A monthly commentary on financial markets
by Gabriel V. Safdie written on august 2nd, 2016

THIS TIME IS DIFFERENT

1. Upset by being wrong on the Brexit outcome, investors reacted by selling equities. Thus, EUR 19.2 billion were withdrawn from European equity funds in June, i.e. the highest level in a year. But insofar as the consequences of the vote are limited in the short-term (except for investments in the UK), but important in the long run for the impact it will have in the European Union, once the bad mood was overcome, markets regained their footing.

2. Thus July was a month clearly in the green with even new records for the S&P 500, which ended the month up 3.6 %. The other markets also performed well : +6.6 % for the Nasdaq Composite, +6.8 % for the DAX, +4.4 % for the Euro-Stoxx 50, +6.4 % for the Nikkei and +5.3 % for the MSCI Emerging Markets index in USD.

3. Regarding commodities, after 4 months of consecutive increases, the CRB commodity index fell 6 %. The index is now at its 200 day moving average and if it can rebound successfully from this level it will increase the odds that the current 16 % move up from the February 2016 low represents a trend reversal.

4. The currencies market was again the quietest sector with not many changes and the dollar ending the month at 1.1175 against euro and 102 against yen.

5. Finally in the bond sector, the yield on the 10-year US Treasury was almost unchanged at 1.45 %, while its German equivalent safely remained in negative territory at -0.19 %. And at 6.73 %, the Bloomberg USD High Yield Corporate Bond's yield has moved back to its level of 12 months ago.

6. Bond yields have therefore remained close to their record low levels prompting Mr. Alan Greenspan, the former chairman of the FED to declare : “We get very nervous when the stock price goes to high P/E, we ought to be somewhat nervous when the bond rate does the same".

7. And it is the same Alan Greenspan who on December 5th, 1996 delivered a famous speech in which he wondered whether irrational exuberance had not unduly escalated asset values. Through this rhetorical question he wanted to draw attention to the valuation of the stock market which, at that time, was already considered to be excessive.

8. This conspicuous speech did not prevent however markets to rise anew and in particular the Nasdaq Composite, which moved up 21.6 % in 1997, 39.6 % in 1998 and 85.58 % in 1999. And it is only in 2000 that the technology bubble finally burst.

9. If the bull move was able to extend well beyond the imaginable, it is first because Mr. Greenspan did nothing to prevent it, as he finally considered that his job was to manage the consequences of the bursting of a bubble but not to prevent its expansion. His attitude has been much criticized afterwards and even so more because, after this one, appeared the housing bubble where he also remained inactive.

10. But the bull market benefited also from an unexpected factor : the change of millennium. There was great uncertainty by the end of last century on whether computer systems were able to manage the transition date from 12.31.1999 to 01.01.2000 and bleak scenarios started circulating imagining the worst, with computers acting unpredictably and thus capable of generating disasters.

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11. This forced all companies to ensure that their technological equipment was in good standing and led to an early renewal of equipment over those three years (1997/98/99), thus boosting profits. But since the fear of this change of date only brought forward purchasing orders, sales - and therefore profits - collapsed in 2000 for the beloved technology companies.

12. Another factor leading to the meteoric rise of stocks during these three years was the emergence of the Internet, with all the dreams that accompanied it.

13. And all this technological exuberance reverberated on the other sectors, allowing years of high economic growth, to the point that the FED moved up its key rate from 4.5 % to 6.5 % between June 1999 and May 2000; an action which obviously contributed to the bubble's burst.

14. Thus, during those three years more and more investors, for greater and greater amounts, allowed the bubble to inflate and inflate again. And they were comforted by studies which - as is the case for every bubble in fact - appeared to justify the rise and to explain why "this time is different"; why valuations which seemed to be senseless to "traditionalists" were in fact correct.

15. James Glassmann and Kevin Hassett wrote a book, published in 1999, when the Dow Jones index was around 11'000, called : "Dow 36'000 : the new strategy for profiting from the coming rise in the stock market". In this book they explained why the index would reach 36'000 ten years later.

16. Reality proved of course quite different, since at the beginning of 2010 the index was at 11'500.

17. What is also interesting about this book is that it symbolizes the conviction investors then had that, thanks to technology, there was no obstacle preventing economic growth to blossom and blossom again.

