Market Outlook

A monthly commentary by Gabriel V. Safdié
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WHO'S WRONG ?

Generalities (1-6)

1. For financial markets, February was a rather quiet month and even boring for traders.

2. Emerging markets had a respite with even a slight increase of the currencies of the most exposed countries, such as the Brazilian real or the Turkish lira. This was also reflected by a rise during the month of 3.4 % of the MSCI Emerging Stock Markets Index in USD.

3. Developed countries' stock markets also benefited regaining much or all of their January decline : S&P : +4.3 %, Nasdaq : +5 %, DAX : +4.1 %, Euro-Stoxx50 : +4.5 %. Only the Nikkei did not perform : -0.5 %.

4. In the forex area, in relation to the dollar, the euro is back to its level of the beginning of the year (1.38), while the yen remained unchanged (101.80).

5. Regarding commodities, for the third consecutive month, the CRB commodity index was up 6.8 %, with all its components increasing except heating oil and natural gas.

6. And at respectively 2.648 % and 1.624 % for the US and German 10-year government bond yield, the entire rise in yield which followed the start of tapering has been erased. The Fed must be pleased.

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Currencies (7-21)

7. During the last G20 meeting in Australia, member countries committed themselves to act in a coordinated manner in order to improve global growth. To achieve this goal, the communiqué pointed out : "we will take concrete actions across the G20, including to increase investment, lift employment and participation, enhance trade and promote competition, in addition to macroeconomic policies".

8. Of course, beyond these nice words, there was no substance in the declaration since in reality situations are quite different from one country to another. For example, Brazil is still struggling to keep inflation under control, while Japan is desperately trying to create some.

9. For developed countries this means that although monetary policies appears to be similar, in reality there are quite a lot of divergences in the goals that each one of them is trying to achieve.

10. In the United States, one can at the least acknowledge the fact that monetary policy has always been consistent. Indeed, in the last ten years, the US monetary base was multiplied by 5 from USD 740 billion to USD 3'700 billion; and it continues to grow.

11. This made possible the banks' recapitalization, the rise in the value of all assets and the revival of the economy.

12. The fear is that this policy of artificial low rates is leading to a misallocation of resources and that investments needed for future growth are simply not done in favor instead of speculative asset plays.

13. In addition, the end of this policy is not so simple. Any normalization attempt will create a downward pressure on assets which are valued on the basis of very low yields. Thus, exit can only take place with difficulty and slowly.

14. This context could be favorable to the emergence of a new dollar crisis. This idea goes against market's expectation which is rather looking for an increase of the greenback because of the relatively better economic growth of the country.

15. However, despite a favorable economic environment, it may be difficult for a bull dollar trend to appear. In 2013, the balance of payments deficit was USD 470 billion and this is expected to increase if growth improves.

16. This means that simply maintaining the value of the dollar is already a difficult exercise. Therefore in order for the currency to move up, conditions must be particularly attractive.

17. But this should not be the case in the near future. Of course, the dollar plays its safe haven status when a crisis appears in a developing country, but otherwise there is little reason to buy the currency : equity valuations are more attractive elsewhere and real returns on deposits and bonds are low or even nonexistent.

18. Also, it must be added the fact that the FED wants higher inflation. We have already mentioned their change of view; from the fight against inflation to its stabilization, the goal of the central bank is now to increase it. Certainly not by much - it would be satisfied to see it back to around 3 % per year - but the fact remains that it is an increase which is currently whished.

19. So, with the FED remaining very cautious in relation to any rise of its prime rate and since it is not very sensitive to the behavior of the dollar, any increase in inflation will further reduce the attractiveness of the dollar.

20. In conclusion, the paradox of the current situation is that an improvement in US economic growth could result simultaneously in a downward move of the US currency.

21. Unless the crisis appears in relation to the yen.

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Currencies (22-30)

22. For about a year now, the Bank of Japan (BoJ) started a policy of large bond purchases, similar to the FED's program, but in their case with a sole goal : to create inflation. Thus, in the last twelve months, the balance sheet of the central bank increased by 45 %.

23. However, the consequence of this policy has been very different in Japan compared to the US since it resulted in a significant decline of the yen : 25 % against the dollar and 50 % versus the euro. This allowed, for the time being, inflation to reappear : + 1.6 % over the last twelve months.

24. For some, this policy is pure suicide. Firstly, it does not solve the fundamental problems of the country, which are linked to a rigid economic system. One just needs to look at the collapse of the technological sector in comparison to a country such as South Korea.

25. But above all, it jeopardizes the equilibrium which enables the financing of a public debt that, at 220 % of GDP, is the world's largest. For many years, Japan had a surplus of its balance of payments of around 5 to 6 % of GDP. The surplus pushed the yen higher, requiring companies to repatriate their foreign currencies profits in order not to lose money on the exchange. And it is this surplus which allowed, and is still allowing, the financing of the debt.

