Market Outlook

A monthly commentary by Gabriel V. Safdié
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5 YEARS LATER

Generalities (1-8)

1. Alternating between up and down phases, April was at the end a month without major changes, as illustrated by the fact that the FTSE World Index was down 0.80 %.

2. In the US, we are seeing for several weeks now a rotation out of tech stocks, which had substantially increased in recent months, towards more traditional sectors. Thus, the Nasdaq index fell by 2 % for the month, while the S&P increased by 0.6 %.

3. Europe had a better performance, with the CAC40 up 2.2 % and the Euro-Stoxx50 up 1.2 %. Among developed countries, Japan continues to distinguish itself negatively, since the Nikkei fell in April -3.5 % and the decline since the beginning of the year has now reached 12.2 %.

4. Finally, the strong increase of emerging markets in March did not extend to April, as the Emerging Markets Index was up 0.8 %.

5. Regarding bonds, the month was also characterized by up and down moves with no significant change. Thus, the 10-year US government bond yield rose from 2.72 % to 2.80 %, and then decreased to 2.62 % to end the month at 2.65 %. In Germany, the equivalent yield was 1.50 % at the end of April.

6. There was no change either for junk bonds with the yield's premium in relation to the US Treasury, currently at 3.65 %, remains well below the historical 6 %.

7. There was also a new increase of the CRB commodity index (+1.6 %) thanks once again to agricultural commodities such as coffee (+14 %). But metals, nickel (+15.2 %) for example, have also contributed to the rise.

8. Finally, the forex market remains quite boring with the euro against the dollar fluctuating during the period between 1.37 and 1.39 to finish the month at 1.3860. And for the third consecutive month the yen/dollar parity remained around 102-103.

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Equities (9-17)

9. 5 years have therefore elapsed since the low for equity markets. For the S&P it happened on March 6th, 2009 at 666.79. And since then the index rose by over 170 %. The aggressive easing policy of the FED has thus been very positive for equities and, more generally, for all US assets.

10. Elsewhere, the rise has been less flamboyant since, expressed in USD, it is only around 90 % for the Euro-Stoxx50, the Nikkei and the EEM emerging countries index.

11. But they behave quite differently. Before Mr. Draghi vigorously committed himself to protect the euro in the summer of 2012, the Euro-Stoxx50 had risen only by 15% from its 2009 low. The EEM index did the opposite; it reached a peak in July 2011 and since then it is down around 20 %. Finally, almost all of the Nikkei increase happened within 6 months, from November 2012 to May 2013.

12. In this context, it is not surprising that some sectors of the US stock market show signs of exuberance reminiscent of the Internet bubble of the late last century. This is particularly the case of the Nasdaq Biotech Index, which is up 280 % over the last 5 years, including a 60% increase in 2013. The problem is that if 25 % of the index' companies are profitable, the other 75 % are losing money. Thus, if one calculates the Price/Earnings ratio taking in consideration the negative earnings, one gets the figure of 2'000 !

13. And once again we see the same combination of irrational investors' hopes expecting these companies to quickly discover effective and profitable medicines, linked to momentum, where a rise leads to another rise. This is how we end with valuations in fantasy land. It is obvious that most of them will go bankrupt without ever having been profitable.

14. And if momentum trading has always existed it has increased enormously over the last 5 years due to the appearance of high frequency trading (HFT) - i.e. the buying and selling of a stock sometimes in less than one second. This is possible because each trade takes less than 110 microseconds to be done, which is about the time needed for a human being to wink.

15. And this HFT represents today 50 % of the daily volume of equity markets and 1/3 of the foreign exchange market. They create, as we have already mentioned, the illusion of liquidity, since in reality they will keep a position only for a few moments. One of their goals is by the way to benefit from their speed to front run a purchase order of a "normal" investor - which progresses more slowly in the computer systems - and buy this security before the investor in order to sell him at profit the next instant. This is another form of insider trading.

16. Actually, the problem is even more serious than just obliging investors to pay a hidden tax since, as soon as volatility increases too much, they move out of markets. Thus, suddenly, at a time when volume is rapidly growing, a large part of the pipes through which orders navigate are suddenly closed, with the consequences that one can imagine.

17. HFT also accentuated a trend that the 2000 crisis, followed by the 2008 one, encouraged : among investors there are fewer and fewer who take long-term positions and more and more who just follow a move, whichever it is. And, the greater the numbers of participants following this short term approach the more other managers have to do likewise. Indeed, if you are a traditional manager looking for good shares at attractive prices you will be forced to capitulate and to follow the crowd, because otherwise your performance will be too far away from your competitors for 1 or 2 years and your own existence could be questioned.