18. Today it is the opposite. More and more investors are convinced that nothing can enable economic growth to strengthen and that it will remain permanently mediocre. They call it the "new normality".

19. One of the main arguments of the defenders of this theory is the countries' high level of indebtedness which acts as a major brake on growth since it forces governments to maintain fiscal and tax policies which are too restrictive.

20. To this one must add the fact that after a financial crisis such as the 2008 one, credit restarts with difficultly, thus penalizing the economic recovery.

21. On this matter, one must also be aware that new international banking rules, known as Basel III, will further increase in the next years the requirements in relation to capital adequacy which could make credit scarcer

22. And the present recovery has furthermore been weighed down by the various crises in the Eurozone, by the excessive fall of commodity prices and by the recession in emerging countries.

23. And the icing on the cake comes from the fact that, if technological advances of recent years are the source of important deflationary pressures, the productivity gains which should have come with it have not occurred, or at least not yet.

24. So, this led to a situation of low growth and little inflation, which is the most favorable environment for bonds. Furthermore, central banks have greatly contributed to the bull's move through their bond purchases linked to the quantitative easing policy.

25. Thus, it is not surprising that, despite record levels of debt, more and more investors and for greater and greater amounts continue to increase their exposure to fixed income.

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26. And the result is that currently we have the largest bond bubble in human history. This is not an exaggeration. Sidney Homer and Richard Sylla wrote a book on the history of interest rates going back to 3'000 years BC. Never during these 5'000 years yields as low as now had been recorded and even less so negative ones.

27. Bank of New York Mellon Corp calculated that during the first week of June, the yield of 10-year bonds issued by the US, Japan, Germany and the United Kingdom had reached a historical low level of 0.69 %, against an historical average in the past 145 years of 5 %.

28. One of the measures used by the FED to set its monetary policy is what it calls the time premium. It consists for the central bank to calculate the extra compensation investors request to hold a 10-year Treasury bond instead of successive short-term securities after deducting the expectations regarding future moves of short-term rates. And therefore, the higher the premium, the higher the fears that inflation would surprise to the upside, and conversely.

29. In the 1980s, when interest rates were at their highest and the foregone conclusion was that "nothing can stop inflation", the premium was above 5 %. Today, after more than thirty years of a bond bull market, the premium has become in fact a "discount" since it stands at -0.5 %.

30. The present valuation of the bond market clearly expresses the current belief that whatever central banks do, there is no way that inflation could set off again.

31. And, obviously, experts are now hard at work explaining why this time is different. According to them, current valuations are realistic and if the 10-year US government bond yield reached a record low at 1.36 % during the month of July it is because deflation is imminent, with all the dangers linked to it.

32. As was the case when the technology bubble was going on, the above mentioned elements help explain why the bond bubble is not only lasting but continuing to inflate. However, this can only end badly since regression to the mean is one of the strongest laws of nature. While it seems impossible today, we will see the average yield of the 10-year bonds issued by the US, Japan, Germany and the United Kingdom return to their historical level of 5 % and this in a not so distant future.

33. There is not in history the case of country brought down by deflation because sooner or later at the head of the state the “virtuous” are replaced by the “pragmatists” who just start spending and spending.

34. Anyway without even going that far there are presently signs that the pessimism regarding future growth and inflation is excessive.

35. First there is the fact that Brexit had no negative effects on emerging markets or high-yield bonds. However these two sectors should have suffered if Brexit was likely to have a significant influence on future global growth.

36. This point is important, since it is Brexit which convinced the FED not to raise its interest rate in July.

37. However, the US situation would have justified it. Even if at a still insufficient level, GDP continues to increase, by 1.2 % during the second quarter of 2016, and the trend up should continue. This is why, despite the surrounding pessimism, the US stock market is setting new records.

38. The unemployment rate is now below 5 % and job creation remains quite good and it appears that the bad May figure in this sector was an aberration. Gradually, the US is reaching full employment.

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39. And now an interesting phenomenon is appearing. Wal-Mart - the US distribution giant - has decided to sharply increase the minimum wage of its employees because in order to face Amazon's competition they need motivated and efficient troops.

40. J.P. Morgan Chase Bank also decided to increase the wages of its lowest paid employees from USD 10.15/hour to USD 12.5 and up to USD 16.50/hour. Therefore, their income will increase by 25 % minimum.

