

A monthly commentary by Gabriel V. Safdié  
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## THE LAST "CHEAP" ASSET

### Generalities (1-6)

1. It looked like equities were going to have an exuberant month until May 22, when, after an increase of nearly 90 % since June 2012, the Nikkei dropped 7.2 %.

2. Therefore, in the end, the month was just good for American (S&P +2.1 %, Nasdaq +3.8 %) and European stock markets (DAX +5.5 % Euro STOXX50 +2.1 %). On the opposite, it was down for Japan (-0.6 %) and emerging markets (-4.8 %).

3. Regarding currencies, for the 8th consecutive month, the yen continued to fall against the dollar from 97.50 to 100.5, while the euro retreated - but in a much smaller way - from 1.3170 to 1.30.

4. But the most significant development in May in this sector was the decline of the Australian dollar, following a surprise 0.25 % drop by the Reserve Bank of Australia of its key interest rate. This decrease is linked to the country economic slowdown, which is also affecting in a broader way most commodities exporting countries. With a drop of 7.7 % against USD, the AUD has returned to the exchange rate of 12 months ago. This is an important level for the Australian currency, since if it gives way, the currency could fall by another 15 %.

5. In terms of commodities, it was a difficult month for precious metals (silver -7.9 %) and agricultural products (sugar -6.3 %), but copper recovered by 3.3 %. Globally, the CRB index was down 2.2 %.

6. Finally, the volatility which had emerged in recent months in the bond market intensified, especially in Japan where, for example, the 10-year bond yield moved up from 0.61 % at the beginning of the month to 1 % on May 23, before closing May at 0.857 %. As for the equivalent US 10-year, it jumped from 1.67 % to 2.13 % and the German one from 1.22 % to 1.50 %, thus erasing not only the decline of the previous 3 months, but even climbing to the highest level of the year.

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## Equities (7-19)

7. May was quite disappointing in terms of economic performance. For most countries, with the exception of Japan, the vast majority of the published data was worse than expected. For example, the excuse given to explain the nearly 8 % fall of the Nikkei was the publication of an index indicating a contraction of the manufacturing activity in China in May.

8. Actually, this bad data just confirms what has been obvious for months, i.e. that China has currently no momentum.

9. In Europe, if the budgetary policy is not restrictive anymore, it is far from having become a help for the economy.

10. In the US, an important index of economic activity fell by 0.53 % in April, a sign of weak growth. And we do not really know how to interpret the 25 % drop in the price of wood in the United States in the last 4 months, at a time where the construction sector is improving quite noticeably.

11. Anecdotally, it is interesting to mention the fact that McDonald's felt compelled to lower its prices to attract consumers as they appear to be so cash-strapped to the point of having a negative influence on the sale of Big Macs.

12. Basically all these elements confirm that the global economy is undergoing a new deflationary wave. And this was forecasted by the decline in bond yields until late April as well as by the sharp fall of gold. And this wave is such that even America, who in relative terms has the best growth in the world, cannot escape.

13. All this confirms what we foresaw as of our January commentary entitled "Discrepancies" : the global economic situation is not really improving in a meaningful way. So, what can explain the good performance of equities illustrated by the 10 % increase of the FTSE World index since the beginning of the year ?

14. It is mainly due to a change of perspective from investors. Until the summer of 2012, traumatized by the events of 2008, the market had a tendency to value stocks on the basis of the worst possible scenario. And therefore, as we often mentioned, it was sufficient for things not to be as bad as expected to enable the market to move back up. This is what happened after the falls of 2010, 2011 and 2012.

15. But investors' psychology has changed since last summer after the famous speech by Mr. Draghi, who brought, as if by magic, calmness to the euro area. Then, a few weeks later, Mr. Shinzo Abe announced a bold plan to move Japan out from its chronic deflation.

16. These two events reassured investors since they indicated that other central banks have joined the FED in their loose monetary policy and this therefore reduced the risk that deflation could take hold. In addition, the market has presently the view that bad news are actually good news, since it allows for the monetary policy to remain quite easy.

17. In a way, we are presently in the opposite situation of previous years as the stock market is being priced on the best possible scenario, with the risk of disappointing later in the year.

