SAGA Market Outlook

A monthly commentary by Gabriel V. Safdié
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ACCELERATION IN SIGHT

Generalities (1-6)

1. Wall Street's new norm : "a completely dead day". This is how the Wall Street Journal recently headlined regarding the very low volatility in the financial markets and which can be illustrated by the fact that for the S&P 500 it is currently at a level only reached in 1 % of the market's trading days since 1970.

2. And this is happening just as the US stock market is regularly breaking its record. One should therefore have expected more euphoria from investors. Anyway, in June, US markets once again performed well : +1.9 % for the S&P, +3.9 % for the Nasdaq and this was also the case for the Nikkei +3.6 % and the EEM emerging countries index in USD : +1.6 %. Only Europe was down : -0.5 % for the Euro Stoxx 50 and -1.1 % for the DAX.

3. The US bond yields remained almost unchanged at 2.53 % for the 10-year US Treasury bond, while its German equivalent moved down from 1.36 % to 1.24 %, as was also the case for the Bloomberg USD High Yield Index from 5.25 % to 5.09 %.

4. Quietness likewise on the foreign exchange market, with a virtually unchanged dollar against both the euro (1.3690) and the yen (101.30).

5. Finally, a small increase (+0.9 %) in the month for the CRB commodity index but once again with a high amplitude of performances : up for silver (+12.4 %), but down for orange juice (-11.7 %).

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Equities (6-15)

6. Since 2009 we have been mentioning the economic battle between deflation and inflation.

7. At its heart is the current trend of the economy to naturally move towards deflation. This is due, from the one part to globalization which, if it allowed millions of workers in the poorest countries to access the labor market, has also put under pressure the wages of Western workers, and, on the other part, to the technological developments which by allowing significant gains in productivity, contribute to lower prices.

8. Normally, such a development would have been welcomed, since it increases the citizens' purchasing power by providing them with better goods and services at a lower cost. And indeed, this was the case in the nineteenth century and during the first half of the twentieth, when deflation was quite common.

9. But today the situation is different due to the high level of governments' indebtedness, since deflation would make the debt service impossible. Also one needs to add the fact that, if a century ago the state weight in the economy was in peacetime of around 10 to 15 % of GDP, it has become far heavier in our modern economies since its spending - and therefore the taxation that goes with it - is now between 35 % and 55 % of the annual GDP. This makes things more difficult since its ability to reform itself and to adjust its spending to its means is much lower than for the private sector.

10. Furthermore, as illustrated by a recent Portuguese example, even when there is political will, other blockages are common. In Portugal, the country's constitutional court cancelled a measure aiming to reduce the salary of government employees, thus making even more difficult a return to a balanced budget. From this point of view, inflation rather than deflation would have helped the government, since its objective of reducing costs could have been achieved in a simply passive manner by increasing wages less rapidly than inflation.

11. This deflationary pressure had already prompted central banks to keep, since the stock market fall of 2000, their base rate at the inflation's level. The real return for the investor had therefore become nonexistent.

12. And the 2008 financial crisis, with the dangers it created for the banks and the financial system in general, forced the US central bank - the FED - to have an even easier monetary policy with negative real yields and this with the dual purpose of restoring the banks' health and not allowing deflation to take hold.

13. However, even once these objectives were achieved, the FED continued to apply increasingly higher doses of its medicine - the monetary easing policy (QE) - in order to boost growth. And it is striking to note that even now, while the US situation is much better than in 2009, the QE still in force today is larger than the first QE program of 2009.

14. This can be explained by the fact that the FED is very comfortable with this medication, since the side effect - which would have been inflationary pressures, and which were expected by many - did not materialize, while the benefits it brings can be seen in the fact that the United States has currently the strongest growth among the major developed countries.

