SAGA **Market Outlook**

A monthly commentary by Gabriel V. Safdié
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FLOWMAGEDDON

Generalities (1-7)

1. April confirmed the recovery of financial markets after the difficult start of the year.

2. And junk bonds benefited the most. Indeed, the yield for the Bloomberg USD High Yield Corporate Bond index, which peaked at above 10 % in mid-February and was still at 8.45 % one month ago, decreased to 7.6 % at the end of April. This is a level 0.4 % lower than the average of the past 12 months.

3. It is true that this sector was helped by the rise of the price of oil which is up over 70 % from the low reached earlier this year. And it is quite remarkable that even the inability of the producer countries to agree on a limitation of output during the Doha meeting on April 17th had no negative effect as the barrel ended April at USD 45.9, up 15.6 % for the month.

4. The price of oil is now higher than at the beginning of the year and this good performance also enabled the CRB commodity index to move in positive territory, up 4.9 % for 2016.

5. Regarding sovereign bonds, the yield of the US 10-year Treasury rose from 1.77 % to 1.83 % and the German one moved from 0.15 % to 0.27 % - while the Japanese one remained with a negative yield of -0.07 %.

6. For currencies the month was rather quiet with the continuation of the upward move of the yen, which versus the dollar is now at 106 against 120 at the start of the year and this despite the introduction of negative interest rates in yen. The euro also climbed slightly against the greenback in April from 1.1380 to 1.1450.

7. Finally, in Europe the Euro-Stoxx50 index as well as the Dax rose in April 0.8 %, but they remain negative for the year at around -7 %. On the opposite the S&P 500 is slightly positive this year and it was up 0.3 % in April as was also the case for the MSCI Emerging Markets index in USD (+0.4 %), while the Nasdaq composite index fell 1.9 %.

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Equities (8-16)

8. "Flowmageddon" : this is the term used by Morningstar - a company which analyzes investment funds - to describe what is happening in this industry in the US. The word is a combination of flow and Armageddon – a term used in a generic sense to designate battles at a planetary level with a catastrophic connotation – to illustrate the fact that active funds are presently being crushed by passive funds.

9. As a reminder, active funds are those seeking to outperform a benchmark index, while passive funds (also known as Exchange Traded Funds - ETF) merely aim to replicate the behavior of an index.

10. In the US, equity funds sustained withdrawals of USD 124 billion in 2015 and USD 34.9 billion during the first quarter 2016, while for the same periods ETFs received new money inflows of respectively USD 200 billion and 7.6 billion.

11. For Morningstar, this evolution is clear : "ETFs have gained the upper hand in the active/passive debate".

12. The reason behind the move is easy to understand. A recent study by S&P Dow Jones Indices shows that over the last 10 years 98.9 % of US equity funds underperformed their benchmark, as was also the case for 97 % of emerging markets equity funds and 97.8 % of global equities funds. The record is held by the Netherlands, where in the last 5 years 100 % - i.e. the totality - underperformed their national equity benchmark index.

13. And now one must also add the fact that the European Financial Markets Authority (ESMA) has discovered that a number of European funds supposedly active were in fact funds following a purely passive strategy in order not to move too far away from their benchmark and thus avoiding investors' displeasure. ESMA considers this to be a deception as investors pay higher management fees for an active fund than for a passive one as the latter does not require any research or analysis.

14. It can also be noted that even hedge funds are affected. These are the funds which charge the highest fees since they are supposed to be most sophisticated ones. Yet, according to Hedge Fund Research Global Hedge Fund Index, their overall performance was -7 % in the last 12 months. And this bad result follows several years of poor performance which the hedge funds then attributed to the lack of volatility in the markets. However despite the fact that volatility has returned since last August, they have been unable to benefit from it.

15. The consequence is that in the first quarter 2016 outflows from these funds reached USD 15 billion.

16. So the debate seems to be over : passive funds cost less and provide better performance. Hence this "flowmageddon" towards passive funds, a sign that investors are now convinced that this is the “truth”.

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Equities (17-28)

17. But as financial history demonstrates, it is at this moment that everything starts to go wrong.

18. Economy is not a science with immutable laws. On the contrary, “truth” evolves according to circumstances. In the asset management field, no strategy can work in all types of environment.