26. However, the situation is changing in a negative way. First, the Fukushima accident led to the closing of the nuclear power plants and therefore to a massive increase in energy imports, thus reducing the balance of payments surplus to 2 %.

27. Then, the yen decline mechanically pushed up the cost of imports. It also increased the hope that exports will strongly rise. This is likely but it has not yet occurred as the trade balance deficit reached USD 27.4 billion in January. Let's mention that any significant improvement in exports will mainly be achieved to the detriment of Germany. From this point of view, Japan could export its deflation to Europe.

28. For Japan, the difficulty of the exercise is twofold. Firstly, it is not a sure thing that the policy will succeed - or more precisely, it is possible that the purchases done by the BoJ until now could be insufficient. Of course, inflation rose to 1.6 %, but this increase may not be sustainable. Furthermore, as speculative downward positions on the yen are quite large, not much may be needed to create a bullish counter-move in favor of the yen. This implies that the BoJ may have to inject much larger amounts than it forecasted until now, thereby increasing the stakes.

29. The second difficulty will come once the goal has been reached with inflation being well entrenched at 1.5 - 2 % per year. To achieve this result, negative real returns had to be created, even for longer maturities. Thus the current 0.586 % yield on the 10-year Japanese government bond.

30. With such a return the only possible buyer is the BoJ and the danger would come from the emergence of a self-feeding mechanism which could become a trap for the central bank. The question is how the BoJ, once it considers that the inflation level is appropriate, will be able to stop its purchases. Indeed, if the BoJ is no longer involved, bond yields could quickly and sharply move up in order for real returns to become positive once again. This could create financial problems and the sharp move may also push the country into recession. So, if the BoJ wants to avoid such a scenario, it would then be forced to continue its purchases, further increasing the money supply, thus leading to a new decline in the yen and therefore worsening inflation. As the mechanism becomes self-feeding, doomsayers consider that Japan will then be moving from deflation to hyperinflation.

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Currencies (31-41)

31. But perhaps the crisis will once again come from the Euro.

32. The danger here arises from the opposite direction with the possibility that a mistake of the European Central Bank (ECB) pushes the area into deflation. The risk arises from the fact that in the last 12 months its balance sheet shrank by 25 %.

33. The monetary policy of the ECB is currently more restrictive than of the other central banks. This is happening at a time when the euro crisis obliged the participant countries to have their balance of payments at least in equilibrium. And with some doing even better than this, the fact is that presently the balance of payments for the whole zone is showing a surplus of EUR 150 billion. So, while other major economies have a deficit, the positive number of the area means that, without intervention from the ECB, the path of least resistance for the single currency is up. This would further increase the deflationary risks for a large number of countries which have already difficulty competing today.

34. And the situation is even more complex since the ECB is a young institution with quite a strict chaperon - Germany. This can be illustrated by the decision of the German Constitutional Court (CC) in relation to the outright monetary transactions program (OMT) established by the ECB.

35. The CC has considered that this program : a) violates the German constitution; b) exceeds the ECB mandate; c) endangers the very principles of the aid programs to the troubled countries of the zone; d) represents a serious attack of democratic rules, as Germany could suffer losses because of the program and this without the German parliament having given its authorization. Finally, the CC considers that the program itself amounts to debt monetization, since the ECB, even if it does it on the secondary market, has to print money in order to buy sovereign debt and this is strictly prohibited by the monetary treaty.

36. In short, as one observer pointed out, except for a military putsch, it is hard to imagine another decision that could violate, all at once, so many constitutional principles than this OMT program. And all this for a program announced by the ECB but which has not be concretely implemented.

37. For the time being there were no consequences as markets are rather in a good mood lately. They have considered positively a move by the CC who, after all the findings mentioned above, decided to postpone its decision in order to ask the European Court of Justice (ECJ) if it shared its views.

38. Investors welcomed this announcement, as they believe that the ECJ will play ball with the ECB. This is not so certain, as courts are always quite cautious in matters related to their independence.

39. But, most importantly, based on the answers of the ECJ, the CC will then write its own judgment, with the risk of a constitutional crisis if the two courts reach conclusions too far apart.

40. Whereas before the CC had always answered "yes, but" regarding euro matters, in this case it clearly said no. The ECB cannot ignore the CC hostility and therefore its room for maneuver has become even narrower. It will therefore be very careful in its interventions and it is now hopping, as do the other central banks, that time will play in its favor and that, economic recovery helping, it will not have to take any controversial measures.

41. The danger of course is that the ECB acts too late and that consequently growth in the area is insufficient even just to stabilize the debt of many countries of the zone. Moreover - and paradoxically - the euro could also increase in value, before a new crisis puts an end to its rise.

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Currencies (42-46)

42. Incidentally, it should be mentioned that the poor economic situation of the zone has greatly increased the number of Eurosceptic citizens, as it will become obvious with the spring European elections, and therefore, far from increasing European integration – which is essential for the euro - a reverse process could even appear.

