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**Is Europe Sleepwalking To the Brink?**

This year most developed-market stock markets have rallied nicely, but investors remain unconvinced. In the markets where growth prospects are strongest (the US and Japan) valuations seem stretched, whereas in the markets where stocks are relatively cheap (Europe, and in the developing world China), the growth outlook seems dodgy.

A common theme of our recent conversations is that clients still hunger for some sign of sustained growth across all major economies. Whenever the signs turn positive, something intervenes to crush confidence. First it was the scare over Ben Bernanke’s hint that the Fed’s QE asset purchases could start tapering by the fall. Then in June came the credit squeeze and spike in interbank rates in China, which finally drove home the message that Beijing is content to allow economic growth to slow sharply.

As the summer wears on, might we finally be out of the woods? US growth was surprisingly strong in 2Q. Chinese growth will not improve, but it will not get much worse either, and we think markets have already discounted a further slowdown next year. Japan’s 2Q real GDP growth disappointed, but consumer spending and the GDP deflator moved smartly up. Since the government is targeting not GDP growth but an end to deflation, this report was actually relatively positive.

Finally, Europe is crawling out of its double-dip doldrums. The three biggest eurozone economies all reported 2Q growth ahead of expectations (Germany 0.9%, France 0.5% and Italy –0.2%), and euroland as a whole is now registering positive growth. Moreover, German business confidence surveys—which tipped the 2012 eurozone recession—now suggest the strong pickup in German industrial production and imports will accelerate in coming quarters.

All well and good, but the chance of something nasty emerging from the European woodwork in the next six months is uncomfortably high. The main worry is complacency. European authorities have proved dismal at anticipating even obvious crises, and signs of modest growth may lull them into a stupor in which they can bungle yet another tough moment [(e.g. the impending second Greek bailout, or a **potential French debt problem**).](http://research.gavekal.com/content.php/8816-France-As-A-Lynchpin-by-Louis-Gave)

The ECB crows about shrinking Target 2 balances, showing that banks in peripheral Europe rely less on funding from the core. But Target 2 balances are shrinking mainly because peripheral banks are simply lending less. The credit system in southern Europe still cannot finance decent growth, and work on structural productivity reforms seems at a standstill. If you must worry about something, worry about Europe.

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# US: An Unusual Arbitrage Opportunity

In a normal circumstances there is no particular reason to think the US stock market should outperform the UK stock market over the long term. Over many years I have argued that total return of the US stock market compared to the UK stock market offers no discernible trend—my series goes back to December 1969 and is based on reinvestment of dividends, price appreciation and currency changes.

What tends to occur is massive deviations depending on the prevailing level of investor optimism or pessimism expressed at the time to each country. To play the inevitable mean reversion investors should use these deviations to buy the market which is one standard deviation (or even better two) undervalued vs. the other.

The same logic holds for both nations’ bond markets. Since neither the United States nor the United Kingdom is likely to go bankrupt any time soon, the long term return of their bond markets should be the same. The inevitable mean-reversion in their relative performance opens the way for more massive arbitrage possibilities. And in this regard we find ourselves at a most interesting market juncture which is rich with possibility.

My valuation work tells me that I should be selling US shares to buy UK shares, and at the same time selling UK bonds to buy US bonds.

**I do not remember having ever seen such a configuration as is currently available.** For our readers the current market pricing provides an ideal opportunity to capitalize on the stupid manipulations that the authorities have been indulged in over the last few years.

Such a trade has the advantage of requiring no overall increase in risk to the portfolio as the switch is shares vs shares and bonds vs. bonds. It should, however, result in a massive increase in returns. Once in a while our policymakers present investors with an opportunity which is simply too beautiful to be true. This is probably one of those cases.

## Charles Gave

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**Three reasons to switch UK and US allocations**

As our readers know, before making any recommendation we like to look at three things: Liquidity, valuation and the state of the economy.

In this instance, liquidity is not a

major consideration. On valuation grounds, US bonds are clearly a buy versus UK bonds and UK shares are a buy versus US shares.

[For the reasons which outlined in **A Supply Sider’s View Of The UK**, I expect the UK](http://research.gavekal.com/content.php/8789) economy to surprise on the upside, while the growth outlook in the US looks far less certain.

