

A monthly commentary by Gabriel V. Safdié  
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## 2014 IN 2014 ?

### Generalities (1-7)

1. After starting the year with a continuation of the rise of developed countries' equities, the end of the month was characterized by investors suffering an anxiety attack

2. Thus, markets ended January in the red : S&P -3.6 %, Nasdaq -1.7 %, DAX -2.6 %, Nikkei -8.4 % and MSCI Emerging Markets in USD -8.6 %. All this can be summarized by a 4 % fall of the FTSE World Index.

3. Unsurprisingly, this favored the asset which was the less liked i.e. government bonds, since the 10-year US government bond yield declined from 3 % to 2.64 %, while its German equivalent moved down from 1.93 % to 1.66 %. On the other hand, yields remained unchanged for junk bonds.

4. In the foreign exchange market, we saw a further decline in the commodity related currencies such as the Australian dollar (-15 % approximately against USD in the last 12 months) or the Canadian dollar (ditto : -10 %).

5. But the most significant declines during the month came from the emerging markets' universe with noteworthy falls against the USD of the currencies of countries such as South Africa (-5.6 %), Turkey (-4.8 %) or Brazil (-2.1 %). Therefore, the JPMorgan Emerging Markets Currency Index has now declined by more than 20 % against the US dollar from the peak reached in May 2011.

6. In relation to the major currencies, the greenback ended the month up against the Euro at 1.3490 and down against the yen at 102.

7. Finally, it is interesting to note that the commodity index actually rose 1.1 %.

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## Equities (8-18)

8. 2014 in 2014 ? This is the level at which the S&P could finish the year if analysts' expectations are fulfilled. It would represent a 9 % increase for the index.

9. But before this happens, investors will have to overcome their fears. Although a correction was long overdue, the current one is explained by the fact that investors have realized that equities are no longer cheap and this at the same time when the press was making much noise around the idea that since more than 400 days have elapsed without a 10 % correction of the MSCI World Index, consequently the probability of such a move had greatly increased. Who knows why 400 days became such a magical number.

10. There was also the discomfort to know that at the beginning of this year, the number of participants expecting a market decline was at a very low level.

11. And these factors combined themselves with two older ones : the crisis in some emerging countries and the growing uncertainty regarding the situation of the Chinese economy.

12. Furthermore, it is quite interesting to mention that the US media was buzzing about whether or not there is currently a bubble in the US stock market.

13. To this the answer is quite simple : the very fact that the question is being asked indicates that this is not the case and also that is quite likely that it will not happen.

14. Indeed, for a bubble to occur, the first condition is that the majority of participants had not experienced a previous one. Secondly, euphoria must be such that all the warning signals are ignored because "this time is different". Obviously this is currently not the case.

15. Switzerland, for example, experienced a real estate bubble in the late 1980s and its burst resulted in heavy losses for banks. This episode is still in the national memory and explains why, for a year now, authorities are taking strong measures to cool a sector which is certainly expensive, but where prices are still in line with disposable income or rent prices.

16. In the United Kingdom, on the contrary, despite the fact that prices are already 30 % above the desirable level according to the two criteria of income and rent, the government has taken new measures to allow buyers to increase their indebtedness. Therefore, it is not looking to cool things, on the contrary. By the way, the situation is similar in Canada, where the central bank is doing nothing to contain an overheated real estate market. It is therefore the national trauma that counts and from this point of view the US real estate crisis does not act as a warning to other countries.

17. But the fact that we are not in a bubble does not mean that a bear market - i.e. a drop of more than 20 % from the peak - cannot occur, as it was the case in 2008, for example. However such a drop must anticipate a recession.

18. However, a recession can only occur in three scenarios. The first one is a political or environmental event of high intensity. For example, a quadrupling of oil prices as it happened in 1973. This scenario being by definition unpredictable, investors have not therefore the means to effectively protect themselves. One can simply notice that presently, despite increased tensions between China and Japan, there is nothing really tangible to indicate that there is the risk of a major political event which could negatively influence the global economy in coming months.