43. Finally, in the UK, the government's economic policy is also doubtful, as it consists, once again, in increasing household debt which is also reviving the real estate bubble. This situation means that it will be difficult to increase interest rates when it will be needed. And one should not forget that the deficit of the balance of payments has reached 7.5 % of GDP. Therefore, tumultuous sterling moves cannot be excluded.

44. In conclusion, it is clear that the deflation-inflation war also affects currencies and that every major currency carries, each in its own way, significant risks.

45. Of course, if growth improves everywhere, it is likely that the dangers mentioned above will not materialize.

46. But it is also possible that the market will eventually consider that a central bank is wrong and that its policy has failed. At that moment, its currency will suffer the consequences. And as fund managers are desperately looking for trends, the move could quickly get bigger as some will just follow what others are doing. It’s the classic herd instinct.

Bonds (47-51)

47. Our regular readers know of our concerns related to the fact that the 0 % interest rate policy has obliged investors to take excessive risks in this sector, accepting a remuneration which is too low from debtors of poor quality; and this at a time when most central banks are trying to reflate their economies by all possible means.

48. The move also coincides with the fact that after the events of 2008, investors want above all to avoid volatility. And it is the bond market which appears to them as this safe haven. It is a phenomenon that can be found even in the institutional area, where many pension funds have drastically reduced their equity investments. Thus their exposure to the sector is at an historical low level. In other words, the lower the returns on bonds, the larger the purchases.

49. And this bull move is going on at the same time where there has been a sharp reduction in liquidity in the fixed income market. For example, US banks have reduced their bond stock by 70 % since 2007. Consequently, volumes on the secondary market, despite the strong increase in public and private debt, have also declined by more than 2/3.

50. And this lack of liquidity has brought - identically to the subprime products linked to the real estate market - the creation of synthetic bond products, which allows an exposure to a particular sector of the fixed yield market without having to hold bonds. If this phenomenon were to amplify, when the next bear market will come, losses may be much larger than usual, as it happened with the real estate bubble burst.

51. Bonds continue to benefit from a level of growth which is neither too weak nor too strong. This allows monetary policy to remain lax while preventing debtors to suffer too much.

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Equities (52-58)

52. The corrective move of the beginning of the year created a cooling off period. However, the expected acceleration of US growth in the next months is not in jeopardy.

53. Regarding Japan, one should expect that the aggressive monetary policy will continue as it looks to boost its growth.

54. In Europe, the contraction phase is over and growth, even if still insufficient, should appear for the whole zone. In particular, it will be helped by an acceleration of consumption in Germany. It should also be mentioned that in Spain the main economic imbalances linked to the housing bubble have been corrected and, another good point, the country is once again competitive as evidenced by the 25 % increase of its exports.

55. However, we may be disappointed in relation to global growth, since the problems faced by emerging countries will take time to be solved.

56. The danger coming from emerging markets is that the decline of their equities and of their currencies could eventually bring a similar downtrend of the bonds issued by debtors of these countries. This would not be surprising, since the worsening of economic conditions also adversely affect the health of businesses. And it is likely that some companies took advantage in recent years of the euphoria of investors regarding bonds to indebt themselves perhaps in an excessive way on the basis of forecasts of earnings growth which may not materialize.

57. Where this event to occur, then it could also contaminate the junk bonds issued by debtors domiciled in developed countries and this could then impact western stock markets.

58. The conclusion is that in the absence of a significant worsening of the situation in emerging countries, the improvement - even so slow - of growth will remain a significant support to equities, particularly in a world which lacks investment alternatives.

Commodities (59-62)

59. The gold rise (+10.4 % since the beginning of the year) is encouraging and it could be linked to important purchases from China.

60. This would not be really surprising given the current state of the major world currencies.

61. In a broader way, the rise of commodities in the last three months is a positive signal, particularly as it is happening in spite of the problems of some emerging countries. In particular, the 200 days moving average has been broken to the upside which is good from a technical point of view.

62. However, it is too early to declare victory, even if omens have become favorable. And the trend could also indicate that China is being able to reduce the excesses in the credit sector, while maintaining growth at 7.5 %, which is needed to stabilize the labor market.

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Conclusion (63-66)

63. In the late 1990s, investors in US equities were reassured by what they called the "goldilocks" effect, where the US economy grew neither too fast, nor too slow. This situation was quite favorable to higher corporate profits and was the reason justifying paying higher and higher multiples for equities.

64. This "goldilocks" effect can now be found at the bond level, with this global economic growth which is neither too warm, nor too cold, thus allowing the current low yields. Therefore, it will be the exit of this equilibrium which will create trouble for bonds, as was the case for equities in 2000.

65. And once volatility appears in the fixed income area, it will mechanically spread elsewhere, starting with currencies since we are in uncharted waters in relation to monetary policy.

66. For the time being, we continue to believe that exit will be upwards i.e. by an acceleration of growth. This is why we continue to advise that risk exposure should be primarily taken through equities; but always with a safety margin because of the fragility of the current situation.

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