SAGA

Market Outlook

A monthly commentary by Gabriel V. Safdié
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WHEN GOOD NEWS BECOMES BAD NEWS

Generalities (1-6)

1. The stock markets' fall, which had gained momentum during the last week of July, continued into the first week of August to the point where it was possible to consider that, for the first time in two years, a market correction (i.e. a decrease of more than 10 %) could happen in the US.

2. But the 1'900 level on the S&P 500 held and the trend reversed, even allowing for a new record for this index which ended the month up 3.8 %, while the Nasdaq was at +4.8 %.

3. If at the end the S&P 500 correction was only of 3.9 %, the fall was larger in Europe, as it is more exposed to Russia, with for example a 10 % decline of the DAX. However, with the resumption of the US bull move, the other stock markets also reversed their trend and this allowed the German index to rise 0.7 % in August and the Euro-Stoxx50 1.8 %. This was also the case for the EEM index of emerging countries in USD +2.8 % and it was only the Nikkei 225 in Japan which moved down 1.3%.

4. However, probably the most striking element of the month was the decline below the 1 % level of the 10-year German sovereign bond yield at 0.89 % by the end of the month. Thus, it has clearly moved closer to the Japanese one, currently at 0.50 %. And even the US equivalent yield fell from 2.58 % to 2.34 %.

5. The previous month alert regarding high-yield bonds was partially withdrawn, with a yield's decline from the 6 % level reached early August to 5.5 % at the end of the month. These figures should be compared with the record low level of 5 % of late June.

6. Meanwhile the CRB commodities index was down 0.6 % for the month, including a further 2.2 % decline of oil. Thus, the European Brent variety is down over 15 % from the peak reached at the time of the first tensions with Russia.

7. Finally, regarding currencies, the euro continued its decline at 1.313, with speculators positioning themselves in the hope of new monetary measures by the ECB aiming to help the stalled economies of the zone. The dollar also rose against the yen to 104.1.

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Bonds (8-17)

8. Two years after the end of the euro crisis, it is interesting to note how the first analysis of the events was wrong.

9. Indeed, at the time all the attention was focused on the indebtedness problem of the Mediterranean countries and on their ability to honor their debts.

10. However, it now appears that this matter was in fact quite secondary since in the last two years the indebtedness of these countries in relation to their GDP continued to rise without this having any impact on their ability to borrow. On the contrary even, since from the end of the crisis yields continuously declined to the point that presently Italian and Spanish sovereign bonds for example are at a historical low level of below 2.5 % for the 10-year maturity. Even France, despite its current annual deficit above 4 % of GDP, had never been able previously to borrow at 1.25 % for a decade.

11. And because debt was not in fact the real issue one can now understand why the market did not put to the test the president of the European Central Bank (ECB) - Mr. Draghi - when he declared two years ago : "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

12. In fact, what the market tested during that crisis was the political will, both from the fragile countries as well as from Germany, to maintain intact the monetary union. And one can remember that the first massive purchases of bonds from southern Europe debtors were those of Greek sovereign bonds (after the debt restructuring) once hedge funds found out that despite going into an economic depression, the support of the Greek population towards the euro remained intact.

13. It is therefore likely that the next test for the single currency will come when a political party unfavorable to the euro could come into power in a country of the zone.

14. Today in a certain way, one can deplore the fact that the market did not test the commitment of the ECB president. Indeed, it may have obliged then the central bank to maintain a much easier monetary policy that the one followed in the last twenty four months, where it has kept reducing its balance sheet while its foreign counterparts were doing the opposite.

15. The present decline of German bond yields indicates that it was a mistake since the Eurozone is now flirting with deflation and being with almost no growth.

16. The market now expects the ECB to engage in a quantitative easing (QE) policy similar to what other central banks have done. And they are encouraged by the fact that Mr. Draghi has acknowledged that, not only on the short-term, but also on the medium and long-term, inflation expectations are now well below its 2 % target.

17. However, it seems unlikely to us that he will do so in the near future and this for several reasons.

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Bonds (18-26)

18. First, since the 2009 crisis the market sees that any softness in the US economy drives the FED to take new QE measures which then bring yields down and push the value of all type of assets up. Thus, having learned this lesson, the market has already largely anticipated such an ECB move with the current substantial decline in European yields. From this point of view one of the main goals from QE – lower interest rates - has already been achieved.

19. Moreover, as noted by Mr. Draghi himself, the problem today in Europe is not the level of interest rates, but of the access to credit.

20. To solve this problem, the first step taken by the ECB is to ensure that banks are adequately capitalized so that they can function normally and therefore be able to resume lending. Hence the new bank's stress test which will happen this fall. This will be done on the basis of criteria which have been published well in advance to allow banks to be proactive and quickly recapitalize themselves in order not to fail the exam.