## Equities (19-30)

19. The second possibility would be a tightening of monetary policy. However, currently, there is no way that the FED would take any action whatsoever that might impact growth. It is rather the opposite. The FED's objective remains to do its best to help the economy accelerate. One could also imagine that an unwanted monetary tightening happens through significant higher long term interest rates. But such an assumption would imply that economic growth is significantly better than current expectations, which at first would be quite positive for equities. One can also note that for the time being government bonds are behaving in a conventional manner with yields falling as the stock market declines.

20. Therefore, a single possible scenario remains : an increase in deflationary pressures to such an extent that the liquidity barriers put in place by the FED would be broken. This is a scenario which worries us, since deflationary pressures have sharply increased in recent months, as was forecasted by the sharp fall of gold last year and they have now fully appeared in the emerging world.

21. For months we have been mentioning that US economic recovery remains fragile since real income continues to deteriorate and an increase in investment spending has not yet happened. There is also the possibility that the quantitative easing policy has reached the limits of its effectiveness.

22. But at the same time, the economy has gained enough speed for growth, even weak, to be maintained. Furthermore there is currently no sign that growth could slowdown significantly.

23. Regarding the worsening situation in emerging countries, it is for the time being insufficient to materially affect the United States. Moreover, there is a large heterogeneousness in their situations.

One just needs to compare, for example, the situation between Turkey and India.

24. The only thing which could really be destabilizing would be a sharp slowdown in Chinese growth. But on this subject there was nothing really new in January.

25. In summary, the beginning of the year's decline looks more like a correction than a real trend change.

26. This is the reason why we are maintaining our equity exposure, while being aware that the volatility could be higher this year than in 2013.

27. And it is not ruled out that the rise for US equities may be poor - or nonexistent - this year, if the market takes its time to digest last year's huge increase. However, this could allow other stock markets to catch up at least partially.

28. On this subject it should be noted that in the United States, if January is negative, there is a high probability that this will also be the case for the whole year. The few exceptions, such as 2009, for example, occurred after a relatively large decline in the previous year; which is obviously not the case today.

29. In addition a fairly reliable model from the asset manager GMO regarding the returns that can be expected in the long-term – indicated at the end of 2013, that the average annual real return on large US capitalizations will be -1.7 % for the next 7 years.

30. Therefore we could be in a situation where if in the short-term the situation remains favorable to the stock market, in the medium-term this asset, as others, will be under pressure by the normalization of interest rates. And one could even expect that in real terms the decline will be higher for the real estate or the art market than for stocks.

## Equities (31)

31. Finally, one should note that this situation is specific to the US, where the stock-market recovery has been particularly quick. There is still room for improvement elsewhere, illustrated by the fact

that GMO's model expects an annual real increase of 1 % for major foreign capitalizations and of 3.5 % for emerging countries. Anyway, in all cases, we remain far away from the real historical returns of US equities of 6.5 %.

## Bonds (32-39)

32. So, deflationary fears have surfaced in recent weeks, to the point that the IMF chief Christine Lagarde declared that "If inflation is the genie, then deflation is the ogre that must be fought decisively".

33. This awareness is healthy and illustrates the change of paradigm of central banks. Today, inflation is not to be fought; on the contrary, it is even desired. Thus, sooner or later their wish will be achieved.

34. This is even more likely since a growing number of influential economists, as for example those from Harvard University, Carmen Reinhart, Kenneth Rogoff or Larry Summers, are calling for a policy to push inflation up since in their views this would help the United States move out from the current stagnation. In addition, they support the idea of an ambitious public spending program to develop the country's infrastructure. In this regard, history will probably consider as a mistake the fact that countries around the world have not significantly increased their investment spending by taking advantage of low interest rates, while at the same time reducing their day to day public spending.

35. And all, politicians and economists, are following with keen interest the Japanese experience, which has today the most aggressive reflationary policy.

36. Meanwhile, the fixed income sector continues to benefit from an economic environment which is neither too hot nor too cold and from the fact that low interest rates have pushed normally conservative investors to position themselves in the junk bonds area.

37. But one must be aware that this kind of bonds remains strongly connected to the stock market and a significant reduction of the latter would also result in a significant increase in yields and therefore much lower prices on these bonds.