18. But another important factor has also appeared. Weak economic growth coupled with an easy monetary policy is extremely favorable to assets in general. And the market "discovered" that in comparison to short-term deposits, bonds, real estate, art, gold - in short, compared to all other assets - equities were the last "cheap" investment.

19. And this is why investors have now accepted to value profits at a higher multiple than previously. In other words, the risk premium on equities, which had increased substantially with the 2008 events to above 5 %, is gradually returning towards its historical normality level of 3 %.

## Equities (20-25)

20. Furthermore, this move is accentuated by the fact that investors are beginning to accept the idea that the current low rates could continue for years. If instead of fluctuating between 4 and 5 % - as it was the case during the first decade of the century - the yield of the 10-year bond moves between 2 and 3 % until the year 2020, for example, this would lead to a reduction of the return requirement by equity investors. Therefore, if the risk premium is reduced from 5 to 3 %, if the accepted risk-free return also declines from 5 to 3 % and if to these two factors it can be added a modest but steady increase in profits, all this would allow equities to rise in a substantial way, even with low growth.

21. Therefore, in this scenario, it is the weak economic environment which becomes the greatest ally of equities.

22. Thus, contrary to what some are claiming, the current rise is not artificial, nor creates a bubble : it is simply the consequence of the current situation.

23. But it is also easy to see how uncomfortable the situation is. Any unexpected shock can easily tilt the global economy into recession, sending to the rubbish bin the dreamed scenario of an environment not too hot not too cold.

24. This is the reason why the rise is happening without enthusiasm. In Europe, for example, the volume is at its lowest level in 12 years, which, under normal circumstances, will be considered as an important warning signal, since the rise is not broad based.

25. The situation can thus be summarized as follows. It is enough that a small portion of the cash coming from maturing bonds is invested in equities to allow the rise to continue, and the longer it goes on, the bigger the buying wave will be. But from time to time, because of a particular news and due to the low volume, a significant decrease, as the one we saw in Japan, can happen.

## Bonds (26-33)

26. Unless the bad surprise comes from the bonds sector.

27. In Japan, despite the announcement that the Bank of Japan will buy 75 % of the new government bonds issued, interest rates have tended to rise sharply during the month of May. This is the first time that easing monetary policy had such an effect.

28. The Japanese authorities cannot allow it, since, from the one side, any significant rise will create problems to the local banks which are the largest holders of such securities and, on the other, it will negatively impact the expected benefits of the new monetary policy.

29. Even if it looks that this situation can be managed, it is a new small tremor for the bond market, following the previous ones.

30. And some will consider that this is just the pre-announcement of a major crisis that will sooner or later affect Japan.

31. The reasoning is the following. The Bank of Japan cannot, as we have just explained, let its interest rates rise. Thus, it is going to be forced, at some point, to increase its bond purchases if current holders decide to sell them.

32. This will therefore increase the amount of yen available on the market, with, as a natural consequence an acceleration of the decline of the currency, which could then lead to new sales of bonds, forcing the BOJ to further increase its purchases, thus creating a self-feeding spiral.

33. In short, in such a scenario, Japan will at the end lose control of both its debt and its currency.

## Bonds (34-45)

34. And this risk has increased after Fukushima, since by closing almost all its nuclear plants Japan is forced to import its energy. And so, the country has lost its balance of payments' surplus, which enabled it to finance until now a debt that exceeds 200 % of its GDP.

35. In the worst case, the country could even go, in a relatively short period, from deflation to hyperinflation.

36. This scenario is of course not inevitable, but it is strongly linked to the ability of the new policy to generate the necessary growth to reduce the country's financing needs and of its capacity to enable an increase of exports in order to have a positive trade balance.

37. But there are also other dangers for bonds. For example, how will the market react when bond funds will have more sellers than buyers ? We have already mentioned previously that in America since 2008, the bond market grew by 50 % while the ability of Wall Street to maintain an inventory of bonds is only 1/10 of what it was.

38. One word about the rise of US bond yields in May. If this increase is only due to the fear that the quantitative easing policy will end quicker than expected, it will be difficult for the move to further extend itself.

39. Indeed, if unemployment has moved down from 9.2 % in 2011 to 7.5 % today, it is because there has been a reduction in the number of those looking for a job. If the percentage of the population seeking work had remained the same, the unemployment figure would currently be at 8.8 %.

