

A monthly commentary by Gabriel V. Safdié
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CAUTION OR AGGRESSIVENESS ?

Generalities (1-7)

1. If there are months where until the last minute it is unclear whether they will be positive or not, this was never the case in November for US stocks, as the rise was steady, with little setbacks.

2. And so the US stock market established new records throughout the month, with at the end rises of respectively 3.5 % for the S&P and 3.6 % for the Nasdaq.

3. On the other hand, in Europe, equities marked time with, for example, the Euro Stoxx50 index is up 0.6 %. The notable exception in the area was the DAX : + 4.1 %.

4. The drop of the yen against the dollar from 98 to 102.40 favored the Nikkei, which rose 8 % in JPY and 3.4 % in USD. On the other hand, at 1.3590, the EUR/USD rate remained virtually unchanged.

5. Once again, emerging markets were the lagers, with a 0.25 % fall of the index of emerging countries in USD.

6. A new decline also for the CRB commodity of 1 %, with renewed downward pressure on gold (-5.5 %) and silver (-8.6 %).

7. And as a matter of fact it was only in the bond sector that one found some volatility in November, with the 10-year US government bond yield fluctuating according to the news - a few days up and a few days down, between 2.55 % and 2.80 % - to end the month at 2.75 %. Its German equivalent being at 1.69 %.

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Equities (8-22)

8. One of the basic rules in portfolio management is diversification, illustrated by the popular saying "of not having all your eggs in the same basket."

9. But what is often omitted is to add that diversification has also a cost, since investing in assets as uncorrelated as possible from each other often implies that if some are moving up, others may be on the way down at the same time, thus reducing performance.

10. And from this point of view, 2013 was particularly painful.

11. The sole position worth holding was in developed countries equities, where gains in dollar were from more than 10 % for the British stock market to over 30 % for the Nasdaq.

12. All the rest were negative. As per November 22nd, the figures are as follows :

- EEM emerging countries index in USD : -5 %
- Gold in USD : -26.1 %
- Gold mines index in USD : -52 %
- 10-year US Treasury bonds : -4 %
- Evolution of Norwegian krone against EUR : -12 %.
- Evolution of Canadian dollar against USD -5.5 %.

13. These figures show that 2013 was the year in which investors abandoned assets considered as "safe", overcame their fears after the 2008 trauma and became much more optimistic in relation to the future.

14. This last point can be illustrated as follows : "The equity increase was mainly due to the expansion of valuation ratios. Indeed the rise of the price/earnings ratio (PER) explains 99 % of the S&P500 increase, more than 142 % of the Stoxx 600 and 75 % of the Topix" (figures

provided by Christophe Donay, head of asset allocation at Bank Pictet).

15. This situation has led to larger than usual performance divergences, since the greater a portfolio was diversified outside equities, the higher the negative impact on performance.

16. Investors have therefore agreed to pay more for their equities than what would have been justified just by the increase in profits. This is what we have already noted in our May report entitled "The last "cheap" asset."

17. And the question now is to establish which attitude one should have regarding equities after this year's sharp rise. Caution or aggressiveness ?

18. Favourable elements which justify maintaining equity positions, or even strengthening them, are significant.

19. First there is momentum, i.e. the fact that a rise leads to another one. The more an asset moves up, the greater the pressure on both, professionals and private individuals, to increase its weight in their portfolios.

20. And it should be mentioned the fact that generally private investors currently have a very low equity exposure. Thus, this is a potential important fuel source for the continuation of the bull market.

21. Moreover, contrary to what bears believe, the 2013 rise is not illegitimate. In our view, it erased the undervaluation of the US index, which presently is at fair value. And there is still a strong rise potential in Europe if the economic situation in the region continues to normalize.

22. Another very favourable element for equities is the end of budgetary austerity around the world.

Equities (23-35)

23. In the US, the main impacts of the budget cuts are behind us. And a good surprise could even come from an agreement in Congress on two points : a) an increase of government revenues through a reduction of tax shelters. This could be acceptable to Republicans, since technically it is not a tax increase. b) a large investment plan in favour of the country infrastructures, since everyone now realizes that the situation in this area is quite unsatisfactory.

24. The year-end increase is also sustained by the hope that with renewed confidence, companies will feel more comfortable increasing their investment spending, which could result in a surprising acceleration of economic growth.

25. In Europe, not only the ECB is ready to increase market liquidity if necessary, but governments will also contribute positively to the economy. In Germany, Mrs Merkel has just accepted the main demand of the Social Democratic party and will therefore introduce a minimum wage, which will be favourable for consumption.

26. At the other end of the chain, it is likely that Greece will refuse - successfully - any new austerity measure. Indeed, not only has the country erased the deficit of its balance of payments, but also its budget is now in primary surplus, i.e. the country spends less than it earns before the payment of interests. This means that Greece could, in an extreme scenario, default on its debt without major consequences for the country.

