*	11,70
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*	*2017*
Real GDP (YoY)	3,94	1,55	-2,32	3,99	2,96	2,08	2,16	2,52	*3,20*	*3,50*	*3,40*

Global Market Overview

	Price as 29th June 2015	Last Month Variation	Year to Date
	Stock Indexes		
FTSE Mib	22569,95	-0,03%	17,98%
DAX	11083,20	-2,16%	13,50%
S&P 500	2057,64	-1,52%	-0,03%
Nasdaq 100	4379,87	-0,67%	3,54%
Eurostoxx 50	3468,90	-2,19%	10,49%
Nikkei	20109,95	4,24%	15,52%
MSCI Emerging Markets	959,42	-8,45%	0,60%
MSCI World Index	1737,60	-2,02%	1,93%
Global Hedge Fund Index	1243,35	-0,10%	2,04%
	Benchmark Stocks		
Microsoft Corp.	44,37	-6,79%	-5,11%
Apple Inc.	124,53	-1,01%	13,90%
Facebook	85,80	10,62%	9,37%
Google	541,25	-0,33%	2,21%
Alibaba	81,07	1,92%	-21,75%
Intesa San Paolo	3,27	10,64%	33,09%
Fiat Christler	13,13	-0,83%	35,71%
	Forex and Commodities		
€/£	0,71243	-3,30%	-9,02%
€/$	1,12130	0,11%	-6,57%
CRB Index	223,58	-3,14%	-2,11%
Gold	1178,61	-1,29%	-0,82%
Brent	4058,00	7,27%	-18,46%
WTI	58,33	-3,43%	10,70%
	Yield curves		
T-Bond 10 years	2,33	6,4%	10,1%
Bund 10 years	0,79	54,5%	59,8%
BTP 10 years	2,39	32,4%	37,3%
Spread Btp BUND	159,30	-	-

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