19. In fact, we are not surprised by this underperformance of active funds. Regular readers know that since 2009 we are suggesting a strategy with on the one side, liquidities placed with zero risk (and thus de facto with a yield close to zero taking into consideration the level of interest rates in many currencies) and on the other, an equity allocation at a level which allows each investor to maintain the positions regardless of volatility. Furthermore, we have been focusing on the developed countries’ largest companies.

20. However back then we were far from imagining that in 2016 we would still be advocating the same policy. This of course is due to the fact that, even if there has been no relapse into recession, strong growth also did not return and therefore the inflation/deflation battle is still going on.

21. Thus by maintaining the same strategy for so long we ended up with a buy and hold approach. And this is the strategy that a passive fund follows as it constantly replicate the benchmark regardless of the circumstances.

22. And if since 2009 active funds are in trouble it is because any attempt to try to anticipate an upward or a downward move is doomed to failure as investors, traumatized by the 2008 events, have being changing their views every 3 to 6 months, moving quickly from one extreme to the other on the slightest pretext. Furthermore those are windshield wiper type of moves with everything rising or falling at the same time without much differentiation.

23. And market moves tend to be even larger as, on the one side liquidity is much lower than prior to 2008 and, on the other, since that time a considerable amount of assets is almost not remunerated anymore due to the low level of interest rates. These assets, which historically were "frozen" in fixed income investments now "float" with the currents, from one investment to another.

24. Everything comes to an end and the current investors’ exuberance towards index funds is for us a sign that their future will be far less bright than it has been until now.

25. Presently there are no indications that a trend reversal is imminent. However we believe this to be the beginning of the end of their outperformance in relation to active funds.

26. One can think of Winston Churchill’s sentence after the victory of the British forces at El-Alamein against the German troops led by Marshal Rommel : "Now this is not the end. It is not even the beginning of the end. But is it, perhaps, the end of the beginning".

27. This is how we interpret the first US interest rate rise of last December. Certainly, presently the upward move is still quite slow; but inevitably, sooner or later, it will accelerate as the US enters into full employment.

28. Actually there is a scenario which allows for interest rates to rise faster than what is expected today.

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Equities (29-38)

29. Earlier this year, many investors were convinced that the deflationary abyss was opening under their feet because of the fall of commodity prices. However if the recovery that we are seeing since mid-February in the commodity area is sustainable, this would be enough to add 1 % to the inflation rate over the next 12 months for most developed countries.

30. Moreover, it is a sign that, globally, the industrial sector is beginning to suffer less.

31. And we could also witness an earnings rebound from large multinationals. Since the end of 2014, their results have been disappointing, resulting in a stock market's stagnation. But this situation has now been discounted by investors as the poor results of the first quarter 2016 did not push stock prices down.

32. Thus it should be sufficient that for the remainder of the year news in this area are just less bad than expected to favor equities.

33. Another favorable element is that for the first time since 2009, less negative economic signals are appearing simultaneously around the world. Indeed, the European economy is improving faster than what Europeans currently feel. And the worst of the contraction in emerging countries may be behind us. For example, Brazil has seen its GDP fall by 5.89 % in 2015 - i.e. the biggest drop since the Second World War - but this year, the Brazilian stock market index -Bovespa - in USD is up 43.4 %. This figure does not mean that everything will be fine, just that the situation could be better than what was expected at the end of 2015.

34. If the world economy stabilizes, then a major factor which has been impacting negatively US growth will fade away. And as we saw last month, the US domestic situation is good; it is close to full employment which should lead to real income increases which will improve growth.

35. Finally, there is the fact that investors have given up any hope that the central banks' aggressive monetary policy may end up having a positive effect on growth. The surprise will be all the greater if it were to finally happen and even more so as fear continues to dominate among investors.

36. So, the conclusion is that if - and this is an important if - the signs of recovery are confirmed, there is a path leading by the end of the year not only to a surprising rise of stock markets, but also in the US to an acceleration of both growth and inflation.

37. Thus, if this year the FED moved from a forecast of 4 interest rate increases of 0.25 % to just 2 - which was a major contribution to the stock market's rebound - it will then be obliged on the opposite to increase at the end of 2016 its expected forecast of rate hikes for 2017.

38. However, to give a chance to the scenario mentioned above it is essential that the S&P 500 index is able to move in coming weeks above the 2'130 level reached in May 2015. The index has tried several times in the last 12 months to break unsuccessfully this resistance and at 2'065 at the end of April we are once again close to it.

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Equities (39-40)

39. We are therefore at a very important crossroad. As the rest of the world should not weight anymore negatively on US growth, one must now see if the US slowdown of recent months will be overcome or not.