This is one of those trades that I love; heads I win, tails I don't lose.

# Europe: How To Invest

At the risk of sounding obnoxious, investing in Europe has actually been quite simple for the better part of the last eight years. **All one had to do was overweight the stock markets of the countries which did not belong to the euro and underweight those within the doomsday machine**. Such a strategy would have ensured that the investor comfortably outperformed the main European benchmark.

For those that either had to be in the eurozone or simply wanted a bit more diversification then the only game was the German stock market—German industry was able to slowly but surely destroy the French, Italian and Spanish industrial base as a consequence of a grotesquely undervalued exchange rate vs its fellow EMU club members.

However, what is often forgotten in the Teutonic success story is the vulnerable underbelly of Germany’s success. All those current account surpluses meant that Germany had to accumulate financial assets issued by neighboring economies which were furiously consuming its industrial exports—the likes of Greece, France, Italy or Spain (after all, its called a balance as it has to add to zero).

After the turmoil of the EMU debt crisis, the German private sector is understandably skittish about accepting debt issued by EMU weak links. Yet through the Target 2 EMU clearing system, fellow central banks are in hock to the Bundeksbank for more than €500bn.

What this means is that, for all intents and purposes, there is a potential multi-billion euro loss in the system, with the ECB providing the biggest carry trade in history. Worse still, nobody has got a clue of who is going to take the loss if ever it becomes official that it is really a “bad debt” (which of course, it is). Once again, I have no clue on how all this is going to end, but the problem is getting bigger and not smaller.

So as investors focus on the ebb and flow of PMI data and the latest GDP statistics, they should be cautious about getting too micro in playing the cycle. For those who have to be invested in Europe, I believe that what has worked for the last eight years will continue to work: stay with the non-euro part of Europe.

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**Continue to stay out of eurozone equities**

This chart shows the relative perfor- mance of non-EMU stock indices com- pared to EMU stock markets. One can clearly see that overweighting the non

-EMU markets was the better bet.

Overweighting Germany was also a good idea, but given the German ﬁnancial sectors exposure to weak EMU debt this is a much riskier bet. The fundamentals of this trade can be seen given the continued dominance of the German industrial system versus all of its European rivals.

# Asia: Japan’s Third Arrow Dilemma

Abenomics may go down in history as the one of the most mysterious economic stimulus plans of all time. So far Prime Minister Shinzo Abe’s platform has invigorated markets, delivered soaring corporate profits, boosted consumption and lowered deflation— all this, and yet Japan’s bonds are the only ones in the region to have gained this year.

The ride has, however, been volatile and we are reaching a stage where the many internal contradictions of Abenomics will come to the fore. Take the 2Q13 GDP print this week. The headline number at an annualized 2.6% rate disappointed, but on the bright side, the GDP deflator rose to -0.3%, the least deflationary quarter since 2Q98. Consumption looks good but corporates are failing to reinvest their profit windfalls. Capital spending fell -0.1% QoQ in 2Q, a sixth straight quarter of decline.

This puts pressure on Japan to start shooting the “third arrow” of Abenomics – i.e., to follow up monetary and fiscal stimulus plans with more details about promised structural reforms. Slated reforms include relaxing Japan’s fairly rigid labor market to encourage hiring, liberalizing trade to improve competitiveness and consumer choice, and shutting excess capacity. Which brings us to the issue of internal conflict. The first two arrows of Abenomics are helping beat deflation—but

liberalization reforms can be deflationary. Thus the necessary backdrop of aggressive monetary expansion.

Or consider the most debated third-arrow reform: a rise in the consumption tax. Most analysts agree this has to happen: Japan needs a structural fix to stem the never-ending expansion of its fiscal deficit. But the 2Q GDP miss has led Japan’s “deficit denier” camp to call for deferring or watering down the consumption tax hike due April next year, for fear it will reverse the growth gains brought so far by Abenomics.

No corporate would initiate investment if Japan looks to be going down the path followed by Greece. Better to offset the negative effects by cutting corporate taxes, an idea now being discussed in parliament. Re-opening more nuclear facilities (to lower energy bills) should also be on the cards.

Maintaining a commitment to the consumption tax will strengthen public confidence that Japan’s politicians have what it takes to push through other reforms aimed at revitalizing the corporate milieu. A mysterious process, perhaps, but one that we think the master Abe can make work: especially if he gets some help from a US recovery.