27. And it is difficult to see how any government could accept new austerity measures just to serve a debt which is practically owned only by major international institutions.

28. Regarding Greece, one should therefore expect in coming months much ado about nothing, as, in the end, the country will not do anything more, and the international community will have to find

a formula to save face, while allowing the burden of debt to be reduced to the level of what the country can do today.

29. Finally, in Japan, the government will continue throughout 2014 to take measures to support growth.

30. And if one add to this situation, the ultra-accommodative policy of central banks, nothing seems able to prevent another triumphant year for equities.

31. Even one of the most respected professionals, Jeremy Grantham of the asset management company GMO, wrote at the end of a report which explains why in his view the US stock market is overvalued and why its performance in real terms (after deducting inflation) will be on average negative during the next seven years : "My personal view is that Greenspan-Bernanke regime of excessive stimulus, now administered by Yellen, will proceed as usual, and that the path of least resistance, for the market will be up. I believe that it would take a severe economic shock to outweigh the effect of the FED's relentless pushing of the market."

32. Therefore, if even those who do not like the stock market are expecting that it will rise by another 20-30 % over the next two years (which could result in an increase of 40-50 % in Europe) why are we reluctant to be aggressively bullish ?

33. All the above mentioned factors explain why we have advocated and continue to advocate the idea that the main risk exposure in a portfolio should be in equities. But at the same time, we have not advised to overweight this asset in a significant way, preferring to be rather cautious.

34. Several factors explain this attitude.

35. First, let's note that it is disturbing that currently even pessimists do not foresee the possibility of a decline.

Equities (36-47)

36. But the main element is the fact that the potential fall for stock markets is large if the hopes on which this rise happened are not fulfilled.

37. In 2013, three quarters of the world had growth below what the IMF expected twelve months ago.

38. In Europe, for example, GDP growth fell from 0.3 % in the second quarter to 0.1 % in the third. This is a clear sign of deceleration, which would normally have been reflected in the stock market. And, by the way, this was one of the reasons why we did express concerns throughout the year.

39. But the stock market has so far superbly ignored this situation, as it is reassured by the easy monetary policy which reinforces its idea that the slowdown around the world is just temporary.

40. The difficulty is that we do not see in the leading indicators tangible signs that growth in 2014 could be a pleasant surprise.

41. In the US, all hopes rest now on an acceleration of investment spending, since with a real average purchasing power back to the 1989 level, there is a limit to consumer indebtedness.

42. But here too, figures remain disappointing. While shares buybacks by S&P 500 companies rose 18 %

to USD 118 billion in the second quarter of 2013 compared to the first one, real non-residential fixed investment on equipment declined in the last twelve months to the end of September by 3.7 %.

43. Therefore, managers continue to be mainly interested in boosting equity prices in the short-term in order to increase their bonus rather than investing for the long-term.

44. And then there are the limits of the quantitative easing policy. Everyone has noticed that the US stock market stalled, or even declined, at the end of the easing programs no 1 and 2, and it was necessary for the current third one to be of no set time limit for the rise to last this long. In addition, injecting increased amounts of liquidity was needed to keep the boat afloat.

45. So, nobody knows how the market will react when the FED will begin to reduce its purchases.

46. Finally, one can notice that from a technical point of view, emerging countries stock markets look quite fragile at the moment. Therefore a new downward move is possible, in particular because domestic demand is no longer growing as before and this is happening while at the same time their production costs are increasing.

47. How markets will react if this were to happen ?

Bonds (48-49)

48. And this question is all the more important since the credit risk on these countries has increased significantly. The Bank for International Settlements (BIS) - which is the central bank of central banks - observed that the interbank credit in favour of emerging markets is at an absolute record.

49. In addition, the value of bonds issued in foreign currencies by private companies from countries such as Brazil, China and other developing countries exceeded for the first time the total amount of bonds issued by companies located in developed countries.

Bonds (50-62)

50. And this is all the more remarkable since in developed countries corporate bond issuance is also exuberant.

51. To get an idea of the extent of the phenomenon and of the problems this situation is creating, one can just look to some articles published in the Financial Times in November.

52. "Wall Street feeds the ravenous debt beast." In this article, the journalist notes that for the first time in history over USD 1 trillion of leveraged and high coupon bonds have been issued.

53. "Ex-Moody's staff raises alarm over ABS meltdown." One has not forgotten that it was the asset-backed securities (ABS) which were at the heart of the 2008 crisis and this former senior executive at Moody's believes that their current rating is too high.

54. "Triple C bond sales hit record high". A triple C rating indicates that there is a greater than 50 % risk of default by the issuer. The article notes that USD 38 billion were issued until now this year in the US and that the average yield of this sector has fallen to 7.75 %.