15. And noticing this, little by little, the other central banks followed the US move. And even the most conservative one, the European Central Bank (ECB), has finally recognized at the beginning of June the deflationary risk in the euro area and thus developed a first set of easing measures which were deemed satisfactory by the market. Market which was moreover comforted by the fact that Mr. Draghi - chairman of the ECB – declared that he was far from finished and that he would continue to add new measures in the future.

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Equities (16-25)

16. With this recognition by the ECB and the fact that now this deflationary risk has been clearly identified and fought everywhere, the time has come to declare that the struggle is over : except for a few disinflationary pockets here and there, and unless an unexpected shock pushes the global economy into recession, deflation will not win.

17. And we can go even further. In recent years, we used the image of a plane to describe the global economy : it certainly took-off, but it had not yet climbed enough to reach its cruising altitude. This is the most dangerous moment in a takeoff as the plane has left ground, but the slightest incident can still make it crash. Such was the situation since 2009 in relation to growth : it was certainly present, but it remained quite fragile and the slightest incident could have pushed us back into recession. Fortunately, this did not happen and it now appears that finally growth will be able to accelerate in the US and also to benefit the rest of the world.

18. And a symbol can illustrate our point of view: finally, more than five years after the end of the Great Recession of 2008, the number of Americans having a job has returned to its pre-crisis level. This means that even if unemployment remains high, wage increases will now be inevitable in areas where the shortage of qualified staff will begin to be felt. This will be favorable to consumption and therefore to growth.

19. Moreover, the latest report of the US labor market was very good in almost all areas. Clearly, we have entered a positive loop : growth promotes employment and wages which, themselves, promote growth.

20. Another important novelty is that, for the first time since the crisis, there is a sharp increase in credit demand. Over the last three months, industrial and commercial loans are up 16 % on an annualized basis. And the velocity of money circulation is also in strong acceleration : 7.7 % for M2 and 15.8 % for M1. These figures are also reflected in the increasing number of mergers and acquisitions, which are largely financed by credit.

21. And to this good behavior of the US economy, one must also add the fact that the contraction in the rest of the world is over and that each region will bring, in its own way and even if quite weakly at first, a positive contribution to global growth.

22. In summary, both in the US and elsewhere, growth will pleasantly surprise. And this is not expected by investors, who remain positioned based on the expectation of a continuation of the sluggish growth that we have had so far and therefore they continue to act on the basis of still a long period of 0 % interest rate and of a real return that should remain negative until 2017 at least.

23. Moreover, the market is now convinced that all the liquidity created by central banks - and which indeed continues to be injected - will have no inflationary effect. Rather, it will be the opposite as the press is currently focused on the deflationary fears and this at a time when this threat is in sharp decline. However, if the credit growth that we are witnessing since the beginning of the year should accelerate, it would be logical that inflation moved back to an uptrend, even if a modest one.

24. In conclusion, an improved growth with a moderate return of inflationary risks, synonym of better economic health, will paradoxically be bad news for financial markets, as the adjustment that will be needed in the valuation of assets could be important.

25. If at first, equities should benefit from this faster growth, they will have afterwards to overcome two shocks. The first will be to digest the prospect of a first rise of the US prime interest rate during the first quarter of 2015, i.e. far earlier than expected today.

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Equities (26-32)

26. This rise expectation will create uncertainty. For example, will the economy be able to endure it ? And even if our answer to this question is positive, uncertainty is always a source of volatility and could justify a 10 to 15 % stock market decline in autumn-winter, especially if it continues its recent move up during the summer.

27. But this will not be the beginning of a fundamental bear market, since the goal of the FED will simply be to gradually normalize the situation and not to slow growth. Thus, the stock market may subsequently resume its growth, although with more volatility than presently, thanks to the increase in earnings that comes with any economic expansion phase.

28. From this point of view, we do not share the concerns expressed by the media and by some analysts regarding the markets' current level which should by itself justify an important downward move. Firstly, we are still far away from the investors' irrational exuberance which existed before the 2000 fall. We don't even find currently the euphoria associated with more traditional peaks.

