Market Outlook

A monthly commentary by Gabriel V. Safdié
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L'ILLUSION DE LIQUIDITÉ

Generalities (1-6)

1. As was the case with the boreal summer, September and October were fairly quiet, except for a few scattered storms.

2. Indeed, the world economy remains at an insufficient growth level despite the massive support of central banks. This maintains the yield of the German and Japanese 10-year sovereign bond at the microscopic level of respectively 0.16 % and -0.05 %. And if the US equivalent yield rose to 1.83 %, we are still far from the 2.25 % level of the beginning of the year.

3. As for the yield of the Bloomberg High Yield Corporate Bond, which had reached a 10 % level in mid-February, at 6 % presently it has returned to its level of 12 months ago. Clearly, the market is not worried anymore by the prospect of US interest rises. As for Bloomberg USD Emerging Sovereign Bond, it has stabilized since June between 4.20 and 4.40 %. Regarding currencies, the near certainty of a rise in US interest rates in December sent the euro against dollar down to 1.0980. And for the time being the amplitude in 2016 between the low of the year at 1.0750 in January and the high at 1.1500 in May is one of the smallest historically. As for the dollar/yen, after flirting with the level of 100 in September, it has returned to 104.85. But it remains far from the level of 120 of the beginning of the year.

5. In relation to commodities, the CRB Commodity Index has been digesting in the last four months its first semester's rise by moving within a range of 180 and 190.

6. Finally, US equities have been stagnating in the last weeks thus allowing other markets to catch up totally or partially in relation to their year to date performance.

IN THIS ISSUE

P 1	Generalities
P 2	Currencies (7-21)
P 3	Currencies (22-24) Bonds and equities (25-31)
P 4	Bonds and equities (32-40) Currencies
P 5	Conclusion

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Currencies (7-21)

7. This sector - which has been quiet for months - suffered last month the equivalent of a summer storm thanks to the pound sterling.

8. Indeed, on October 7th - in 2 minutes - the British currency plunged 6.1 % against the US dollar.

9. Of course, the decline occurred early in the Asian day, when the foreign exchange activity is at is slowest; however, this is not enough to explain its magnitude. Little by little investors are learning what has happened.

10. One of the recent novelties in the financial sector is that algorithms have been programmed to search the internet for rumors and/or news and then based on their findings to automatically launch purchase and selling orders.

11. And at 7:04 AM Hong Kong time (midnight and four minutes in the UK), while the GBP/USD was at 1.26, an algorithm issued, without human intervention, large sell orders on the British currency after it found a negative comment made by President Francois Hollande a few hours earlier in relation to Brexit. However these transactions were done without considering the market's ability to absorb them.

12. Once the decline began, another algorithm followed the move with an important transaction in the options market, thus accelerating the fall.

13. Then - just like an avalanche which gains speed - the fall accelerated as stop loss orders were automatically triggered.

14. And once the level of 1.20 was breached, a new flood of sell orders descended upon the British currency, this time to cover options that had been previously issued.

15. Thus, with ultimately very little human intervention, at 7:06 AM, the pound had reached its lowest at 1.1840.

16. Eight minutes later, the exchange rate returned to 1.24, where it remained until the end of the day. Thus, the decline for the day was only of 1.6 %.

17. So far, two algorithm programs called Cowpox and Triple have been blamed for the fall. But there is more to it.

18. The reality is that staff reductions, scandals around price manipulation, stricter regulations, have all contributed to a reduction of the quantity of traditional liquidity available. And the consequence is that Bank of America has estimated that transactions on the currency market have 60 % more influence on prices than just two years ago.

19. On the opposite, algorithms and high frequency trading have more than tripled their volumes over the past three years. And it is their actions which creates the illusion of liquidity.

20. Indeed, when everything is going well one can have the impression that there are many buyers and sellers; but as soon as the wind picks up and the weather becomes stormier, the ability to buy or sell for real participants is greatly diminished as all these new automated participants either withdraw from the market or contribute to increase the stress in the system.

21. Therefore, the pound's crash is not an aberration, but rather the second warning (after the flash crash of the US stock market on May 6th, 2010) that the nature of financial markets has changed and that they have become more unstable during tough periods.

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Currencies (22-24)

22. In recent years, the quantitative easing policy of central banks, coupled with low growth, led to a sharp reduction in market volatility. But once these benign circumstances come to an end markets will be more nervous. Thus, one can fear that such episodes will then occur more frequently and more violently, as is currently the case in the real world where global warming leads to more dangerous hurricanes.

23. And if such episodes were to occur on a regular basis, they could shake the trust that investors have in financial markets. Thus, it would be quite appropriate to properly regulate the trading activity of these new technologies. Unfortunately, it seems that as long as there haven't been significant damages, regulators will not be willing to intervene.

24. Investors should therefore be aware of this new environment of markets' sharply reduced real liquidity. This situation reminds us of the joke which says that a banker is someone who lends you an umbrella when it is sunny and who takes it back as soon as thunder is heard.