40. Even if the FED concludes its quantitative easing policy sooner than expected, it is quite unlikely that the central bank could start a tightening phase in the next months.

41. But it is also possible that other less obvious factors are at work. For example, the fact that current yields are simply just too low.

42. Bank of America recently mentioned that USD 19.4 trillion of government bonds - i.e. more than half of the global world bond market - have presently a yield below 1 %. This leads investors to more and more exotic names, such as Rwanda, which has just issued its first bond ever for USD 400 million despite the fact that the country largely lives of foreign aid.

43. Finally, we should note that a new cause of concern has recently emerged. It is linked to bonds issued, in order to satisfy Western demand, by companies located in developing countries.

44. The problem here is double. Firstly, there is the fact that in 2012, as stated by the Financial Times, 20 % of the bonds issued in Asia ex-Japan for a total of USD 124.7 billion came from companies that have done it for the first time. This figure is of 3 % in the US and Europe. One can therefore expect that a higher than usual number of debtors will be unable to reimburse and this will be particularly true if growth remains mediocre.

45. The second concern would be a decline in Asian currencies in relation to the US dollar, which would push investors to try to sell the bonds issued in local currencies.

## Currencies (46-47)

46. As a matter of fact, the possibility of a dollar rise has increased in recent weeks. Despite the US trade deficit, the greenback tends to behave well when deflationary pressures - as it is currently the case - intensify. In addition, the US is increasingly

seen as an oasis of growth in a world at a standstill and this could attract investors.

47. Furthermore, the weaker yen puts an enormous pressure on other Asian currencies to follow the move.

## Currencies (48-51)

48. It has already started, as demonstrated by the fact that both the dollar index and the euro index have been increasing together, but it may now accelerate, implying the sale of equities and bonds issued in local currency.

49. However, towards the euro, a dollar rise should be much less pronounced.

50. A last word regarding the yen. Last month, we expressed our suspicions regarding the downward trend of the yen, of which only hedge funds have benefited so

far and which could lead to a more or less strong counter-move if they were forced to take profits. A reader pointed out that one could discuss the timing for selling yen, but since there is absolutely no reason to buy it, it is quite difficult for this counter-move to happen.

51. In fact, the question is whether the Japanese are ready to sell yen against dollar at 100, when 6 months ago it was at 80 and they did not do it. And the answer to this question is largely linked to what will happen on the Japanese bond market.

## Commodities (52-57)

52. The decline in commodity prices is good news for the Occidental countries, since it is equivalent to a tax reduction.

53. From this point of view, we are less concerned than others which believe that this decline is forecasting a new recession, since we consider that the move is mainly explained by a rise of the offer.

54. And the stock market is having the same interpretation.

55. However, any further decline in this sector will be incompatible with the current

equity move, which implies at least stable growth; growth that should therefore be able to sustain the price of commodities.

56. In the same way, any significant further decline in gold should be interpreted as a signal of danger, since it would mean that deflationary pressures are continuing to increase.

57. In short, it would be desirable to have a slight rebound of commodity prices in coming weeks to be reassured regarding the health of the global economy.

## Conclusion (58-60)

58. The market has integrated the fact that the quantitative easing policy is not inflationist, since it has been unable until now to lead to an increase in the velocity of money. Indeed, it is quite impressive to note that, despite all the billions injected, the velocity of money in the US has just fallen to the 2008 level.

59. In other words, one can bring the donkey to the river, but one cannot make him drink more than what he wants.

60. But this policy allowed the global economy to keep its head above water. And this is what counts for the stock market.

## Conclusion (61-64)

61. Thus, the investor is in an uncomfortable situation. On the one hand, global growth remains anemic with the still existing risk of the outbreak of an unexpected infection.

62. But on the other, everything pushes him to buy the last "cheap" asset - equities - since it is the only one that still makes sense.

63. Our investment policy reflects this situation : equities remain our main risk taking, but it is difficult for us to be invested in an aggressive way.

64. Currently, we are not closing any doors. The new context will require us to act in a more dynamic way than previously as equities are the only possible source of potential profit. But the fact remains that the base of the rally is relatively unstable.