Market Outlook

A monthly commentary by Gabriel V. Safdié
Written on July 1st, 2015

SKIRTS AND THE STOCK MARKET

Generalities (1-6)

1. During the month, European stock markets fluctuated mainly according to the evolution of the Greek crisis and ended down 4.1 % for both the DAX and the Euro-Stoxx50. In the United States, the Nasdaq reached a new record in June, but also finished down 1.6 %, while the S&P500 lost 2.1 %.

2. In Japan, the Nikkei fell 1.6 %, while the MSCI emerging markets index lost 3.6 %.

3. Earlier in the month, the yield on the 10-year German sovereign bond (called Bund) continued its rise initiated on April 20th, 2015 from the level of 0.07 %, to reach 0.981 % on June 10th, before this level of almost 1 % attracted investors and enabled the yield to move down to 0.76 % by the end of the month.

4. A similar evolution also occurred for the US equivalent which, after moving up to 2.50 %, ended June at 2.35 %. As for the yield of the Bloomberg USD High Yield Index, while it was virtually unchanged in May during the first phase of the rise of long-term interest rates, it climbed 0.50 % last month to 6.68 %.

5. In relation to currencies, the surprise was that at no time in June the Greek crisis had a negative effect on the euro. But it is far from finished and regardless of the referendum result, many new episodes are yet to happen. Anyway, in the month, the euro even improved against the dollar from 1.10 to 1.1140. Regarding the yen, following its sharp drop in previous months against the dollar, the exchange rate stabilized in June at 122.40.

6. Finally, the Bloomberg Commodity Index seems to have found an equilibrium as it has been fluctuating in the last three months at around 100. This is also the case of the price of oil, with a barrel at around USD 60.-.

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Bonds (7-18)

7. Our regular readers know that one of our major convictions is that the most extreme volatility - which historically was the realm of currencies, and then of equities - is gradually moving towards bonds, where sooner or later record levels will be reached.

8. Thus, the recent yields' rise in German sovereign bonds pushed the 90-day volatility on the 10- year Bund from its long-term average of 20 % since 1990 all the way up to 240 % recently.

9. And this is just the beginning. Although the increase of nearly 1 % of the German yield translates into a decline of nearly 10 % of the value of the bond, it is in fact only one of many small tremors that will occur before The big earthquake, which we believe to be inevitable.

10. Indeed, the strategy pursued by central banks - consisting in keeping monetary policy as lax as possible, for as long as possible - means they will end up being behind the economic cycle. And when the market will take notice, it will be a mad rush.

11. Currently, the market expects that the first interest rate rise in the US will happen in September. However it is not this move which is important, since it is rather a symbolic one. What matters to the market is at what rhythm the following rises will occur.

12. And from this point of view, a recent speech of a member of the FED - Lael Brainard - illustrates how much cautious the central bank will be. She said that regarding the matter of raising rates she would want to see : "further improvement in the labor market with solid further employment growth and further evidence of a narrowing of resource utilization gaps based on various indicators, including the unemployment rate, the labor force participation rate, the percentage of employees who are working part time for economic reasons, and faster wage growth".

13. In short, the FED does not want to take any risk whatsoever of jeopardizing growth, which remains, it is true, quite irregular and unable to move back to the usual 3 % level.

14. This can be explained in particular by the fact that currently in the United States, despite the attractive level of interest rates, most large companies borrow only in order to buy back their own shares and not to invest. It is currently the main reason why growth remains so anemic.

15. This is now becoming an issue. A renowned British economist - Andrew Smithers - observed that since 1990 investments in the UK have moved down from 26 % to 17 % of GDP. And he also noticed that in America unquoted companies have been investing twice as much as quoted ones.

16. And he believes that this difference can be explained by the fact that unquoted companies favor a high investment level, as it improves their productivity, while executives of quoted companies only care about their bonuses and therefore prefer to focus on the short term by taking measures – such as for example, buying back their own shares - which quickly pushes up the stock price and thus the value of the options they hold.

17. Hence his desire to see these manager's bonuses linked not only to profit targets, but also to increases of productivity. And he calls for a public debate on this matter.

18. Be that as it may - whether it comes from political pressure, or just because it is possible to delay the investments only up to a certain point - if the business attitude changes and a virtuous circle takes hold, growth could then accelerate quickly, thus forcing investors to call into question the idea that interest rate increases will happen in slow motion.

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Bonds (19-32)

19. And then everything could move very quickly knowing that historically the FED considers that it pursues a neutral (i.e. neither lax, nor restrictive) monetary policy when its prime rate is at the level of the real growth rate of the economy + 2 %. Therefore, in a normalized situation, the prime rate should be 4 % and not 0.13 % as is the case today.

