Market Outlook

A monthly commentary by Gabriel V. Safdié
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FASTEN YOUR SEAT BELT

Generalities (1-8)

1. Volatility which appeared in the bond market in May increased in June. This can be illustrated by the fact that the 10-year US government bond yield, which was at 2.13 % at the beginning of the month, moved down to 2 % on June 6th, before strongly increasing to 2.61 % on June 25th, to end the month at 2.49 %.

2. The yields on the equivalent bonds of other developed countries suffered similar fluctuations, and for example the German one ended the month at 1.73 %.

3. Unsurprisingly, risk premiums on investment grade 5-year US bonds moved from their historic low of 60bp on May 8th, to 77.5bp at the end of June. But one should note that it is still below the beginning of the year level of 94.6bp.

4. The Bloomberg Global Investment Grade Corporate Bond Index climbed from its lowest of 2.18 % on May 2nd, to 2.83 % at the end of June, i.e. at a higher level than at the end of the year (2.35 %), but still below the level of 3.02 % of 12 months ago.

5. The rise was sharper for the Bloomberg Global High Yield Corporate Bond Index, since its yield increased from 4.6 % on May 9th to 6.6 % at the end of the month; but here also we remain 0.5 % below the level at the end of June 2012.

6. In any case, this volatility, which has been attributed to the phasing out of the FED's purchases of fixed income assets, affected less US stock market (S&P and Nasdaq -1.5 %) than the other developed markets (DAX -4.7 %; Euro Stoxx50 -6.03 %).

7. Regarding the new fall of emerging countries equities, with a decline of their MSCI index expressed in USD of 6.5 % in June, it has helped to totally erase all of the 12 past months gains.

8. Regarding the foreign exchange, currencies of emerging countries were under pressure with, for example, a decline in the Brazilian real, which has now reached 8.8 % since the beginning of the year.

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Generalities (9-10)

9. Among the major currencies, the correction that we anticipated on the yen finally appeared with an increase of 8.6 % of the Japanese currency to 94.30 from its 103.20 lowest on May 17th, against the US dollar. The Japanese currency ended the month at 99.10, while the US dollar was unchanged against the euro at 1.3010.

10. Finally, if globally commodities have not significantly dropped (CRB Index -2.2 %) thanks to an increase in agricultural products and oil, the most worrying element is that industrial metals (copper, nickel, aluminium) were again down around 7 % for the month.

Bonds (11-20)

11. In late April, Apple has launched the biggest bonds' sale in history by issuing bonds with different maturities for a total of USD 17 billion and demand was such that it could have borrowed USD 52 billion. Will this be the symbol of the peak of the bond bull market which started around 30 years ago ? Bill Gross - the best bond manager in the world - seems to think so, as he declared on May 16th, that the bull market was over.

12. In any case, the buyers of the Apple bonds are suffering, since the one maturing in 10 years fell by 7.3 % and in 30 years by 10.9 %.

13. Regarding the evolution for the next months, it will depend in particular on the investors' attitude who have massively bought bond funds in the last 3 years. If the reimbursement requests are important, then the rise in yields could reach surprisingly high levels, since the managers of these funds will have to sell in a highly illiquid market.

14. We have often mentioned this liquidity problem and the more we look at it, the more this situation seems dangerous to us.

15. James Grant - one of the best specialists in this field - has recently questioned one of the managers of the Loomis Sayles Bond Fund with assets of USD 22 billion. And he told him : "It used to be you could buy USD 500 million in 30-year US Treasuries without moving the market. Now it's USD 50 million".

16. And if this is the situation in what is the most liquid bond market, one can imagine what is happening elsewhere.

17. And James Grant gives another interesting information. In 1981 - the starting date of the great bond bull market - the US government debt held by the public amounted to USD 789.4 billion, i.e. 25.8 % of GDP, with a 9.2 % weighted interest rate. Today, this amount has increased to USD 12.4 trillion, i.e. 76.6 % of GDP, with a 1.9 % weighted interest rate.

18. If investors decide at a certain point to massively sell bonds, the outstanding amount in circulation is such that the FED will have difficulties to gradually deflate the balloon as it wishes.

19. However, the risk of this happening now is only moderate and in particular for reasons that we explain in the equity portion. But our regular readers know, as we only hold short term investment grade bonds, that we are not really directly involved. Therefore we can be mistaken, as indeed it has been the case with the upward trend in 2012.

