SAGA Market Outlook

A monthly commentary by Gabriel V. Safdié
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THE UGLY LITTLE YELLOW DUCK

Generalities (1-5)

1. The economic figures published in August in China reported a sharp slowdown in the economy to the point that the growth target of 7.5 % for 2014 may not be achieved. This prompted the central bank to inject USD 81 billion of cash in the five largest banks of the country to facilitate credit. This is the equivalent of a drop of 0.5 % of the base rate.

2. This led to a further decline in commodities with the Bloomberg Commodity Index - more diverse than the CRB Index - reaching its lowest level since July 2009. Nearly all sectors were impacted with copper, iron, coal and oil, down on the industrial side while, among agricultural products, soybeans and corn are at their lowest level in four years.

3. The Chinese weakness was also obviously reflected in the stock markets of emerging countries with a decline for the month of the MSCI emerging countries index in USD of 7.8 %. In contrast in Europe, thanks to the expectations of greater ECB intervention to boost growth, the CAC rose 0.8 % and the Euro Stoxx-50 1.7 %. In the US, the indexes were negative : -1.5 % for the S&P, -1.9 % for the Nasdaq and -6.2 % for the Russell index of small caps. As for the Nikkei, its rise of 4.8 % in yen was completely offset in dollar terms (-0.5 %).

4. Indeed, the yen fell against the greenback to 109.65, a level last reached in August 2008. The euro also dropped from 1.3130 to 1.2630. The rising dollar was quite broad as illustrated by the move of the dollar index, up 3.9 % for the month.

5. Regarding bonds, the yield on the 10-year American government bond ended the month at 2.49 %, unable to overcome to the upside the resistance level at 2.6 %. Its German equivalent was at 0.95 % and the Japanese one at 0.53 %. Finally the yield of the Bloomberg USD High Yield Index rose from 5.5 % to 6.27 %.

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Commodities (6-13)

6. One of the major criticisms of the quantitative easing policy is that it has forced investors to shift from safety to speculation; in particular they have had to buy more shares and more bonds of poorer quality than what they would normally do.

7. Illiquid assets also increased so much to the point that we are left with houses that are empty, art that is hidden in safes and wine that is not drank but carefully stored in its original cases. Indeed secondary homes, old masters and great Bordeaux wines have become investment objects, held primarily for their ability to add value over time, since their cash flows are negative: they yield nothing, and one must pay for safekeeping them.

8. The evolution is quite remarkable if one remembers that at the end of the nineteenth century the great American fortunes, such as the Carnegies, Vanderbilt and Astor, bought those items only for the purpose of enjoying them. Then, money was earned through a productive activity and not by storing luxury objects.

9. Coming back to the present, one can notice that there is presently an asset which is more liquid that a share or a bond but with a negative cash-flow such as the prestigious assets mentioned above and which, like Asterix's Gallic village, resists the broad upwards trend. It is naturally this ugly little yellow duck: gold.

10. Gold which is indeed quite a strange animal because it is not just an asset. It is also simultaneously a medium of exchange, alongside the dollar or the euro for example, with the advantage or disadvantage depending on your point of view, of not being linked to any country. Bitcoin dreams in the digital world to become the equivalent of gold in the physical world and the model used to obtain bitcoins replicates the mining exploration since one needs to "dig" in order to extract bitcoins.

11. Gold's strength rests on the fact that today - as was the case 3,000 years ago - the equivalent of one ounce of gold allows a human being to obtain, immediately and in the whole world, the three basic elements he needs: food, clothes and shelter.

12. Despite the fact that nothing else on this planet has such a power, it has not discouraged during the last century, economists, governments and major financial institutions wishing that gold loses its monetary element. From their perspective, it is just "a barbarous relic", to use Keynes words, having no place in a modern economy.

13. In contrast, the more an individual is suspicious of the state and the more he is a "gold bug", a gold supporter. These individuals believe that only physical gold guarantees their freedom since governments cannot easily appropriated it. And also for them, in the long run, only gold can protect one's capital against the continuous monetary degradation organized by every country.

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Commodities (14-23)

14. The battle between the two groups will continue but in any case its recent behavior demonstrates that it retains its uniqueness and that it can only be compared to itself.

15. In comparison to 36 months ago all assets - liquid and illiquid - have moved up with the exception of gold, which, since its peak in September 2011 at USD 1,900.-/oz. is down more than 35 %. In other words, it needs to go up 60 % from the current level to return to its peak.

16. Yet, at the time, nothing seemed to be able to stop gold's upward move. Indeed, on the supply side, known reserves are declining, production costs have tripled to about USD 900-1'000.-/ounce and there are no opportunities to significantly increase production for at least ten years.

17. As for demand, given the amount of dollars created by the FED through its quantitative easing policy, it seemed natural that central banks would exchange some of their dollars into gold. And if emerging countries' central banks were to hold 15 % of their reserves in gold, as is the case for developed countries' central banks, this would represent about twenty years of the world's annual production.