20. When they will realize that the situation is changing, investors will want to protect themselves from these rate increases by selling their bonds. But to whom ?

21. Let's first recall that the debt level - and mechanically the amount of bonds issued - has exploded since 2008. The Bank for International Settlements (BIS) estimates that the debt for the 12 largest economies rose 50 % to USD 125 trillion at the end of 2014. The consultant McKinsey has calculated that on average, for the 47 countries they follow, the debt's increase is around 20 % of GDP over the same period.

22. And just when this was happening, there was also an important transformation regarding the holding of these bonds. In the US, the Citigroup analyst Stephen Antczak has found that US corporate bonds holdings - representing USD 3.7 trillion - are now concentrated in only three types of investors : bond funds, foreign investors and insurance companies.

23. If one can consider that insurance companies are not natural sellers, the situation is different for the other two.

24. Bond funds are forced to sell bonds when redemption' requests exceed subscriptions, in order to have the liquidity needed to make the repayments.

25. And if these redemption' requests reach significant amounts, to whom will bond funds be able to sell their securities to meet their commitments ?

26. This question is becoming essential, since most professionals are aware that liquidity in this sector has become very low. Royal Bank of Scotland estimates that it has fallen by 10 % over the past 12 months and 90 % since 2006. The BIS considers that in the US less than 5 % of bonds in the market are changing hands every month, against 20 % in 2007.

27. Martin Gilbert - who manages USD 112 billion in the Aberdeen Asset Management' bond fund - recently said that in such a situation things could quickly become ugly and therefore, in order to be prepared, he has set up a credit line of USD 500 million and he is keeping USD 1 billion in cash. However, one can notice that this represents only 1.22 % of its assets under management.

28. And this lack of liquidity in the bond market even leads Pascal Blanqué - CEO of Amundi, who manages EUR 950 billion - to request more government regulation to limit the damage. He notably stated that "banks are less risky but the risks have just been shifted elsewhere in the system".

29. Some argue that since this problem of lack of liquidity is now widely recognized, measures will be taken to limit its consequences. But in truth, not much can be done today.

30. Presently, central banks certainly do not want yields to move up and therefore they must consider, that this liquidity problem does indeed exist, but that they don’t have any other choice than wait and treat it if and when it occurs.

31. This is why, if reimbursement’ requests in bond funds become quite important, stress on yields will be considerable and therefore volatility will explode.

32. We then expect that managers will react by freezing redemptions in order to have time to organize sales in an orderly manner. And we consider that in this scenario the sole possible buyers will be hedge funds, which will obviously require substantially marked down prices.

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Bonds (33-37)

33. Finally, let us mention that in the last major phase of rising yields in 1994 - with for example, a rise from 5.5 % to 8 % on the 10-year US Treasury bond - foreign investors have also been forced to sell their US bonds, since the first that did it repatriated their capital thus triggering a downward move on the dollar.

34. In short, we have only one piece of advice for investors in traditional bond funds : if you're going to panic, be among the first to do so.

35. But other asset holders should not rejoice too much either. If the earthquake happens, equities will decline and afterwards other illiquid assets, such as real estate or art.

36. It is therefore likely that there will be a year in which both bonds and equities will drop.

37. However in order for this scenario to occur, faster growth is obviously essential. But it is rather the opposite which happened early this year.

Equities (38-47)

38. And indeed regarding equities, despite the strong behavior of the US stock market, concerns are mounting.

39. First, there is the fact that the last correction of more than 10 % at closing was in October 2011 and, as with an undefeated team on which the pressure increases at every subsequent game, it makes investors nervous.

40. Then, there is the fact that if the Dow Jones Industrial (the known one) set a new record on May 19th, the Dow Jones Transportation Average remains at about 10 % of its record of December 29th, 2014.

41. The worry is that historically if a record in one index is not confirmed by a record in the other, it is a very strong bearish signal. And the underlying logic is simple. If manufacturing is going really well, we also should see an increase in shipping and transportation in general. Of course, the opposite is also true.

42. Investors are worried, since they remember that in recent years, when a non-confirmation occurred, the consequences were major. The Dow Jones Industrial reached a record on August 25th, 1999, which was not confirmed by the transportation index and we know the result. In 2007, it was the opposite : a record for the transportation index not confirmed by the industrial one.

43. In short, the fact that the transportation index is down in 2015 - meaning it has almost returned to its level of one year ago - is a problem.

44. And then there is the length of women's skirts.

45. The Financial Times fashion columnist - Jo Ellison - recently asked : "The hem is plunging : will the market follow ?"