38. This is particularly the case for subordinated bonds issued by banks. With these bonds the capital is at risk if the bank's financial situation deteriorates since their goal is to allow the banks to recapitalize themselves using these funds to the detriment of the bondholders. Thus, if the economic situation is good it is unlikely that the banks will suffer heavy losses. But, if on the contrary the opposite were to happen and therefore losses may potentially increase, bondholders could be at risk of suffering a loss. It will then be very difficult to value them since if the prospectuses clearly mention the risk of a partial or total loss of capital and also the possibility of a forced conversion into shares, it is left at the discretion of the bank to decide when and how to do such a move. This is why some professionals call them "sudden death bonds".

39. This explains why we still advise that instead of investing 100 in junk bonds, it is more sensible to purchase 30 in quality stocks while keeping 70 in the safest possible manner. This may seem paradoxical, since equities increase volatility. But on the long run this strategy provides a lower risk exposure, with a performance identical or superior.

## Currencies (40-47)

40. The significant decline in January suffered by emerging countries' currencies indicates that their growth continues to deteriorate. And even if it would be surprising that the current crisis reaches the 1997 climax – since financial imbalances are today much smaller - it still remains a negative factor for the global economy. And for the time being, despite the decline already registered, one should not try to bottom fish.

41. However, currencies of commodities rich countries such as the Australian or Canadian dollar, which have also suffered much, have reached attractive levels, particularly if commodity prices stabilize.

42. It is interesting to mention that in 2008-09, at the peak of the crisis, the Australian central bank did lower its key interest rate only to 3 % before raising it back to 4.75 %. But today, while the situation is much better than in 2008-09, the rate is at 2.5 %. Clearly, the bank wants to weaken its currency despite a very respectable growth in 2013.

43. The same reasoning can be done for Canada, where the governor of the central

bank continues to show its desire to weaken its currency, even if the country's growth last year was higher than in the US.

44. This means that since their economies are performing well, if global growth improves as expected, both will be forced to react much quicker and much stronger than expected.

45. In fact, today's reality is that no central bank wants to be the first to raise its key interest rate, nor does it want its currency to strengthen.

46. Among the currencies of developed countries, the ECB is currently the most restrictive central bank. Consequently, this tends to benefit the single currency. And it will be interesting to see if the ECB will show signs of unease if the euro were to rise beyond 1.40 against the US dollar.

47. In any case, the rise of the euro is a curse for most countries of the area and one can note that the pressure has substantially increased on the ECB to fight against what is perceived as a deflationary threat; threat which increases with a euro rise.

## Commodities (48-51)

48. It is interesting to mention that neither commodities, nor gold have fallen with the market's correction.

49. This means that deflationary pressures are not increasing for the time being. It is significant since it indicates that the current deceleration among emerging countries is counterbalanced by an improvement elsewhere.

50. And from this point of view, a rise in gold would be a very positive leading

indicator of an improvement in global growth. A rise in gold would also help calm down existing fears about the risk that despite all the central banks' efforts, fiscal and monetary policies taken together, could currently be too restrictive taking into consideration the deflationary pressures.

51. Consequently, one can consider that in the current environment, a sustained increase in equities would require at least a stabilization of gold prices at current levels.

## Conclusion (52-57)

52. The market's decline at the beginning of this year should be considered as a warning to investors. It is likely that last year's performance of the US stock market was twice what it should have been. Therefore, if the result this year is close to 0 %, the equilibrium would then be restored and fears of an overvaluation of shares would fade. This is why it is not obvious that 2014 in 2014 can so easily be achieved.

53. Moreover, it is time for the rest of the world to show signs of recovery as tangible as in the United States in order to prove that the situation is effectively normalizing. This should then translate in an outperformance of these markets.

54. Some are worried by the fact that the current bull market has been going on for long time and that therefore a bear market should not be too far away. And it is true

that if we were in a normal situation, central banks would now be starting to tighten their monetary policy bringing then an end to the move. But this is not the case presently.

55. We consider that since the worst postwar recession resulted in the weakest economic recovery since 1945, it is reasonable to expect that the rise will be, in terms of duration, the longest since the war.

56. Thus, if deflation risks can be contained, the bull market should continue at least until the end of 2015. And this even if one should be aware that in a world in which interest rates are close to zero, stock markets' double-digit increases will remain the exception rather than the norm.

57. In conclusion, we believe that risk taking should continue to mainly be done on equities.