18. Regarding investors, their overall allocation to gold was only at 2 % and it was fun to calculate the profit one could make if the exposure to the yellow metal increased to just 4 %; a level which did not seemed to be extravagant in view of the rising level of sovereign indebtedness and of the negative real interest rates that continue to prevail.

19. So, what happened ?

20. Gold was simply victim of the fact that it is an asset with no cash flow while being very liquid.

21. When the FED announced its unlimited quantitative easing in September 2012 gold was at USD 100.- from its peak. However, after the FED's statement gold did not moved up, contrary to what had happened after previous announcements. This was due to the fact that the financial and sovereign crisis had by then abated and that the quantitative easing policy had not brought, as many feared, a rise in inflation.

22. Traders then felt that there was an opportunity of going short since the fact that gold was unable to move up indicated that it was likely that there were no more potential buyers at that price level. Such a trade can easily be implemented because the gold market is a small one with relatively small transaction volumes; one does not need to do much to create an imbalance between supply and demand.

23. The rise in gold had started below USD 300.- in 2000 when the real return on interest in USD became zero. It then accelerated after the creation in the United States of the first gold ETF, i.e. a share which tracks the price level of physical gold. This allowed Americans to invest much more easily in the yellow metal as American banks were not at that time technologically equipped to allow US private investors to buy and hold physical gold in their bank accounts.

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Commodities (24-36)

24. And the move continued until a plateau was reached in 2007 at around USD 800.-.

25. Then, with the financial crisis followed by the euro one, a second wave of gold price increase started at the end of 2008.

26. This bull move was going to reverse itself in September 2012, with the decline continuing until June 2013, when after falling more than 10 % during that month, gold bottomed at USD 1'200.-.

27. Gold's liquidity can be evidenced by the fact that, despite the significant drop in price, investors were able at all times to receive a quote and met no difficulty in selling. And because gold has no cash flow, it is difficult to assign an objective value which could have then naturally attracted investors. Thus, we ended being in a scenario where a fall led to another fall. Investors were pushed to sell because, as is the case with a share, each fall was immediately visible in the valuation of their portfolios. From this point of view, real estate or art are much less stressful because their loss is not shown on a daily basis.

28. And this how withdrawals of assets from gold's ETF funds reached USD 31 billion in 2013.

29. But there is also another complementary explanation. The second wave of increases, the one which started in 2008, had its origin on the fragility of the financial system and the fears that the Lehman bankruptcy would not be the only one.

30. Consequently, once this fear was gone, those buyers moved out. Their motivation was thus quite different from those investors who bought a painting or a flat in London.

31. However, the buyers of the first wave have kept their gold because the reasons that led them to it (government debts and negative real yields) remain valid.

32. For the future, the first challenge for the yellow metal will thus be to overcome the aversion of investors in front of such a volatile asset.

33. Then, it seems that a bull trend can only appear for two reasons. The first would be a return of a fear related to a particular event. This is unpredictable by definition.

34. The second possibility is that the deflationary tendencies are overcome and central banks afterwards are too slow in rising rates, thus allowing inflation to move up.

35. And from this point of view presently it is rather the opposite which is happening as the 200 dollars decline in the price of gold since mid-March confirms the intensification of the deflationary pressures.

36. Currently, gold is approaching again USD 1,200, the level where the decline halted in June 2013 and which had already been tested in December 2013. Should this support give way, it would be a very negative sign for world growth.

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Bonds (37-46)

37. The decline to around 1 % of the yield on the 10-year German sovereign bond is another testimony of these deflationary pressures in the Eurozone.

38. The situation is quite the opposite in the United States since, as we have already mentioned in previous reports, the signs of normalization of the economy are becoming more and more visible. Thus, it was not surprising that at the last FED meeting, the average of the FED members' expectations regarding the level of the US prime interest rate rose to 1.375 % for the end of 2015. However, it should be noted that the market remains much more skeptical as it is currently pricing the rate at only half this level.

39. The coming months should be quite interesting with the United States warming up while the rest of the world cools down.

40. But what the fall in gold has demonstrated is that a trend reversal can happen even without a change in the economic data. Sometimes, it is just an imbalance between supply and demand which starts the move and which will be explained afterwards by beautiful analyses.

41. Should this happen in the fixed income sector, then it is likely that the fixed income ETFs will behave as the gold ones did, because if these funds held only USD 60 billion in assets in 2007, the figure is now above USD 390 billion. As with gold, it is quite easy to go short on bonds and if done at the right time, a bear trend can be established. And then, if investors see the value of these funds going down in their portfolios, they could accelerate their requests for the reimbursement of their investments. This would oblige the funds' managers to sell bonds at any price in order to raise the cash needed for the repayments; thus, weighing even more on the prices of such securities.