29. And the mere fact that the rise has been going on for 5 years is not sufficient by itself to justify a decline, since, as we have the slowest postwar economic recovery it would not be surprising that this equity bull move be also the longest one of the postwar period. It is not the elapsed time in itself that pushes equities down, but the fact that, in the past, growth having being much higher than presently, this was the moment of the recovery when central banks entered in an active phase of monetary tightening. And this is just not the case today.

30. Certainly, from an historical perspective, valuations are high, but this can primarily be explained by the low level of interest rates. It is equivalent to receive USD 609'000.- today or USD 1'000'000.- in 10 years if the interest rate is at 5 %. But if the rate is 2.5 % as is the case today, this million presently corresponds to USD 779'000.-, i.e. a difference of one third. Therefore, at current yields the market is valued at its fair value. It is neither under or overvalued.

31. The current level could be worrying if we were at the top of the economic cycle, with slower growth on the horizon. However, we expect the opposite to happen which should allow profits to continue to grow. Therefore, it would simply be desirable that from now on the equities' rise be proportional to that growth.

32. In conclusion, a correction defined by a market's decrease of betweem 10 % and 20 % is possible at any time and this is what justifies that the equity allocation for each investor be at a level which allows him to support such a fall without losing sleep. Nevertheless, equities are still currently the most attractive asset.

Bonds (33-35)

33. This is not the case of bonds, which, at current yields, are the most overvalued asset. And the awakening may be difficult if the growth acceleration we are expecting occurs.

34. If a yield's rise is the second potential shock that equities will have to overcome, it will be primarily bonds which will suffer,since in this area irrational exuberance continues to grow.

35. Is it really reasonable that the yield of Italian or Spanish debt be at the same level as the American one ?

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Bonds (36-43)

36. However one should note that there is a reason which explains it. Many articles have been published regarding the increased requirements in relation to the banks' balance sheet and which are known under the name of Basel III. The aim of these measures is theoretically to make banks safer by forcing them to adjust their capital to the risks associated to the loans they give. For example, if a large bank wants to lend EUR 10'000'000.- to a German medium size company at 6 %, it will have to put aside 9 % of the loan to cover a default risk. Thus, the first year it will collect EUR 600'000.- in interest, but it will have to put aside EUR 900'000.- as collateral for the loan. Therefore, its earnings that year will be reduced by EUR 300'000.-. But, if it buys EUR 10'000'000.- of a 10-year Italian bond with a yield of 2.8 % it will not have to put anything aside and it will be able to show an increased profit of EUR 280'000.-. And it could do even better if it bought Greek government bonds, which currently yield 5.8 %. In fact, as strange as it may seem, for Basel III, the holding of sovereign bonds of OECD countries involves no reserve requirements of any kind. Thus, Greek and German sovereign risks are considered to be identical and the probability of default is deemed to be nonexistent for all OECD country bonds.

37. But let’s return to our subject. We are currently seeing a strong increase of new corporate bonds with a 50-year maturity. This flatters the current profitability of a bond fund, as they are currently paying 0.2 to 0.3 % above a 30-year bond yield. But if yields were to rise next year, at what price will these bonds be valued when there will still be 49 years to maturity ?

38. Another sign of this exuberance is the issuing of what the market calls “catastrophe bonds”. Against a high remuneration, of around 15 % per year, holders agree to cover losses related to natural disasters, such as storms or forest fires. If such an event were to happen, the loss of capital could go all the way up to 100 %. The problem is that, contrary to the normal insurance activity, there is no reliable statistical model for the risk taken. And one must also take into consideration the global warming effect which seems to bring more extreme weather events. Finally, it should be noted that the famous investor Warren Buffet doesn't hold anymore any of these.