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Equities (18-30)

18. This means that the market has become much more unstable than before 2008. During a bad day there are a lot of sell orders, but very few purchase ones, so that we now need a price move much larger than in the past to balance supply and demand.

19. This leads to a kind of paranoia among money managers : as soon as the market goes down - and now in a bigger way than before - the return of 2008 is feared, but as soon as it moves up - faster than yesterday - there is the panic of underperforming.

20. And to this uncomfortable situation, one must presently add the fact that the US stock market has already integrated a lot of good news. Goldman Sachs indicated that from 2012 to February 2014 the expected Price/Earnings ratio moved up from 12 to 16 with the consequence that 2/3 of the 45 % rise of the S&P during this period were due to valuation expansion rather than better earnings expectations. This is clearly a phenomenon which cannot continue.

21. Profits have now to increase and we presently believe that this will be the case for developed countries. Furthermore, it is not unreasonable to expect that European equities will outperform US ones, since their valuations are more attractive.

22. The only negative element - and it is a major one - are emerging markets.

23. Firstly in China, where increasingly it appears that growth is "normalizing". This means that there will be no return to the past exuberant growth rhythm, but also that an economic crash, expected by some, will not happen either.

24. Most likely, annual growth of the economy will stabilize at around 7 %. This is a very respectable figure, but it will lead initially to a reduction in investments as the needs will be reduced.

25. And in such a scenario the deflationary wave which started 12 months ago - and which has been illustrated by gold’s 30 % decrease - is expected to continue, as China will be brought to globally reduce its imports from commodities to luxury goods.

26. The other problem for emerging countries is that if China is excluded, the combined deficit of their trade balance has reached 2.4 % of GDP. It was the level reached just before the start of the emerging crisis in 1997.

27. Certainly, conditions today are quite different from 1997. In particular, the foreign exchange reserves of these countries are far higher than then. Also, the current economic situation indicates that the present deficit of USD 385 billion per year can continue to be funded from abroad without problems and this despite the fact that one is aware of the market's ability to transform in 24 hours an ocean into a desert. Nevertheless, sooner or later, their currencies will have to decline to restore the equilibrium.

28. Meanwhile, the difficulty which appears is that given their current fragility, the above mentioned Chinese slowdown could have a larger than usual negative influence on other emerging countries.

29. Weighing the pros and cons, we continue to be invested in equities of developed countries, as the path of least resistance remains upwards thanks to the - oh so slow - improvement of Western growth.

30. Also, the 20 % fall of the biotech index since the end of February is an encouraging sign that excesses can be corrected relatively quickly. Rotation out of these equities towards more properly valued securities is fairly healthy and it would be essential that this continues.

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Equities (31-32)

31. Furthermore, the markets' behavior of the last 5 years suggests that among financial assets, Western equity markets could have the best performance this decade.

32. But as one still needs to be able to surf on the volatility, he should not be too heavy and therefore exposure to this sector should be kept at a reasonable level. Ourselves, we have sailed depending on the changing circumstances between 20 and 40 % during the last 5 years and this is what we still recommend.

Bonds (33-40)

33. It is also interesting to note that 1/3 of the capital invested in equities - as we have advocated since then - brought the same remuneration as 100 % invested in investment graded bonds 5 years ago. Simply, in the second case, the risk exposure was higher and would have had more serious consequences if the worst, which was expected by many, had happened.

34. These are the figures : the FTSE World Index rose by about 18 % per year over this period, while in 2009 the 10-year US government bond yield was around 3 % and lower quality bonds were around 5-6 %. For comparison, junk bonds were at more than 9 %.

35. It is therefore interesting to note that 5 years later the decline of the sovereign bond yield is only of 0.5 %, but that the decline in the risk premium has been spectacular, since it is even, as we previously mentioned, at a far lower level than its historical average. Once again, thanks to the FED.

36. For several months we have been indicating the dangers linked to bond positions, taking into consideration their insufficient yield. Here is another example : Marty Fridson, a high-yield bond specialist, estimates that losses related to US junk bonds will be approximately USD 1.6 trillion if the default rate during the next slowdown phase rises back to the usual 10 % level. It is currently at 2.4 % against an historical average of 4.6 %.

37. He does not think that this will happen before 2016 as he expects growth to accelerate before slowing down again. His vision is therefore identical to the consensus - to which we belong ourselves - that the situation will continue to improve. However, should this not be the case, the number of defaults could quickly start to rise.

38. Another concern for investors is that, faced with these pitiful yield levels, traditional bond funds are in the process of transforming themselves into bond funds with no investment restrictions. This means that if previously each one invested in a well-defined area, they will now be able to invest anywhere geographically, in all kinds of debtors good or bad, with a very short or very long duration. They will even have the opportunity to position themselves short bonds in order to benefit if yields rose.