46. In her article, she refers to "the hem index", identified in 1926 by the economist George Taylor who noticed that in times of economic prosperity, skirt lengths shorten. And Jo Ellison mentions that in the last fashion shows from top designers, length has plunged all the way to the ankles. Thus, this could be the harbinger of some ghastly financial meltdown.

47. Of course, like every theory, this one has its supporters and detractors. In fact, there is probably a link between the length of skirts and the economic situation. When all is going well, the society is more open to others, willing to take more risks and skirts go up. On the opposite, during crises, people become inward looking and more cautious and skirts naturally come down.

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Equities (48-49)

48. What needs to be established is whether the current skirt's dive is the consequence of the fact that most people have not yet recovered their pre-2007 economic serenity, or if it reflects unconscious fears about future events.

49. But what could be these fears : a deflationary spiral linked to an imminent recession, or on the opposite an inflationary move that would lead to a rise of yields, thereby adversely affecting all assets ?

Commodities (50-54)

50. In any case, if we refer to gold, the answer would be : neither one, nor the other. Indeed, the yellow metal remains close to USD 1'200.-/ounce, i.e. the level reached in June 2013 after its fall of USD 600.-. Since it is the best leading indicator of price developments, this stability would indicate that the inflation level should not change much in coming months.

51. Thus, this would be good news for the bond market, which has become more nervous this year.

52. This nervousness is in particular due to the fact that the strongest deflationary pressures are behind us. Indeed, it is unlikely for example that energy prices could fall further in the same proportion as they did last year. Moreover, based on the trend of recent months, US inflation, excluding volatile components such as energy and food, could reach in 2015 the level of 2.5 %; which would be the largest increase since 2006.

53. Even Europe shows visible signs of recovery. The increase of the monetary indicator M3 is of 5.3 % in the last 12 months, i.e. the strongest growth in 6 years. And the evolution of the short-term monetary indicator M1 indicates an annualized growth based on the last 6 months of 12.6 %. These are figures that would previously have concerned the Bundesbank, but that the European Central Bank (ECB) deliberately ignores, since it wants to stimulate activity in the Eurozone at all costs.

54. It should finally be noted that regarding commodities the technical analysis is much better, with the CRB index behaving in a way that makes it possible that the current consolidation phase ends with a rise in the sector. This could likely lead to higher inflationary pressures towards the end of the year.

Currencies (55-57)

55. Currently, the majority of the players in this field continue to believe that the expected rise of US interest rates will trigger a second bull move of the dollar against the euro which would push the single currency below the parity level of 1 for 1 between the two currencies.

56. The difficulty is that the FED is aware of this risk as it sees every day the negative impact on US growth of the nearly 20 % rise of the dollar index in 2014. Therefore, if the dollar strengthens too much, US growth will need to be very strong in order for the central bank not to take into consideration this element when it will have to decide to raise or not interest rates.

57. One must also not forget the fact that the Eurozone continues to have a strong surplus in its balance of payments, while the US one remains heavily negative.

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Currencies (58-60)

58. And finally, contrary to what usually happens, for several months now rises in the stock markets have resulted in the dollar moving up and inversely.

59. This is how we got the surprising move up of the euro when the stock market fell because of the Greek crisis. Then, the single currency fell when stocks went up once an agreement between Greece and its creditors had become probable. And even the surprise of a Greek referendum only made the currency fall for a few hours.

60. All this means that it is currently difficult to position oneself aggressively in favor or against the greenback and the more so that, also in this sector, liquidity is much lower than it was before, which makes the market even more unstable.

Conclusion (61-68)

61. Mario Draghi – the president of the ECB - clearly indicated to investors that "we should get used to periods of higher volatility. At very low levels of interest rates, asset prices tend to show higher volatility".

62. And from this point of view, one must expect that bonds will behave more and more like equities, particularly for long maturities, as the leverage is quite high because of the current low level of interest rates.

63. Today, investors are reassured by the fact that growth is ideal for them - neither too weak, nor too strong - as it limits the scope of central bank' interventions. However when doubts regarding this scenario will appear, investors will suffer a lot.

64. But who will suffer first : investors in bonds or in equities ?

65. It is amazing that despite everything central banks have done for so long this question can still be asked.

66. For the moment - and as long as the US stock market continues to behave well - we consider that we must still favor equities, as we see no reason why the US economy should spontaneously move back into recession. But we are also aware that a number of indicators have turned red.

67. Obviously, and as we have often pointed out, as monetary policy is now in uncharted territory, all historical references are more suspicious than usual. But this does not mean that we can consider them as automatically void.

68. This is why we would be more reassured if skirt lengths could quickly be shortened again. And honni soit qui mal y pense.

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