39. And we are also witnessing the return of CLO (collateralized loan obligations), which are leveraged securities since they borrow short term funds in order to buy several debtors’ junk loans with long maturities. They are expected to bring 7-9 % per year, but they were blown into pieces during the 2008 crisis because of the leverage.

40. Another sign of a return to the pre-crisis excesses is the issuing since the beginning of the year of USD 4.2 billion of bonds that allow debtors, if they want, not to pay the interest due but to increase the existing debt by capitalizing them. As a matter of comparison, at the previous peak in 2007, the total amount issued for that year was USD 5.6 billion.

41. And one must always emphasize the fact that this important risk-taking is occurring at a time when yields are at record lows and with a market that is valued for perfection, i.e. for the continuation of the sluggish growth of recent years.

42. This perfection also means that any surprise, that sooner or later will inevitably appear, will most likely be nasty surprise for bond holders. And volatility could then become exceptionally high, taking in consideration the level of risk taken and the low liquidity in the sector.

43. And from this point of view, it will be the upheavals in the credit market that will have an impact on the other assets and not the contrary.

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Currencies (44-48)

44. Would a faster US growth be favorable to the dollar against the major currencies ?

45. This is possible, but not certain, since everything will depend on how events will unfold. The central banks' zero interest rate policy has led to a strong correlation between the assets of the countries which have this rate.

46. If this should continue, the dollar could then strengthen. But if, for example, US yields were to move up faster than European ones then, paradoxically, the dollar could first suffer and this as long as the FED has not raised its prime rate at least two or three times.

47. For the time being, we consider that at current exchange rates there is no reason to be a bull or a bear in relation to the USD.

48. Regarding the evolution of peripheral currencies - such as the Australian dollar or the Brazilian real - one can notice that these exchange rates are now correlated with the evolution of their national stock market and with the US one. If both stock markets are up, this leads to an increase in risk-taking and pushes up the currency of the smaller country. And the move reverses once one of the two stock market declines.

Commodities (49-53)

49. The recovery in this sector since the beginning of the year is directly linked to the better behavior of the emerging countries equity markets.

50. But it should be noted that this recovery is not confirmed by the usual economic indicators and that the move up seems to be more technical - these markets were too oversold - than fundamental.

51. And it also seems that the rise is coming to an end and therefore one should expect a continuation of the underperformance of these equity markets compared to Western ones.

52. In this context, it is difficult to imagine that the commodities bull move could continue, except for political reasons, for example with oil and the situation in Iraq. This vision is also related to the fact that a Chinese growth which, as it is likely, stabilizes itself at 6-7 % per year, strongly decreases the pressure on commodity prices.

53. Regarding gold, we are encouraged by the fact that the USD 1'200.- level has not even been tested and that the yellow metal was up 6.7 % for the month at USD 1'327.-. Indeed, our hope for an acceleration of growth is incompatible with a fall of gold, which would mean an increase of deflationary pressures. Consequently, if gold were to plunge, our scenario of growth acceleration would be strongly weakened, or even discredited.

Conclusion (54-56)

54. We have therefore become more positive in relation to global growth.

55. But paradoxically this will create problems for all type of assets which will need to be adjusted to this new situation.

56. The extension of the easy monetary policy by the US central bank with the goal of boosting growth has a harmful secondary effect as it allows for an increase of indebtedness. Thus in 2014, the public debt of the major developed countries added together has returned to the level where it was at the end of the Second World War.

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Conclusion (57-60)

57. The private sector also benefited from this situation by borrowing massively, to the point that today its net debt to GDP is at a record high.

58. Certainly, it is quite logical for debtors to borrow the maximum they can, given the current rates, but for lenders the situation may become more difficult, especially when this mountain of debts will face the expected growth acceleration.

59. Of course all assets will then experience volatility, including equities. But shares will benefit in the long run of the increased profits which accompany better growth.

60. This is the reason why we still continue to advise that the main risk-taking be done through equities, but at a level which will not be too uncomfortable for the investor once volatility increases.

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