Market Outlook

A monthly commentary by Gabriel V. Safdié
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THE DECISION MAKER

Generalities (1-6)

1. If during most of the month the deterioration of the political situation did not have a negative impact, the accumulation of bad news finally led in the last week to a stock market sell-off, in particular in Europe were the Dax was down 4.3 % and the Euro-Stoxx50 3.5 %. In the US the S&P dropped 1.5 % and the Nasdaq 0.9 %.

2. However the Nikkei at +3 % and the EEM index of emerging countries at +1.4 % behaved better.

3. The currency market was fairly quiet, with a dollar rise against the euro from 1.3690 to 1.3390 and more modestly against the yen at 102.80.

4. The CRB commodity index fell 4.5 % under the influence of agricultural products (-21.6 % for cotton !) and more surprisingly taking into consideration recent events, the energy sector (-13.9 % for natural gas and -6.8 % for oil).

5. The bond market was also quite sensitive to geopolitical events with each bad news pushing yields down, to 1.12 % for example for the 10-year German sovereign bond before ending the month at 1.15 %. Its US equivalent behaved in the same way until good US economy statistics at the end of the month pushed the yield back up almost to its starting point at 2.56 %.

6. On the opposite, the high yield bonds sector suffered from profit taking, with its worst performance in the last twelve months. Thus the yield of the Bloomberg USD High Yield Index moved up from 5.09 % to 5.73 %. Could this increase be one of the first visible sign of our expected US growth acceleration ?

IN THIS ISSUE

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Bonds (7-16)

7. It is too early to answer this question, as one single month of yield's increase is insufficient to signal a trend change. And it could be just profit taking, following the declaration of the FED's President Janet Yellen indicating that the yield on this type of debtors appeared to be too stretched.

8. But it is also possible that this market is "sniffing the end of easy money policy" and that the FED's strategy could be close to a turning point.

9. Moreover, no professional ignores the existence of a serious liquidity problem in this sector. Indeed, while on the one hand we had a boom of new issues in recent years, on the other major banks have reduced their inventory by three quarters in comparison to 2007. This means that their ability to buy bonds during downturns is strongly diminished. This is an important issue because historically they were those who provided support to bonds in times of crisis.

10. In order to understand the importance of this phenomenon, it is interesting to mention a study that James Grant, one of the best bond analysts, made on the portfolio of the US Templeton Global Bond Fund, which is one of the stars of the industry. At the end of May the fund had USD 72 billion in assets and his study clearly shows the difficulties that the fund will have to sell positions if faced with significant reimbursement requests.

11. Two examples : the fund holds 7.5 % of its portfolio in Hungarian securities and it will take 79 days of trading to sell them if the fund wishes to represent only 15 % of the daily volume, in order not to put too much pressure on the price. And even at 50 % of the volume, 24 trading days would still be necessary. Regarding its exposure to Malaysia, it represents 7.1 % of the portfolio and respectively 40 and 12 trading days would be necessary to dispose of it.

12. Another problem is that on some specific bonds the fund is by far the largest holder. Example : the fund is the owner of 31.8 % of the USD 2.3 billion 5 % Ireland October 2020, while the next holder has only 1.6 % of it. Regarding the USD 1 billion bond of 6.375 % Hungary March 2021, the fund is the owner of 62.35 % and the second is only at 2.3 %.

13. And it should also be mentioned that these figures reflect only bonds held in one of the group's funds. Temgini for example, which is the European equivalent of the American fund, also has exactly the same type of bonds in its USD 38.6 billion portfolio.

14. In a way, bond funds have the same problem as banks : they "borrow" short-term and "lend" long-term.

15. In relation to banks this situation led in times of stress during the first half of the twentieth century to bank runs when suddenly all depositors of a bank queued to immediately withdraw their savings; savings which had been lent for a more or less distant maturity. This led to the collapse of that institution, with all the collateral damage to the others. And it was to end such bank runs that governments have put in place mechanisms to guarantee bank deposits up to a certain amount.

16. Currently, the whole bond sector is at the mercy of such an event. Just in the US investors have increased their bond fund exposure by over USD 1 trillion since 2009. And investors may at any time request the redemption of their holdings while, as we have seen, the ability of the funds to sell bonds in order to create the necessary liquidity for reimbursements is limited.

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Bonds (17-27)

17. Thus, if stress where to appear in this sector with yields that begin to surprise on the upside - similarly to the way they have been surprising on the downside until now - and rumors start to fly on a particular bond fund, this latter could then receive massive reimbursement claims, forcing it to dump bonds in the market. This would then accelerate the yields' rise and by contagion suffering would spread to other funds; which could then lead to much more widespread reimbursement claims.

18. And then we'll see if bond yields will rise three times faster than what it took them to move down, which is a characteristic of equity bear markets as shares fall three times quicker than it took them to rise.

19. This scenario is not so farfetched. Newspapers recently reported that the FED is studying the possibility of introducing exit fees to investors wishing to redeem their bond fund holdings in order to prevent a panic that would shake the US bond market, which represents USD 10 trillion.