21. Then the ECB will conduct over a two year period targeted longer-term refinancing operations (TLRO), in order to increase bank lending activity to the non-financial private sector. It should also now, faster than expected, initiate purchases of asset-backed securities.

22. Therefore, the ECB policy is clearly oriented towards measures that stimulate the offer of credit in the zone, hoping that companies will take the opportunity to develop their activities. And from this point of view, QE is only of marginal interest.

23. Mr. Draghi also mentioned recently that more leeway will be given in relation to the member states' deficits, which means an end to the public spending cuts which have very negatively impacted growth. However there is no mention of allowing higher spending measures as this would increase existing deficits. Clearly, countries are now allowed to take their foot off the brake but not to press the accelerator.

24. The reluctance of the ECB to launch a QE program is also enhanced by the fact that the Japanese experience is not a success so far. Indeed, despite the sizeable sums injected by the Bank of Japan, economic growth over the last twelve months was close to zero and the weaker yen generated by this policy has not brought, at least for the time being, the expected gains for the Japanese economy. In contrast, the inflation generated by the decline of the yen led to a decrease of the Japanese real income by 3.2 % from a year ago.

25. In addition, one should not underestimate the fierce German opposition to bond purchases by the ECB and therefore the central bank will take such a measure only in a case of extreme necessity.

26. In conclusion, even if growth is weak, with bad quarters such as the second one of this year, economic activity in the area is no longer contracting. It is therefore unlikely that the ECB will take further important steps in coming weeks, as it will wait to see the impact of measures already announced. In addition, it believes that it is the structural reforms in each country which will allow for a sustainable return to growth.

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Bonds (27-37)

27. The ECB will also “keep talking” the euro down, hoping that this will be enough for the single currency to continue its current slow decline.

28. Anyway, whether QE happens or not, is presently of little importance for the European bond market which is in the best of worlds. On the one hand, growth is low enough to prevent a rise of interest rates in 2015, and on the other, growth is nevertheless adequate to allow companies to continue to honor their debts.

29. Obviously the situation is different in the US where, given the normalization of the economic situation, it is likely that the first increase of the prime rate will occur sometime in the first half of 2015. And from this point of view the market has been considering in recent weeks that good economic news are actually bad financial news, as they push forward the moment when the rise will happen. Hence the surprising investor euphoria when a lower than expected economic data is released.

30. And it should also be noted that the bond market does not believe in this normalization, or at least considers that it will not bring a significant rise in interest rates, since the yield of the 10-year bond is down this year from 3.03 % to 2.34 %.

31. Much has been written to try to explain this bond evolution.

32. From our point of view, it is a source of concern, as it could be forecasting a slowdown rather than a growth acceleration. But we can also consider that after having doubled from 1.4% two years ago to 3% at the end of 2013, it remains for the moment a normal correction.

33. Actually, this kind of move is rather typical at the end of a cycle as it strengthens' the conviction of investors that every fall is a buying opportunity, thus pushing them to further increase their investments. And when the turnaround finally occurs, pain is even more intense.

34. And this is the case not only for individual investors. Institutional investors also are lulled by this evolution. In the last two years, UK pension funds hold in their portfolios more bonds than equities and this in an increasing proportion. This had never occurred before and is happening at a time when long-term interest rates are at historical low levels.

35. Another strategy which has become popular among managers is that of volatility risk parity. Historically, a traditional portfolio consisted of 60% equities and 40% bonds. The two large bear markets of the last decade led to the development of the volatility risk parity concept, the goal of which is to have an equal exposure to volatility for all asset classes. For example, if the risk model used indicates that equity volatility is 3 times higher than for bonds, the strategy leads to modify in the portfolio in order to hold 3 times more bonds than equities and this is generally achieved by creating a leveraged position on the bond allocation. Apparently, some investors believe that the last 30 years of declining yields have made this sector invulnerable.

36. It is difficult to know how many follow this concept, but as the legendary investor Warren Buffett rightly said : "If past history was all there is to the game, the richest people would be the librarians."

37. Therefore, we continue to be under-invested in this area and remain focused on equities.

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Equities (38-47)

38. Equities, where by the way a lot of skepticism remains among investors, which we believe to be healthy for our holdings.

39. One of the arguments of the skeptics is that since equities have greatly benefited from lower yields (this is indeed correct), any increase in interest rates could only be bad for stocks.

40. This point of view does not convince us, on the contrary. We are more concerned about the fact that the long-term US yield has fallen 0.5% this year than if the opposite had happened. Indeed, a moderate increase in rates that would come from an acceleration of growth can easily be digested thanks to the higher profits that come along. Therefore the danger today is the opposite as the yield's fall may be forecasting a slowdown in the economy and thus reduced profits.

41. For the moment, we consider that the 0% interest rate policy, the bond purchases by the FED and the current exuberance of investors towards bonds has made this indicator less reliable than in the past. However, we would not like this move to continue for too long.