39. This means that the bond world is about to evolve towards what has become the world of equities which we have described above. Managers will therefore increasingly copy each one and feel compelled to buy and sell a lot more often than today. This will contribute to the increase of volatility that we expect in this sector.

40. And the question which arises is whether they are not in reality becoming hedge funds in disguise.

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Bonds (41-44)

41. The other fashion we are currently witnessing is the explosion of market neutral funds, which hope to obtain a return of around 4-5 % per year, regardless of the market direction. Here also, the funds' strategy is based on historical volatility models, with the irony that their own dynamic management will mechanically contribute to its increase.

42. Moreover, in a period such as the one which started at the beginning of the year - with it's up and down moves, but no net change - this type of strategy does not work very well.

43. Unlike many, we did not consider that the quantitative easing policy by itself would be inflationary and that is why we have never recommended to be positioned to benefit from an eventual rise in yields.

44. Our problem is simply that yields are insufficient compared to the risks taken and that an investor is not paid enough for any unforeseen event.

Commodities (45-49)

45. We have previously mentioned how important it is for copper to remain above the level of USD 300.- because if this support is broken, technically the metal would then be vulnerable to a return to the lows of 5 years ago, when it was trading around USD 220.-.

46. This is currently the case but all danger cannot be discarded if what seems to be going on in the Chinese economy is confirmed. As a matter of fact, the possible decline in demand which we have mentioned above could then heavily weigh on its price.

47. Unlike equities and bonds, the rise in this sector has been more modest since the index is up 40 % in the last 5 years.

48. 40 % is also the rise of gold despite last year's fall. Oil has meanwhile doubled in price and copper rose 50 %.

49. All commodities are up, but the weaker moves - of around 20 % - are on agricultural products such as cocoa and sugar.

Currencies (50-52)

50. 5 years ago the euro traded versus the dollar at 1.30; in November 2009 it reached 1.50, before falling to 1.22 in June 2010. 9 months later, it returned to 1.48, before the crisis in the Eurozone send it back again to 1.23 in July 2012. Thus, at its current price of 1.38, the euro is right in the middle of this 1.23-1.50 trading range.

51. The ECB is trying "through chatting" to bring down the euro, but it is unlikely that it will succeed given the fact that the balance of payments of the area is very positive and that there is not a particular interest to invest in USD.

52. Only an aggressive policy of bond purchases - as the FED or the Bank of Japan (BOJ) are doing - could allow it, but it is unlikely that this will happen quickly. The contraction in the Eurozone is now over as the Mediterranean countries are now living within their means. And the simple fact that the bulk of public spending cuts is behind us will mechanically allow the area to have a stronger growth this year; and it should further increase in 2015. The difficulty that it will still be insufficient to substantially reduce unemployment.

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Currencies (53-55)

53. The yen against the dollar traded 5 years ago at 100, i.e. the same level as today. But this hides the fact that for the first 3 years the yen moved up to 75 before the dramatic intervention of the BOJ.

54. Currently, the yen is no longer depreciating. But speculators remain positioned towards a weaker Japanese currency, since they believe that the BOJ will be forced to increase its bond purchases. Thus, either because it does act or because it does not, this exchange rate is the only one who should be able for now to bring some volatility to a lifeless sector.

55. As was the case with Brazil, many emerging countries saw their currency rise with their stock markets until 2011. Thus, the Brazilian real rose from 2.20 in March 2009 to 1.54 in July 2011. It has now returned to its starting level but, as we have already mentioned, like many other currencies of emerging countries, it needs to weaken further.

Conclusion (56-62)

56. 5 years after what economists now call the Great Recession, the situation has not yet normalized. While asset prices have recovered thanks to the liquidity injected by central banks, unemployment remains high and Western workers income is still either stagnating or declining.

57. If investors' fears of a return to recession have disappeared as illustrated by the current risk premium on bonds, the situation remains fragile and the global economy would have difficulties withstanding an unexpected negative event.

58. Moreover, despite all the efforts of Western central banks, deflationary risks have not been removed and this is reflected by the fact that the ratio Debt/GDP continues to deteriorate, while in a "normal" economic recovery phase the opposite should be happening.

59. But we have also been lucky. First, China, through an aggressively lax credit policy in 2009 and 2010, helped growth to remain quite strong in the country, thus acting as the locomotive for the entire global economy. And then, when it slowed in 2011, America took up the baton.

60. Currently the market expects that the US economy will continue to improve and that Europe has now entered the same favorable path taken by the United States in 2011. Thus, assets are presently priced for such a scenario.

61. It is therefore necessary in order for stocks to continue to rise that tangible signs appear confirming this outlook. And as long as this does not happen markets will stagnate.

62. For the moment, insofar as there are no signs that the expected scenario may not occur, we remain positioned in favor of equities.

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