SAGA Market Outlook

A monthly commentary by Gabriel V. Safdié
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FROM DEFLATION TO HYPERINFLATION ?

Generalities (1-4)

1. April was quiet until the two last days of the month, when the announcement of a mediocre US growth for the first quarter of 0.2 % led to profit taking, beginning with the dollar, which fell from 1.0730 to 1.1225 against euro, while the greenback stayed practically unchanged against yen at 119.40.

2. The stock market caught its breath back in Europe, with a fall of 4.3 % for the Dax and 2.2 % for the Euro-Stoxx50. On the opposite, both Japan (+1.6 %) and USA, with the S&P and the Nasdaq up 0.8 %, succeeded in ending the month up. This was also the case for the MSCI emerging markets index in USD, which ended the month at 6.8 %, in particular thanks to a strong rise of the Chinese stock market, up nearly 20 % since the beginning of the year.

3. In relation to sovereign bonds, the yield of both the 10-year German and US bond, respectively at 0.37 % and 2.056 %, moved up only marginally. Regarding the performance of the Bloomberg USD High Yield Index, it benefited from a fall of the yield from 6.50 % to 6.22 %.

4. Finally, the Bloomberg Commodity Index (+5.7 %) partially recovered its previous month decline, thanks to a good oil price recovery of 20.8 %. Worthy of mention, the new fall of 3 % of the price of silver, which is now at only 5 % from its twelve months low.

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Currencies (5-16)

5. Since the Bretton Woods' system imploded in 1971 which led to the introduction of floating exchange rates, never had the US dollar strengthened so quickly. Indeed, the dollar index is up 25 % since the summer of 2014. For the time being - and twice - the increase was stopped at the level of 100, the index ending April at 94.60.

6. The question that naturally arises is whether, given the importance of the advance, an important corrective movement could occur. Any dollar trend reversal is necessarily linked to a rise of the euro, because it is currently the main currency in which investors are short and long dollar.

7. At its present level, the euro/dollar exchange rate has already priced in many negative news in relation to the single currency : the lower growth rate deficit of the Eurozone in relation to the US; the European quantitative easing; a 0 % bond yield in euro all the way up to 10 years for the German sovereign bond against 2 % for the equivalent 10-year US bond.

8. And there is also the current expectation by the market that the FED's prime interest rate will stand at 2 % at the end of 2017, while the European Central Bank (ECB) one would still remain at 0 %. On this subject, it should be noted that US growth has fallen early this year and therefore the FED may have difficulty reaching the 2 % level. This also means that the current forecast by FED members that the rate could even reach 3 % at end of 2017 will have to be revised downwards.

9. Presently, the probability of a first rate hike in June seems rather low and thus the discussion going on is whether it may happen in September or in December.

10. By pushing the dollar up, the market has therefore already anticipated a significant increase of the interest rate differential between the dollar and the euro, and this might not happen as scheduled. Moreover, this is the first time that such anticipation has occurred since previously, because of the chronic deficit of the US balance of payments, it was necessary for the interest rate gap to actually reach 3 % for a sustainable bull trend to appear.

11. Today, one must also take into account the fact that the surplus in the balance of payments of the Eurozone will reach EUR 350 billion this year. In comparison, between 2002 and 2008, during the great upward phase of the euro from 0.90 to 1.60, this surplus was only of around EUR 50 billion per year.

12. And finally, one must not forget that the current level of the exchange rate is weakened by the large number of speculative positions against the euro. These speculators are naturally very sensitive to any unfavorable exchange rate evolution.

13. So far, the market is ignoring all the positive elements in favor of the single currency, including the fact that its fair value in terms of purchasing power parity is around 1.25. All this makes it quite likely that the current exchange rate is also including a risk premium related to the situation in Greece.

14. Since 2010, this country lives a tragedy which can only be described as a … Greek one.

15. In the years preceding the crisis, we regularly mentioned that investors were not paid enough to hold Greek debt in comparison for example to the German one. This mispricing was linked to the fact that the foreign exchange risk on Greek debt had disappeared. And when the market realized that it was wrong and that it had in fact traded the currency risk for the default risk, it was too late.