Bonds and equities (25-31)

25. A recent article by the financial news agency Bloomberg was entitled : "Treasury selloff is about to end if consensus forecast is right." This title is based on the fact that the current yield of the 10-year US Treasury bond at 1.83 % is higher than the median level expected by the end of the year which is at 1.75 %.

26. And the contributors to the article to explain that the recent increase in yields is an anticipation of a FED's interest rate rise of 0.25 % in December; increase that the market considers to be baked in the cake.

27. However, they believe that because of the weak growth and the low inflation level, the FED has little reason to quickly increase it again, thus making bonds attractive at current levels. In summary 2017 should be a copy of 2016 with at best a single rate increase.

28. However, we believe this consensus to be wrong.

29. We have in past reports mentioned the possibility that the global economy could have an unexpected synchronized rebound. And recently, during the G20 summit, Jack Lew - the US Secretary of the Treasury - said that the US has won the debate regarding the need to boost the economy. Indeed, he declared that a consensus has formed around the US position that governments should use all the tools at their disposal to promote growth, including monetary, fiscal and structural reforms. And according to him, this is what we are currently witnessing among major economies around the world as they increase spending and/or reduce taxes.

30. And one can add that in the US itself, one of the few points of agreement between Democrats and Republicans is the need to significantly increase spending in the country's infrastructure.

31. Another positive element for the US economy is the fact that household debt has returned to its level of 25 years ago. And when this is combined with the fact that the low level of unemployment will eventually lead to higher wages, an increase in spending in coming months should therefore not be that surprising.

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Bonds and equities (32-40)

32. US companies could also start investing more, because they can afford it. The ratio of debt relative to profits is at its lowest since the 1960s and sooner or later they will have to increase their investments to raise productivity.

33. What is also interesting is the fact that finally the velocity of circulation of money has begun to rise. One of the reasons why central banks' easy monetary policies have had little impact so far is that the funds made available were injected in too small quantities in the economic circuit. But this is now changing in particular thanks to a sharp increase in loans in the US.

34. And finally there is what Keynes called "animal spirits", which is the individuals' natural enthusiasm. When these prevail, economic agents not only act but they also take more risks. Obviously a crisis like the one experienced in 2008 cools everyone. But as time goes by it is reasonable to expect that the trauma will fade away and that the animal spirits will return. And it should also be mentioned that the American economist Carmen Reinhardt noted, in her study of financial bubbles, that it takes about 10 years after the bursting of a bubble for its impact to be completely overcome.

35. In conclusion, 2017 may be a much better year than expected by economists.

36. And if this were to be the case, then it raises the question of how it will impact financial markets.

37. Much will depend in fact of the attitude of bond investors as a stronger growth will lead to a change upwards of the expectations of how quickly US interest rates will rise. And since UBS has estimated that 70 % of the non-governmental debt issued in USD is held by bond funds or equivalent, depending on the level of anxiety that this unexpected development will bring, investors' redemption requests could then reach a point where they become toxic for both bonds and equities. And then algorithms and other high-frequency trading strategies could compound the problem.

38. Nevertheless in such a scenario the equities' fall should be limited because of the better economic environment.

39. On the opposite, if the yields' rise remains under control, equities will be able to continue their bull run thanks to higher profits.

40. For the time being and given the expected improvement in US growth, we continue to favor equities in particular outside the US; but always at a level which allows withstanding any eventual volatility.

Currencies (41-43)

41. Regarding commodities, it must be mentioned that we are at a very important moment. After its rise of the first semester, the CRB commodity index corrected but has now moved up back to around 185. And from a technical perspective, if it can exceed 195 it would be a very positive signal, heralding a significant new rising phase.

42. Conversely, if it were to decline below its 200 days' moving average - currently at 180 - then the bull move would be over. We are thus in a "make or break" scenario.

43. Regarding the future evolution of gold, it will largely depend on how interest rates will behave. The higher they move and the more gold will suffer and vice versa.

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Conclusion (44-50)

44. Since 2008 a disaster has been periodically announced : new bank failures, collapse of the Eurozone, crash of the Chinese growth, recession in the US, etc…

45. And since then, we are defending the view that disaster is not inevitable.

46. But it just happens that it is sexier to announce a storm rather than a sunny day. Cassandras are seen as thinkers, serious people with a vision above average. On the opposite, optimists are often perceived as happy fools.

47. However, fortunately in the course of our lives we are far longer in good health than ill and this in spite of all these frightening diseases that threaten us.

48. Being optimistic today does not seem to us to be the attitude of someone in denial, quite the reverse. Indeed, investors' distrust which led them throughout this year to sell equities and purchase bonds appears to be an important indicator of an excessive pessimism regarding the real health of the economy.

49. By the way, presently we believe that the main threats to growth are less economic than political, with the rise of populists and their protectionist rhetoric, as well as the increased tensions at the geopolitical level.

50. Certainly, any excessive rise in yields will result in stock market corrections, such as those we have experienced since 2008; but without an exogenous event, it seems unlikely that the equity bull market could be stopped.

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