55. "Corporate default risk models are broken." The text explains why the QE policy rendered inoperative all existing models of risk.

56. "Return of risky pre-crisis lending practices sparks overheating fears." This is what we mentioned in our previous report, i.e. the issue of bonds by financially weak debtors with fewer guarantees than usually (cov-lite).

57. But the strongest attack came from the BIS itself, which in its latest quarterly report analyses the events which took place in markets in May, when the FED mentioned that it may start to slow down its bond purchases.

58. And on this subject the report notes : "The policy announcements occurred after a prolonged period of exceptional monetary accommodation in advanced economies, just as the economic outlook there was turning positive. They caught markets by surprise, reminding them that negative term premium cannot last indefinitely. Even though this resulted in temporarily higher market volatility, equities eventually recovered from the losses incurred during the sell-off. Furthermore, despite their rise, yields remained low by historical standards, thus perpetuating the relative appeal of higher-yielding asset classes. This extended the squeeze of credit spreads and fuelled strong issuance of bonds and loans in the riskier part of the spectrum, a phenomenon reminiscent of the exuberance prior to the global financial crisis."

59. "...reminiscent of the exuberance prior to the global financial crisis." One can understand better these words when knowing for example that subordinated loans, riskier for creditors than normal loans if things go wrong, have tripled this year to USD 52 billion in Europe and quadrupled in the USA to USD 22 billion.

60. The report also notices that the share of leveraged loans in the syndicated loan market reached a record level of 45 %, i.e. 10 % above the previous record of 2007-2008.

61. It is therefore not surprising that commenting this report Mr Borio - head of research at the BIS - declared : "Nobody knows how far global borrowing costs will rise as the FED tightens policy or how disorderly the process may be."

62. His conclusion : "The challenge is to be prepared. This means being prudent, limiting leverage and avoiding the temptation of believing that the market will remain liquid under stress, the illusion of liquidity."

Bonds (63-65)

63. The entire financial world is aware of these excesses, but if the party goes on it is because the market believes that the FED is still very far from raising its prime rate and that meanwhile it will also move slowly with tapering in order to avoid the turmoil that occurred in May.

64. And we must here mention the famous interview that Chuck Prince - then the CEO

of Citigroup - granted to the FT on July 9th, 2007. In this interview, he said : "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

65. The situation is the same today.

Commodities (66-70)

66. By the way, what could also make the music stop is not only an increase in rates, which would at least be linked to an improvement in global growth, but also unexpected fears about the future of the economy.

67. We have already mentioned above the current fragility of emerging countries stock markets. From this point of view, the steady decline in commodity prices for several months now is a sign of weak aggregate demand and the loss of income also increases the pressure on these countries.

68. Similarly, the decline in gold a few months ago seems to have correctly announced the new deflationary wave which is now reaching

the global economy and which could overwhelm the barriers put in place by central banks with their QE policies. And deflation is a deadly poison for indebted countries.

69. Regarding gold, it should not be buried too quickly. This is the first decline in thirteen years, certainly a significant one, but still within reasonable limits with respect to the upward move that preceded it. And this decline could even continue in 2014.

70. But if the scenario of an acceleration of global growth occurs, it is inevitable that central banks, whose priority is now to reduce unemployment, will be late raising their rates, thus giving room for inflation to surprise on the upside.

Currencies (71-73)

71. The last thing the euro zone needs is a rising euro as it is already flirting with deflation.

72. If until now the ECB was pleased with the rise of the euro, since it symbolized the return of investor confidence towards the single currency, it will be difficult for the central bank to let the EUR/USD parity move well above 1.40.

73. Anyway, this sector, once the most volatile, will remain for the moment, thanks to the zero interest rate policy, the least one. And even more so that there are no fundamental reasons to favor, among the developed countries' currencies, one more than the others.

Conclusion (74-81)

74. Yes, we remain positioned based on the continuation of the scenario which has emerged in 2013, the one of a growth that will continue to improve gradually.

75. But we are also highly concerned by the credit excesses as well as by the persistence of deflationary pressures.

76. Professionals have a saying that "the goal of the market is to do the greatest possible harm to the greatest possible number of investors."

77. In 2013, it was not to have been exposed, or insufficiently, to equities. And this could also be the case in 2014.

78. But, sooner or later, the credit bill will have to be settled. And at that moment it will impact a large number of investors which have become insensitive to risk in this sector by the bull market of the last thirty years.

79. And from this point of view, the answer to the question "cautious or aggressive" is quite unpleasant.

80. Be careful and you will limit the only reasonable possibility of gains; be aggressive and you could be slaughtered if the music stops unexpectedly.

81. In summary, each one will have to choose his poison according to his personality.