16. In a normal situation, Greece should have defaulted immediately in 2010. But at that time, all the defects of the single currency construction became apparent and the risk of contagion to other Mediterranean area countries became extreme.

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Currencies (17-27)

17. The euro being a political construction, a collective political decision by the Eurozone countries transferred the Greek debt - then essentially held by private creditors - to the public sector, which effectively then allowed kicking the can down the road.

18. But it was also necessary to simultaneously and quickly solve the problem of the deficit of the balance of payments of the country, which had reached the extraordinary level of 15 % of GDP in 2008. Thus, for economic fundamentals to be restored, the country had to suffer an economic depression - with GDP falling by 25 % - accompanied by a severe deflation to make the country competitive.

19. And this is how, with much pain, by early 2014, fundamentals had been restored. The worst seemed then over and growth was gradually returning. Who still remembers that in April 2014 Greece was able to borrow on the market EUR 3 billion for 5 years and that the bond was oversubscribed to EUR 20 billion ?

20. A year ago it was fair to say that Greece had become attractive again. And the country was even able to post in 2014 the highest primary surplus of the area (i.e. before the payment of interest on the debt) at 2.5 % of GDP, against 2.1 % for Germany and 1.7 % for Italy.

21. But as in all tragedies, a new ordeal awaited the country. The far left and the far right joined forces to prevent the election of a new president for the country by the parliament, obliging early legislative elections which brought to power an inexperienced far left government, thus restarting the Greek crisis.

22. It must be noted - and this will be a surprise to many - that from an economic perspective the weight of the Greek debt is quite bearable by the country. Indeed, 75 % of the debt is now owned by public entities - such as the ECB or the IMF - and it has also been rescheduled with long maturities and very low interest rates. And so it was that in 2014, while Portugal paid in debt service 5 % of its GDP and Italy 4.7 %, Greece disbursed only 4.3 %; slightly more than Ireland at 4.1 %.

23. What makes the particularity of the Greek case is that, unlike other countries in the region, the Greek population has no confidence in its country and therefore refuses to hold its sovereign bonds. On the opposite, in Italy for example, during the 2010 crisis, the population took advantage of the "bargain" of higher interest rates on Italian treasury bonds to greatly increase their purchases.

24. Thus, in order to finance itself, Greece depends on the kindness of strangers, who do not like having to play this part and consequently expect the country to be virtuous, which is not in the DNA of the current government.

25. This situation naturally leads to a deadlock : public creditors want neither the debt to increase, nor for it not to be paid in full, while the government wants to be able to spend more.

26. The room to manoeuvre for each side is limited since the government must show that something has changed, while creditors fear that any concession made to the country would also have to be granted, sooner or later, to other fragile governments of the zone. But creditors must also be careful, as they are facing a paradox: if Greece ends up defaulting and leaving the euro (the so-called Grexit), creditors will then have to be super-friendly to other countries to limit the contagion risk.

27. Much has been written about the risks of this Grexit; some analysts are quite alarming, others more reassuring. In truth, no one can predict what will happen and what will then be the pressure on Cyprus, for example. One can imagine at most that one country could move out, but two will be an entirely different matter.

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Currencies (28-38)

28. But what is the most striking today is the lack of any political vision in relation to this matter.

29. Let us imagine that the worst happens : debt default and exit from the euro. This will immediately mean that, contrary to what might have been the case in 2010, there will be heavy losses for public creditors and repercussions will be felt globally because of the loans granted by the IMF. But, of course, it is the other Eurozone countries that will suffer the main shock. Through the European Stability Mechanism, the Eurozone countries have collectively lent EUR 142 billion and individually the total amount is EUR 53 billion. The ECB has an exposure of EUR 20 billion and Greek banks owe EUR 50 billion to the intra-European payments system.

30. As for Greece, in this scenario with failed banks and a financial system which would have collapsed, the whole economy would be on the ground. This means that in order to stabilize the country's situation, public creditors, despite their losses, will still be obliged then to provide a minimum of liquidities to the country !