42. In summary, we believe that currently only a sudden and significant move in interest rates could adversely and sustainably negatively influence stock markets. Any progressive and proportional increase will have little impact, as was the case when the 10-year yield rose last year in the US.

43. Another bearish argument is that based on the traditional historical measures equities are expensive. For example, the ratio of price to forward earnings has rarely been so high and it is already above the 1987 and 2007 levels.

44. Others worry about the fact that the companies' profit margins are well above historical levels and that they will have to drop sharply in the future to return to the average.

45. In fact, on these last two points, the question is really whether US growth has peaked or if there is still room for improvement. Recessions do not happen spontaneously. In most cases they are linked to the central bank's desire of slowing down the economic activity. This is currently not the intention of the FED. In other cases, it comes from an excess of euphoria leading to a misallocation of resources, as was the case with the US real estate bubble. Here again, there are no signs that something like this is going on. And then there are the cases where it is political events which bring a recession.

46. From our point of view, at the current level the US stock market is at its fair price and therefore any increase that would be linked to improved corporate earnings can be justified. However any rise that would come, like last year, primarily from an increase in the valuation of companies would push equities toward the same excesses that we see today with bonds.

47. By the way, it is a scenario which could happen if confidence towards equities increases among investors. But before this can happen, there will probably be the need of a rise of yields leading to bond losses, but without this evolution hindering the continuation of the bull equity market.

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Equities (48-49)

48. And it should be mentioned that in Europe the situation is even more favorable because, as a result of the euro crisis, European equities are lagging quite a lot compared to the American ones. A market such as the DAX should bring many joys to investors since the current level of interest rates in Germany is too low relative to the level of its economic activity. Growth will also benefit in particular from the strong domestic demand which will follow the increases in real wages that German workers are receiving.

49. Only a deepening crisis with Russia and/or a significant slowdown in China seems to have the potential to derail the German locomotive.

Currencies (50-55)

50. Since the beginning of the year, the euro is down 4 % versus the dollar. This move can be explained, on the one hand, by this summer's fall of European stock markets as withdrawing foreign investors sold their euros and, on the other, by short positions against the single currency in anticipation of a QE by the ECB.

51. The downward move could therefore stop if foreigners return to European stock exchanges and if the ECB, as we expect, does not do much more this year than what it had announced in June.

52. Another difficulty is that currently the US balance of payments deficit is USD 400 billion per year, while the surplus in the euro area is of EUR 300 billion.

53. To compensate for this gap there may be a need for the economic situation to worsen once again substantially in the Eurozone. This seems unlikely as, even if anemic, growth exists. There is also the possibility of a political shock, with Russia for example, or a popular revolt in a country of the area that is poor economic health.

54. One could also imagine a marked improvement of the US situation, but short-term interest rates will need to reach at least 1% to begin to attract depositors and this will not quickly happen.

55. In conclusion, currently we have small currency oscillations linked to micro-events and it would be surprising if significant moves occur in the near future or even if volatility quickly reappears in this sector.

Commodities (56-58)

56. At USD 1'287.- per ounce, gold's rise was stopped; a sign that the deflationary pressures, particularly in Europe, are very much alive. But its decline has so far only been modest suggesting that the global economic situation is not deteriorating.

57. And an important metal such as copper also managed to preserve most of its gains of the past quarter, thus indicating that China's growth remains acceptable.

58. The good surprise came from the decline in the price of oil despite the geopolitical events. At its current level it is exactly at the average price of the last five years and is therefore not an obstacle to economic development.

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Commodities (59)

59. For commodities in general, as is the case with currencies, unless a crisis appears linked to a political event, there is no reason to expect that this sector will provide many strong emotions in the near future.

Conclusion (60-65)

60. And if the rise we expect on bond yields occurs smoothly, without major shocks and if the stock markets' rise remains reasonable, then we could enter into quite a long phase of volatility hibernation unknown to any of today's active professionals.

61. It is also the strategic question facing big banks now. Without volatility, traders cannot make money and so there is no justification for institutions such as Citibank or Goldman Sachs to continue to maintain such a costly machine within their division called FICC : Fixed Income, Currencies, Commodities.

62. They all hope that the end of QE and rising interest rates next year will change the situation, but we feel that, unlike 2006/07 - when the decline in volatility seemed artificial - this is not the case today.

63. It is possible that the countries' level of indebtedness is acting as a brake, preventing the economy to jump forward as it used to do because governments cannot spend as before to restart the economy. Thus, with no big accelerations, strong slowdowns should not happen and therefore there is no need for the financial markets to violently adjust as in the past to constantly changing economic situations.

64. In fact, such a scenario would be quite favorable in the long run for the economy as it would force countries to make the necessary structural changes. Once this would be accomplished, growth would returns, albeit not as strong as before but more solid and sustainable. In such a scenario, stocks would benefit the most in the financial sector.

65. And at that point we would be back in a world where it will no longer be necessary for good economic news to be considered as bad financial news.

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