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| **Connecting the dots**What really matters in the latest Asian economic and market news |
| **What happened What it means** |
| **Asia’s inﬂation pressure stayed benign in July (**Thailand CPI fell to 2%, Philippines 2.5%, Taiwan 0.1%, South Korea 1.4%); **exceptions were Indonesia (8.6%) & India (9.6%)** where inﬂation remains elevated. | For those with improving growth, some sequential pick-up in in CPI is likely on higher oil prices, but **inﬂation is far from being a problem.**Countries with high twin deﬁcits remain under pressure as they are stuck between the tough choices of currency stability and growth; we think that **Indonesia will choose to support its currency by keeping a hawkish stance, while India will turn dovish.** |
| **Asian aggregate exports remained ﬂat YoY** in June in USD terms; **stronger than expected exports in China (+5.1% YoY) and South Korea (+2.6% YoY) in July oﬀered a glimpse of hope.** | Stronger demand from the US and EU as seen in China and South Korea bodes well for other Asian export countries; improving US ISM and European PMI readings are also supportive for future real demand growth; however **prices on tradable goods (ex fuel) still face deﬂationary pressure.** |
| **Japan GDP rose an annualized 2.6% in Q2, a deceleration from Q1’s 3.8% and below expectations; nominal growth however accelerated to 2.9%.** | Inﬂation pressure is building up but growth has lost momentum; surveys also point to a weak start for Q3. The disappointment mainly came from business cutting investment. There is still a lot that Mr Abe can do to enhance the business environment such as lowering corporate tax and dealing with energy imports. These moves will be welcomed by investors and should support growth further through the wealth eﬀect. |

# Resources: Mexican Oil Sector Opening Is No Gusher

The stars seem to be aligning for Mexico. Years of incremental political reform and economic liberalization has put the country in a prime position to benefit from proximity to a recovering US, rising wages in competitor nations and a burgeoning middle class. Unfortunately, Mexico is still holding out on energy sector reform: the much-anticipated proposal for opening up of the state-run oil industry, unveiled yesterday, disappointed.

This is a shame, because stagnant petroleum sector investment and declining oil export revenues are retarding Mexico’s potential growth rate. Without FDI to kick start new output, Mexico’s net oil export revenues will keep falling. And without reforms to lower electricity prices and mobilize its own abundant shale gas reserves, the country is missing out on another boost to competitiveness.

How much faster could Mexico grow with a more open energy sector? Mexican oil output peaked in 2004 at 3.4m bpd and has fallen by roughly one quarter since. Net revenues from the petroleum trade, which were boosting nominal growth by about 0.2% in the mid- 2000s, now constitute a net drag of

-0.1% as rising fuel imports chip away at stagnant crude export revenues.

The knock-on effects of cheaper power and higher energy FDI would be highly significant—boosting potential growth by 1-2% annually according to most estimates. Pemex, the state-owned oil firm, accounts for one-third of the government’s tax receipts: for a middle income nation with big public infrastructure needs and only around 3% nominal growth likely in 2013, this is a significant problem.

In this context, President Peña Nieto’s proposal— which allows for “profit-sharing” between Pemex and foreign firms, but not independent production or ownership of reserves—is a disappointment. Without ownership rights, the oil majors will have limited enthusiasm. And on the electricity side, generation will be opened to foreign investment, but not transmission, which could make it difficult for new generators to get reliable connections.

The nationalist politics of Mexico’s oil sector dealt the president a tough hand. Barring further changes to the plan, Mexico‘s star will be burning less brightly than its potential.

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**Mexico needs energy reform to give growth a kick**

Mexico is still the world’s 10th largest oil producer, but output has fallen by about one quarter since 2005 to 2.6m bpd.

Meanwhile insuﬃcient reﬁnery invest- ment and rising gasoline demand have pushed fuel imports up and net exports down.

The national oil ﬁrm Pemex believes oﬀshore oil potential could be up to 29bn barrels—which would roughly quadruple Mexican reserves—but lacks the expertise and capital for intensive exploration. The US Energy Information Administration also estimates Mexico has the world’s 6th largest recoverable shale gas (545 trn cu ft) and 8th largest shale oil resource (13 bn bbls).