20. Then, we had refused to participate, since for us investing in bonds at current yields was equivalent of "picking up pennies in front of a steamroller." No doubt that some investors, as was the case in 1998-99 for equities, will be able to sell at the right moment, but for the majority…

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Bonds (21-26)

21. David Rosenberg - chief economist at Gluskin Sheff - published in the Financial Times an interesting column and we agree with his comments. It was entitled "The FED has turned bonds and equities upside down." In it he observes that the FED's policy of quantitative easing (QE) has pushed investors to buy defensive stocks for the dividends they pay (around 3.5 % currently) and high-yield bonds for the capital gain they could provide if the spread to government bonds (currently around 4 %) diminishes. And his conclusion was : “equities for income and bonds for capital gains. How fascinating”. Indeed.

22. But if we do not know at what speed a bond bear market could occur, our conviction is that it is time to "fasten your seat belt"; the last 2 months’ volatility is only the appetizer of something much bigger.

23. Indeed, as we already mentioned, volatility which was originally in the foreign exchange market and then moved to equities in 2000 - with its peak in 2008 - is now in the bond market.

24. The Merrill Lynch Move index - which measures volatility in the bond market - has moved since its inception in 1988 in a "normal" fluctuation band between 80 and 100. And this measure was at 60 in March of this year, its lowest level ever. With past 2 months events, the index has risen to 100.

25. We believe that this index is now fundamentally in an upward trend and that it should, during this decade, far exceed the 264 peak reached on 10.10.2008 after the collapse of Lehman.

26. One should remember that volatility is linked to quick up and down moves, which confuses investors. But a steady move in one direction or another, because of its predictability, brings volatility down, as was the case in 2012.

Equities (27-32)

27. This reminder is important, because in June we had the impression of being on two different planets at the same time.

28. In the US, investors are becoming more optimistic regarding the US economy, which appears to have entered a virtuous circle. This can be illustrated by the fact that the FED has raised its growth forecast for 2014 to 3-3.5 % and that it now expects to complete its asset purchases by mid-2014.

29. And it is this new situation that should explain the turbulence experienced in June.

30. For the time being, we consider that it is rather an excuse to justify a correction in the US. But this motive seems to us quite weak to explain the sharp decline which occurred elsewhere.

31. The real question is elsewhere and it is at the heart of the QE policy itself. Through this policy, the FED manipulated interest rates to push them down artificially. Initially it had little success, because if the FED was able to bring down Treasury bond yields, this decline in yields was not transmitted to other types of bonds.

32. The FED then had to increase its program, notably by purchasing mortgage-linked bonds, which allowed for a sharp drop in mortgage rates. This helped stop the dangerous downward spiral that had appeared in the real estate sector.

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Equities (34-47)

33. The risk at that time was that the decline in real estate would have continued, therefore increasing the number of properties whose market value became less than the amount of the mortgage. If this had happened, the owners could then simply hand the keys of their property to the lender without any other commitment, as they have the right. Thus there would have been an increase in the number of properties in default and this additional stock would have exerted further downward pressure on prices.

34. From this point of view, QE was a success. But on the contrary, it was not able to increase the credit in the financial system, since either the banks refused to lend, or potential debtors did not want to borrow.

35. Therefore, there was a very rare decoupling between money that central banks inject into the system and credit that commercial banks create by using the money made available by the central banks. The increase in liquidity in the financial system has not led to a credit expansion, which is reflected by the very low level of velocity of money.

36. This was a surprise and explains not only why US growth has been so modest so far, but also why the QE policy had no inflationary effects.

37. But, as confidence is increasing, will there be a rise in the demand for credit ?

38. If this should be the case, the stock market would face two conflicting pressures : on the one hand, a stronger growth favorable to equities and on the other, a bigger interest rates rise. In such a scenario, the stock market can handle without too many problems a slow increase of rates, but not a fast move.

39. Furthermore, a too fast rise could jeopardize growth itself; growth that itself justifies the higher yields.

40. As we see, the situation is complex. And this more so, that outside US, the economic situation is not fantastic.

41. And it is here where we have the impression of living in two different planets : throughout the month the media focused on the good American news, while at the same time our concerns continue to increase regarding the rest of the world.

42. As a reminder, it was already these concerns which made us reduce our equity allocation by a quarter in April. And as we also wrote previously "our exposure (to equities) is increasingly dependent on the good behavior of the US stock market."

43. And indeed, it is thanks to the relative good behavior on the US stock market that we decided not to reduce further the risk in June. Furthermore, this is a position of moderate size. But this wait-and-see attitude is also due to the real possibility that investors increase their positions in this sector to the detriment of bonds.

44. But it is not without danger. The CSI 300 Index of the Shanghai stock exchange moved up by 33 % between December 2012 and February 2013. But it has now returned to its starting point, thus erasing all the rise; which is never a good sign.

45. As we mentioned above, there is a direct link between growth and credit. When credit contracts, growth is reduced. Presently this is happening in China, which makes its economy vulnerable. And all the more so that excesses were committed in recent years.

46. Charlene Chu - China's analyst for Fitch Ratings (and who is based in the US) - recently reported that the total amount of loans from banks and other financial institutions reached 198 % of GDP last year, against 125 % 4 years ago.