31. Without this help, and it is difficult to see where it could come from, it will unfortunately become likely that the country could fall into chaos, with a weak state desperately trying to create money. Greece could then, after having suffered the ravages of deflation, be swept away by hyperinflation. Democracy, already in difficulty today, may not even survive. What an irony it will then be for Europe which, after the fall of the military dictatorship, rushed to make Greece a member of what was then the European Economic Community in order to strengthen democracy.

32. And the hate - the word is not too strong - that the Greek people would then have towards the European Union would be similar to that of Ireland towards Great Britain in the nineteenth century.

33. It is interesting to remember that Great Britain, then the richest and most powerful country in the world, abandoned an Ireland - so much catholic and making so many children - to the Great Famine of 1846 to 1851 which killed an estimated 1 million people.

34. Of course, the consequences for Greece will not be as dramatic in terms of human lives, but can the European Union morally afford to see the birthplace of democracy moving towards becoming a third-world country ?

35. And then, once the country has been destabilized and with enemies of my enemies becoming my friends, why should Greece not tip over towards Russia or China against financial support ?

36. Fortunately this nightmare scenario is improbable. But it helps in drawing two conclusions : a) in any eventuality a Western support for Greece will be necessary if one wishes that the country remains on the Western side; b) it will be much cheaper, both for creditors and for Greece, if a solution is found within the existing framework.

37. Thus, if logic prevails, both parties should end up finding a solution. And one can also expect, if the bickering between them continues, that the United States will end up intervening to oblige the two sides to come to their senses.

38. Meanwhile, the euro remains hostage of the situation as it waits for an outcome which will bring a 10 cents move up or down.

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Bonds (39-52)

39. In this sector, the purchase of bonds becomes day after day a risk increasingly correlated to equities.

40. This comes from the fact that the disappearance of yield on investment grade bonds is pushing investors to become creditors of ever more fragile debtors and whose ability to meet their commitments is directly linked to the evolution of the economic situation.

41. To buy this type of bond one needs therefore to have a view on growth similar to equity buyers, but with a worse risk/return ratio.

42. Indeed, if everything goes well, the creditor will receive the agreed interest - 4 or 5 % for example - while the shareholder could in this scenario earn much more. If on the opposite, a recession occurs, certainly equities will fall; however according to the importance of the economic decline the bondholder's capital itself could then be in danger. This is what holders of bonds issued by companies drilling for shale oil in the US discovered at the beginning of the year : the sharp drop of energy prices has put a question mark on their ability to repay their debts.

43. Another risk for bond investors is that we are in a financial repression phase, which will last for still quite a long time. Because of their debt level and modest economic growth, the only way for governments to remain in control of the situation is to ensure that the real rate (i.e. nominal interest rate minus the inflation rate) remains durably negative or close to zero.

44. There is also the fact that current yields do not reflect supply and demand as they are under central bank intervention. These administered prices can therefore strongly move away from economic fundamentals.

45. Anyway, for the time being, satisfied by their performance and reassured by the central bank interventions, investors continue to extensively invest in bond funds. Since the beginning of the year, JP Morgan estimates that USD 73 billion were invested in bond funds, against only USD 47 billion in equity funds. Since the collapse of Lehman Brothers, USD 3 trillion of new money was invested in bond funds.

46. In addition, investors are purchasing in increasingly large quantities structured products linked to interest rates, with pretty names such as Yield enhancement.

47. This situation is becoming more and more worrying. James Bullard - head of the Reserve Bank of St. Louis (and who currently has no vote at the FED because of the rotation between the members) - recently said that the zero percent rate policy feeds bubbles.

48. And a recent survey of 300 bond fund managers found that 4 out of 5 of them consider bonds to be overvalued.

49. Thus once central banks' policy will change, the awakening may be quite painful and even more so given the liquidity problems in the bond market.

50. This lack of liquidity is now a well-known factor and one figure can illustrate it. Twelve months ago, it was possible to complete a transaction with a size of USD 280 million on US Treasury bonds - which is the largest and most liquid market in the world - without making the price move. Today, according to Bloomberg, the size has fallen to USD 80 million.