20. Nothing was decided but the fact that the FED is concerned is a positive sign that the problem is been taken seriously. But this also means that investors should expect in case of stress that their reimbursement requests, as it happened with hedge funds in 2008, will be denied by many bond funds.

21. And should this happen one can expect trouble around new issues, in particular for debtors that will need at that moment to issue a new bond to replace an expiring one. If they were unable to do so at a reasonable price it could lead to a payment default on all loans of this debtor, even though its economic activity continues normally.

22. If this danger exists, it is also important to mention that the above described mechanism could appear tomorrow or in 10 years. Fortunately, it is not because there is a risk that it will necessarily materialize.

23. Currently, not only there is no stress on interest rates but we are also not advising to be positioned to benefit from higher levels because most probably if stress were to become significant, the FED will be strongly encouraged to resume its bond purchases, at the risk of losing control of the money supply. From this point of view, one can imagine that yields do an inverted V : going up quickly and then moving back down thanks to the FED; in a way this would be an inverted mirror of what happened during the 2008 crisis for equities.

24. Thus, at current yields, our strategy is to be neither long nor short long term bonds with the liquidity problem being an additional element justifying this position.

25. In any case, investors in these funds should remember this Wall Street saying : "If you're going to panic, panic early".

26. Anyway, it is here that lies the main danger for financial markets, as interest rate adjustments could be brutal if the economic situation suddenly changed, challenging investors' expectations.

27. The bond market has therefore become The Decision Maker. It is the evolution of interest rates that will be in the coming months the main factor influencing the entire financial sector and all types of assets, including equities.

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Equities (28-35)

28. Besides this potential rise in rates, the other main negative risk would be that the current geopolitical degradation impacts the economy to the point of bringing a new recession. Unfortunately, there is not much that investors can do to protect themselves in advance, considering the very unpredictability of such events. We can only follow them and try to establish which one might have dangerous long-term consequences for the world economy.

29. Anyway, if this were to occur, then equities would fall heavily and non-governmental bond yields will move up, since the companies' ability to honor their debts would be reduced.

30. Aside these risks, for the time being, nothing appears on the horizon that could spontaneously lead to a recession in the United States. Instead, it is acceleration in growth that should now be expected.

31. Indeed, psychologically the traumatic events of the great recession of 2008 have finally been overcome in America.

32. The reason why the US recovery has been the slowest of the postwar is linked to the fact that normally business capital spending increases at the end of a recession. But so far in this cycle, they have continued to decline due to the trauma linked to the crisis as well as to the uncertainty around the sustainability of the recovery. It is also important to mention that such an event had never happened before.

33. But today it seems increasingly clear that this phenomenon is in the process of reversing and that investment spending is finally beginning to increase, thus resulting in a clear increase in the demand for credit Thus, at the end of the first semester, all US banks noticed aclear improvement in sentiment compared to the beginning of the year. The bank JP Morgan Chase believes for example that all they have recently seen give them reasons to be optimistic that the trend towards an increase in loans should continue. In support of this opinion it mentions that there is generally a better feeling, a better use of production capacities and an improved outlook. And the bank to conclude : "The phones are ringing. It's across geographies".

34. What the bank is saying is very important for the future. To have an idea of the size of the decline in credit demand, it should simply be mentioned that the ratio between loans and deposits is at its lowest level since the 1974 recession. With the return of confidence among both individuals and companies the future becomes a source of hope - and not of fear as until now - and this will lead to more long-term commitments. Credit demand should thus rise and this demand could even be quite large as rates are very low and this at a time when credit supply has rarely been so abundant.

35. From our point of view, a positive loop is starting which will allow the US economy - and with it the world economy - to find a better level of growth. And we are encouraged by a recent cover of the magazine The Economist which shows a jockey in American colors riding a turtle. The image is to illustrate the fact that the publication considers that the potential US growth is only half of what it was two decades ago. This is good news, since it is usually when a theme makes the cover of a magazine that the inversion of the trend is not so far away.

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Equities (36-45)

36. In conclusion, one should expect that this growth acceleration will bring higher profits, thus maintaining alive the equity bull market.

37. One must note that this expectation is at the opposite of what can presently be read in the press, which is constantly warning its readers that equities are expensive, or even in speculative bubble, and that consequently an imminent decrease is to be feared.

38. Their main argument comes from a ratio used by Professor Schiller to establish how expensive the market is. This is the median price divided by the average of earnings over the last ten years for the largest US capitalizations. This P/E currently stands at 27 against a historical average of 16 since the late nineteenth century. During the bubble in the late 1990's it was over 44.

39. As with magazine covers, it is usually when an index or a number captures the popular imagination that it ceases to be useful.

40. Schiller's P/E worked very well at the end of the twentieth century, but one must now remember that the first decade of the twenty-first century was unusual compared to the past, with two significant recessions, as well as the largest financial crisis since 1929. Therefore one needs to have a fairly pessimistic view of the future to expect that events of a similar magnitude will quickly happen again.