42. And then, if fear were to seize this market then the impossible becomes possible. Everything will be on sale at the same time: good and bad quality, sovereign and corporate bonds : no matter the color or denomination, the goal will only be one. I need to get out, to stop the losses and find the security of cash.

43. Of course I will try to explain it with rational reasons (the risk of higher interest rates or inflation) but the truth is that I just want out because I have too many of these creatures and I am just scared.

44. Professionals are aware of this danger but the fact that the FED was massively buying bonds not only brought the needed liquidity to the market but also comforted it. Soon, however, the FED will stop its purchases and perhaps the psychology will begin to change.

45. But most likely, the trigger for such a move will be an unexpected factor mentioned just by one or two analysts, who will then become, for a few months, the new market's gurus.

46. Once again we would like to emphasize that this is why we consider dangerous to be heavily invested in the fixed income sector. There is no certainty that it will happen.

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Bonds (47-48)

47. Simply we do not want to join the group in this mountain climb because the risk of an avalanche seems to us far too high. We do not wish them any harm and hope that they will be able to reach their destination safe and sound. Our goal is to move forward, perhaps more slowly, but also in a more secure way.

48. The irony being of course that, depending on the size of the avalanche, it will be quite difficult to protect ourselves.

Currencies (49-53)

49. Another source of tension for bonds could come from the forex market and more particularly from a rising dollar.

50. The United States is the only major country where it is possible to imagine a higher interest rate in 2015, while others like the ECB need instead to boost their economic stimulus measures. In this context we can understand why Goldman Sachs expects that in 2017 the dollar and the euro will be at parity, implying a further 20 % drop for the single currency.

51. If this dollar bull move happens, it would lead to a rise of the dollar against all currencies, including towards the emerging countries' currencies. This could then produce a similar shock to 2008 when the rise of the dollar led to losses for 50,000 companies from emerging countries of USD 30 billion. And the fact is that since then, emerging countries' companies have greatly increased their borrowing in dollars and it is not certain that all will be able to properly manage their currency exposure.

52. Fortunately, this risk does not appear to be imminent. The deficit of the US balance of payments of USD 400 billion per year makes it difficult for the greenback to significantly move up only on the basis of an expectation of higher interest rates. And even more so since it will be a gradual move and it is not until late 2016 that FED members expect the interest rate to reach 2.875 %. Also, this forecast has become more uncertain with the deflationary pressures in the rest of the world.

53. It should also be noted that the dollar is presently already technically overbought and a correction of the upward trend, even if temporary, has become more likely.

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Equities (54-58)

54. With the FED's bond purchases coming to an end and the first rise in interest rates getting closer and closer, uncertainty will increase for the stock market. This could justify a correction of the stock market (a decline of more than 10 %) in the last quarter of the year. And the risk has increased since the last correction is already far away and, as with a long undefeated team, the pressure increases with each game.

55. But, with or without correction, we consider it likely that the American economy will be able to support this increase, and the following ones, as it continues to improve. And it would take a significant event, such as a sharp drop in gold under USD 1'200.-, to bring serious doubts to this scenario.

56. In Europe, even without a significant influence of the ECB, the economic situation will mechanically improve as the budgetary and fiscal policy of member states is not restrictive anymore

57. Admittedly the recovery will be weak, but with the current pessimism it will be sufficient to positively surprise investors and enable European stock markets to start to catch up the American ones.

58. Thus, equities continue to be our favorite asset but always at a level that allows an investor to feel comfortable when confronted with the inevitable volatility.

Conclusion (59-64)

59. It is likely that the ugly little yellow duck will remain so for some time.

60. However, we have kept our modest exposure to gold, which is still profitable even if obviously much of the potential profit has evaporated, as we consider that the negative real yield on bonds continues to justify it.

61. But we have also not increased it either given the current deflationary pressures. Any decline below USD 1'000.- could be an opportunity to buy more because it will be difficult for gold to stay during a protracted period at a level below its extraction cost.

62. But then, we will probably have other far more serious worries because such a move would herald the imminent arrival of deflation which, it must be noticed, has not yet happened, even in the Eurozone.

63. And if this were to occur, it could then deal a severe blow to the credibility of central banks which are the only institutions trusted by investors. A new crisis could then start.

64. Last month, we concluded by imagining a peaceful world where good news would lead to other good news.

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Conclusion (65-67)

65. Today, it is almost the opposite that we are contemplating and in an equal plausible way.

66. This strange situation is due to the haziness of the current situation. If we believe that deflation is our enemy, uncertainty remains in relation to our own abilities (the central bank interventions), to those of the enemy (which enjoys the support of cheap labor in emerging countries and technological developments), to the position of our forces (debt weakens us immensely) and to the goals to be achieved (structural reforms designed to return to a healthy and sustainable growth).

67. We remain confident in our victory, but the recent fall of bond yields, of gold, and the need for China to bring oxygen to its economy has put us back in a position more uncomfortable than the one we were hoping to be today.

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