51. Aware of the problem, it is likely that managers will try to anticipate any possible adverse move in bonds and thus it will not take a lot of bad news to quickly freeze the entire market.

52. In conclusion, we continue to recommend avoiding aggressive investments in this sector.

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Equities (53-61)

53. The fact that we regularly mention the dangers of the bond market does not mean that the stock market could come out unscathed. On the contrary, any pressure on interest rates will have an impact on assets such as real estate, art or equities.

54. Only, today, the potential gain in relation to the risk taken is much more favorable to equities than to bonds. In addition, investors tend to underestimate the fact that in a first phase any acceleration in sales exponentially increases profits as the cost for these extra sales is quite low. It is only later, in a second phase, that in order to continue to grow, a company must invest to increase its offer.

55. Thus, the equity market remains attractive. But alas, just as is the case with bonds, it is also much less liquid than before.

56. John Bogle - founder of the Vanguard funds and who was the first to create index linked equity funds - is very critical of ETFs, because he considers them to be an evolution only favorable to brokers and dealers. When he designed his product 40 years ago, his goal was to enable an investor to buy a fund in order to have a diversified and long-term exposure to equities. It is therefore valued only once a day, after the market's closing. The logic of ETFs is different. Of course, they also follow the moves of a particular index, but the goal in this case is to allow for instant buying or selling of an index at any time, since the ETF is structured as an equity with a quotation at all times. Therefore, it has a clear short-term bias.

57. Many investors and managers now use these ETFs to quickly protect themselves. Instead of having to sell one by one each holding in order to reduce equity exposure, they try to do it immediately by selling ETFs.

58. However, as we have already mentioned, in periods of stress, liquidity disappears as companies responsible for creating it through fast electronic transactions simply withdraw from the market.

59. And this is how we end up having a day trader, Mr. Singh Sarao Navinder, who lives in a house subject to the noise of planes using Heathrow Airport, accused of being partially responsible for the US stock market flash crash of 2010 which pushed for example the Dow Jones down 1'000 points before a quick rise erased all the decline by the end of that same day.

60. This story is absurd, but if it is true, it would be extremely serious. One should remember that just the S&P 500 index alone represents a market capitalization of USD 20 trillion. However, according to the indictment, Mr. Sarao would have succeeded by himself and only with a computer and the use of purchase/sale programs which can be bought online, to manipulate, despite its size, the US stock market to the point of pushing it down 6 % in a few minutes.

61. Regardless of how this story will end, it illustrates the present fragility of financial markets with a current framework so odd that there is this feeling that - to paraphrase Lenin - the stock market has created its own rope with which it will be hanged.

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Conclusion (62-68)

62. For the time being the central banks' policy remains very favorable to equities, since its goal is to achieve economic growth acceleration at any cost. On the opposite, bonds pay only peanuts with, for some of them, the significant risk of a permanent loss of capital which could came from a bankruptcy following a recession.

63. Of course if bond prices fall the stock market will also go down, but for quality shares the decline will only be temporary - and this even if temporary may mean a few years. But meanwhile the investor receives its yearly dividend.

64. Therefore, we continue to advise taking risk primarily through equities, but at a reasonable level in order to withstand any unexpected adverse event that would lead a strong downwards move.

65. And one should also not forget that the zero interest rate policy did not prevent the Japanese stock market from fall sharply during the country's economic downturns.

66. An unfortunate end to the Greek crisis could also be one of these moments in particular because of the law of unintended consequences.

67. For example, before the Lehman bankruptcy, there was the Bear Stearns alert. US authorities were convinced that after that incident they had taken all the necessary measures to avoid contagion and that they thus could let Lehman safely go under. The problem was that the Lehman collapse had, in a completely unexpected way, impacted money market funds which were supposed to carry no risk to investors. And this then led to a freeze of all the financial machinery.

68. What seems quite certain is that in the event of an uncontrolled Grexit, there will only be losers, with quite heavy human and political consequences. That is why we must strongly hope that good sense will prevail and that a solution will be found allowing Greece to return to the healing path.

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