40. Meanwhile we continue to favor equities, first in Europe, where monetary policy remains lax and where the stock market is lagging the US.

Bonds (41-47)

41. So, a rise of inflation in the US in a near future is not impossible. Certainly, it will not suddenly rise substantially; but taking in consideration the current deflationary fears, the simple fact that investors may have to deal with a rise from the current 1 % level towards 3 % in 2017 would likely change the nature of the game.

42. Thirty years ago investors were convinced that governments would never be able to reduce inflation and accordingly they required very high real interest rates in order to protect themselves against this risk. Today it is the opposite and they are even lending to government a negative return as they have become convinced that no economic policy can quickly bring back inflation.

43. But presently central banks are trying to do exactly that and they will not stop until they have obtained it, since a simultaneous increase in growth and inflation would allow countries' indebtedness to fall exponentially.

44. Bond investors have therefore no safety margin. Furthermore, if an upward adjustment in yields were to occur, it would be all the more painful since liquidity is only a fraction of what it was previously and this even for quality bonds.

45. This is a theme we have often mentioned and here is another way of approaching the problem. Before the 2008 crisis, US banks were able to keep in stock up to approximately USD 400 billion of US corporate bonds. Today, this figure is closer to USD 50 billion.

46. And to this element one must also add the fact that if between 2000 and 2008 the volume of new corporate bonds was on average around USD 800 billion per year, between 2009 and 2015 this figure rose to USD 1.24 trillion.

47. Of course, all this is not new. But since as time goes by the accumulated volumes become bigger and bigger, if it were to happen, the fire could be quite significant.

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Commodities (48-52)

48. For the moment, the spark necessary to start the blaze has not occured and this in particular because the fall of commodity prices soaked the wood.

49. However, from the low of mid-February, the Bloomberg Commodity Index - which gives a lower weighting to oil than the CRB index - is up 16 %, notably thanks to industrial commodities such as zinc (+30 %) or copper (+20 %).

50. And here too we are now at a crucial level. If this recent rise is only a corrective move within the long-term downtrend, it should end now. Conversely, if the move can continue and decisively break above the current level of the index, it would signal the end of the bear market in this sector.

51. The evolution of the price of gold will also be interesting to watch. The yellow metal had the best performance among the major financial assets during the first quarter of 2016, which we had interpreted as a sign that deflationary fears were exaggerated.

52. Thus, if the move were to continue beyond the current price of 1'293 / ounce (+4.9 % in April), it would be a sign that inflation will accelerate. Otherwise, a return towards USD 1'000.- could be seen as an indication that the FED is not behind the curve in relation to inflation.

Currencies (53-56)

53. Since the beginning of the year, the dollar has suffered from the fact that US interest rates will not rise as fast as expected.

54. But this could change in coming months. Currently, holders of euro are facing painful choices. They can a) keep their euros in deposit and pay a negative interest of 0.4 % per year, b) invest in investment grade bonds to obtain, after costs, a return close to 0 %, while having taken a commitment from 7 to 10 years c) purchase for their yield Cocos issued by banks thus assuming the risks linked to these institutions, d) purchase equities.

55. Otherwise, the temptation to find investments in other currencies will become increasingly attractive.

56. And it is in this environment that any revaluation of the upside potential of US interest rates would be very favorable to the greenback.

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Conclusion (57-62)

57. May has therefore become an important month for financial markets since either growth will continue to improve and this will be reflected in the price of assets or the rise from mid-February will fade away.

58. This means that we are currently maintaining our strategy based on a cautious optimism regarding the future with a reasonable equity allocation.

59. But "flowmageddon" also indicates that we are starting to see too much exuberance from investors towards passive funds, a sign that their success is gradually coming to an end.

60. Their outperformance can continue for a while, but one must be aware that all assets worldwide are valued on the basis of the current very low interest rates and that once these interest rates will start rising, assets price adjustments will be quite painful. Certainly, there will always be rising and falling phases but when one will look at the performance five or ten years later he will notice that they have not increased in real terms during the period. We will thus be in the bunny market mentioned last month.

61. This new environment will favor those able to reduce risk in their portfolios during downward phases which should be more predictable than today. But it will also be favorable to active managers able to identify companies with a strong potential. And their outperformance will be even bigger at the beginning of the cycle since those who will have survived the current bloodbath will necessarily be the best.

62. And this is how investors will then find new heroes.

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