41. If this should be the case, then indeed equities will fall. But if one considers that economically there is nothing in the horizon that could justify a recession before the end of the decade, it would then be enough that profits remain at current levels for the Schiller P/E to mechanically return to its historical average in 2020.

42. Besides, does someone find that the economy is currently so exuberant that there is no more room for growth and thus for an increase in sales by companies ?

43. All this does not mean that equities cannot fall at one time or another since stock market corrections are inevitable and correspond to their normal breathing. But a bear market would be surprising.

44. Finally, one must also consider the fact that, beyond the absolute valuation of a company, it is the more or less deserved hope of profit growth which is an important element for investors. As long as this hope exits, the risks of a significant decline are relatively weak.

45. Thus we continue to believe that risk-taking should mainly continue to be taken in this area.

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Currencies (46-50)

46. The generalized zero interest rate policy explains why for a long time we have been unable to suggest an investment theme in this sector. Certainly currencies are fluctuating but they are doing so in a rather unpredictable way on the basis of short-term positions, while long-term investments - which are those who provide substance to a trend - are much rarer since, as we have already pointed out, each major currency is sick in its own way and without one appearing to be less sick than the other.

47. Presently the dollar versus the euro is back at the 1.35 level following the closing of short-term positions favorable to the single currency after the interventions and comments from the ECB. The market positioning is currently relatively neutral.

48. For the future, indeed higher rates will come first in America but because of the structural deficit of the US balance of trade, the differential with the euro will have to reach a certain level before the deficit hurdle can be overcome and therefore allowing the dollar to move up. On the opposite, the current balance of payments surplus of the Eurozone would normally be favorable to an increase of the single currency, but this is the last thing that the area needs today.

49. Thus, at current rates, there is no reason to favor one currency more than the other.

50. Regarding the yen, it should be noted that significant positions against the Japanese currency still exists - and this for over one year - from speculators who are expecting that the Japanese monetary policy will continue to favor a depreciation of the currency. The problem is that the yen at its current level is already undervalued by over 20 % if one applies the purchasing power parity criteria. Therefore also here there is nothing to do, one way or another, for an investor looking for strategic positions.

Commodities (51-55)

51. A few months ago, we indicated that following a 10 % decline during the first quarter of this year the price of copper had reached a dangerous level from a technical point of view and that if the move were to continue it would be a negative signal regarding future prospects for global growth.

52. Fortunately, the metal has recovered quite nicely since then moving up from the USD 6'400 per tone level reached in March to USD 7'125 today.

53. The main reason for this reversal has come from a reduction in the concerns regarding the future of the Chinese economy. The sharp slowdown feared by some does not seem to be happening and therefore speculative positions against the red metal have greatly diminished.

54. However, it is also unlikely that this bull move can gain momentum since for the time being Chinese demand will not return to its previous level; moreover, an increase of the offer of copper is in sight and finally there is still much uncertainty around some trade finance loans in China which have been set-up with copper as collateral.

55. But in the end all this is positive for the global economy since it is too low or too high commodity prices which are problematic. Ideally it would be desirable that, for most of these products, prices continue to fluctuate around current levels, since there are high enough to remunerate producers, while being low enough not to slow down consumers.

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Conclusion (56-63)

56. The most interesting debate in the financial community revolves around determining how long US interest rates will remain at such low levels, with some even wondering if they could follow the example of Japan, where the 10-year sovereign bond's yield is below 2 % for over 15 years.

57. For the moment, it should simply be mentioned that unlike the Japanese monetary policy which for a long time was restrictive, the US one has been quite lax from the beginning of the recession. It would therefore be surprising that a Japanese-style scenario occurs and therefore the likelihood of potential gains linked to a yield fall under the 2 % level is low. Moreover, even if it were to happen, the profit would still be insufficient compared to the present existing risks. And equities offer better prospects in such a scenario.

58. But one should not be mistaken: the bond market has become The Decision Maker. For example, Goldman Sachs has just reduced its exposure to equities, considering that the market will temporarily suffer in the coming months because they expect a rise in government bond yields.

59. And it is this danger which explains why equity exposure should be at a level where investors can withstand corrections.

60. But as long as the increase does not occur, there are little economic reasons that could justify a spontaneous correction in equities. It could be the opposite even, since the longer yields take to rise, the higher the pressure on investors to invest funds held in short-term deposits, yielding nothing and which have been rapidly increasing.

61. Moreover, this pressure can even become stronger if the earnings prospects of companies have to be adjusted upwards thanks to the acceleration in growth.

62. For the time being, we do not want to anticipate an eventual rate hike to justify reducing equities. We will review our exposure to this sector when The Decision Maker will clearly indicate an uptrend. And this seems to us all the more important since the stock market should be able to withstand a gradual increase in rate if it is concomitant with higher economic growth.

63. In conclusion, if politics does not spoil the party and as long as yields behave, it should be rather good news that will come from developed economies.

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