47. And to quote her : "You just don't see that magnitude of increase in the ratio of credit to GDP. It's usually one of the most reliable predictors of a financial crisis".

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Equities (48-54)

48. And according to her, now that this credit expansion phase is behind us, the economy is inevitably slowing, putting more pressure on borrowers who, in increasing numbers, become unable even to simply pay the interest on their debts.

49. In such a scenario, we are going straight into a banking crisis that will force, at the end, the Chinese government to recapitalize its banks. And it can afford it, unlike European countries, for example.

50. But until then, growth could become more and more mediocre, with all the collateral effects that this would generate.

51. However, one should notice that this is not a shared opinion by everyone. China's analyst for S&P (who is based in Beijing) considers that banks are in a better position than what people believe to tackle non-performing loans. In addition, as far as credit was mainly financed by domestic savings, he therefore considers that there is no risk of a liquidity shortage. And this is the element which triggers banking crises.

52. It is quite surprising that the analysts of two of the largest rating agencies reach such conflicting conclusions. It is as if one believes that the debtor deserves a AAA whereas the other will consider it to be risky with a rating below BBB !

53. This illustrates the difficulty in understanding what is happening in China.

54. China which is, by the way, just one piece of a more and more complex puzzle and which explains our cautious attitude.

Commodities (55-59)

55. Attitude confirmed by the commodities sector in which the strong wind of deflation is blowing.

56. We mentioned last month that if the decline in this sector could be explained so far by an increase in supply, any new weakness would be worrying, since it would be incompatible with a good level of global economic growth.

57. It is therefore essential that current levels hold. Copper is down 25 % from its level of the beginning of 2012 and more than 35 % from its record high achieved in February 2011. Thus, this month's decline is not reassuring.

58. In addition, the new decline of gold, -11 % in June, is another negative signal. As a matter of fact, gold is the thermometer of monetary policy at the world level and therefore its fall indicates that monetary policy is becoming more restrictive. This seems to us to be quite premature and dangerous, given the fragility of the global economy.

59. In conclusion, as soon as one leave the US shore, one witnesses a deterioration of the situation rather than the opposite.

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Currencies (60-66)

60. The deterioration of the situation can also be seen in the foreign exchange market, with the fall of the currencies of emerging countries, as well as of the commodity producing countries The move accelerated in June and, for example, the Australian dollar is now down 15 % from its peak against the US dollar.

61. The Australian dollar moved up significantly since the crisis, as it is one of the few currencies to still offer an interest rate, currently for example 2.8 % at 1 year. But if the economic situation deteriorates and the central bank is led to lower its rates, there is still plenty of space for the downward trend to continue. The fall could reach up to 45 % if the parity were to return to its 2008 level.

62. The most surprising element is that the decline is happening both against the USD and the euro. We do not remember another phase of a rising dollar which did not lead to a drop of the European currencies. It is still too early to draw a conclusion, but who would have thought 12 months ago that the euro would become a safe haven ?

63. Once again, we have another proof that economics is not an exact science and that in finance what was impossible yesterday is today's reality.

64. The yen is therefore up and we are not surprised. In the same way that the US QE has not led to a significant decline in the dollar, the Japanese QE as such, cannot lead to a significant drop in the yen.

65. For this to happen there is the need of strong actions from the Bank of Japan directly in this sector because presently, without such a powerful incentive, there is no economic reason for a Japanese investor, even if it has more cash available, to sell his currency. Why should he be attracted to exchange yens, which pay no interest, for US dollars or euros, whose interest rates are also at 0 % ? And if the goal is to invest in stocks, isn't his own market at least as attractive as the other ones ?

66. Furthermore, it is likely that authorities are satisfied with the current level of around 100 against USD and they have no reason to push it lower. On the other hand, they should quickly intervene if the yen moves dangerously close to 90.

Conclusion (70-71)

67. Thus, the investor is in a difficult situation. In the US it is spring and the market now expects a warmer and warmer summer, but for the rest of the world it is fall and the market is worrying more and more that winter will be harsh.

68. In this scenario, we remain invested in equities in a moderate way. But it is an unstable equilibrium reflecting the difficulty in establishing whether our portfolio should be dressed for summer or winter.

69. Regarding bonds, Bill Gross declared that he is buying 7 to 10-year US treasury bonds. Indeed, he believes that as there will be no increase in interest rates in 2014, the market will calm down and he even considers that the 10-year yield will end the year below 2 %.

70. Considering what is happening outside the United States, we are quite inclined to agree with him. However, an acceleration in the demand for credit in the US would change the situation.

71. Anyway, volatility has now arrived in the fixed income area and it will be with us, with more or less long pauses, until the end of the decade.

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