41. This trend will amplify since competition will be obliged to follow. Furthermore, an increase of the lowest wages requires the company to also raise salaries of those who are just above, as these workers will not agree to be remunerated for what is going to become the new minimum wage. Thus, a large portion of the salary scale will be de facto revalued.

42. This is a very favorable evolution for consumer spending, since any increase in the lowest wages is immediately spent. The most negative aspect is that sooner or later some of these rises will be reflected in prices.

43. By the way, core inflation rate, which excludes the more volatile components of energy and food, is already above the FED's target of 2 %. And if oil could stabilize in the USD 40-50 per barrel area, rather quickly the broad inflation rate could be exceeding 2 %.

44. Thus, there is a massive divergence between the economic figures and the expectation of the bond market. Even at the worst of the last financial crisis in 2008-09, the US Treasury 10 years' interest rate only dropped below 2 % for a brief moment. And now that we are in the seventh year of economic expansion only an imminent recession can justify the current level of 1.5 %.

45. Historically, any rise in consumer confidence translates into a real increase in the level of interest rates. But since 2012 we are witnessing an unprecedented divergence : while consumers became more optimistic, the real yield kept falling to the point of being presently negative.

46. Another important element for growth is that credit is accelerating, with an 8 % increase of bank loans, i.e. the highest level since the recovery.

47. In summary, should growth and/or inflation suddenly accelerate, panic would seize bondholders with then a similar result to what happened for British real estate funds after the Brexit.

48. Fearing for the attractiveness of London after the referendum result, there was a stampede of investors requesting redemption of their investments in the British real estate funds. Faced with such an inflow of redemption orders, more than half of these funds - representing approximately GBP 15 billion of assets - were forced to block withdrawals since they do not have the liquidity required to meet the demand.

49. And, as it happens every time, other funds by contagion were also affected, i.e. those who have a portion of their holdings invested in these real estate funds which cannot currently be valued. And since one of their investments cannot be valued at a fair price they are then also obliged to halt the calculation of the net asset value of their own funds, thus blocking a few more billion of assets.

50. Today, more than ever the bond investor needs to pray not only for the economy not to deteriorate too much, otherwise the ability of borrowers to repay would be questioned, but also for the economy not to improve in an unexpected manner or for inflation not to show signs of life, because otherwise it will be panic.

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51. And even more so as the current level of interest rates makes bonds as volatile as equities. For example, a 10-year government bond with a current yield of 0 % would see its price fall by 15 % if its yield went up to 1 % in a few months.

52. A recent Swiss real estate study found that for a traditional real estate purchase financed with a 20 % down payment, the cost of credit for a 10 year loan for the remaining 80 % currently stands at 1.75 %. If the cost of credit were to drop to 1.5 %, the theoretical value of the investment will appreciate by 19.86 %. Conversely, if it moved back to 2.25 %, the loss would be 25.05 % and would reach 50.5 % at 3.25 %. As a remainder, 20 years ago interest rates on mortgages stood at 7 %. Of course, these figures are based on an unchanged property income and the capital loss would be lower if revenues also went up. But the magnitude of the fall is such that the journalist of the Swiss financial daily Agefi, who wrote an article on the study called it : "A calculation as simple as it is scary".

53. And the clear conclusion of the study - which is also valid for many regions and cities around the world - was summarized in the article as follows : "What has supported the Swiss real estate market since 2000 is the simple and uncertain combination of three sustainable coincidences : a massive population flow, the fall of unemployment and particularly of interest rates".

54. In short, investors should be aware that current bond yields are greatly insufficient to compensate for the risk taken. Thus we favor equities which offer not only an acceptable valuation but also have a good upward potential if growth could finally accelerate as this would boost profits.

55. Of course there will still be a lot of volatility particularly because growth has been constantly disappointing since 2009. This is why each investor should be exposed to a level that allows him to endure the ongoing roller coaster in stock markets.

56. One must also be aware that the mood is quite bad and investors mostly pessimistic. Indeed, many consider that central banks have only delayed the inevitable, i.e. the return of a strong recession. And for them, now that central banks have run out of ammunition, the fall is just around the corner.

57. On the opposite our strategy is based on the belief that central banks always end up getting what they want. It may take time, but they will not stop until growth and inflation have moved back to the levels they have set as their objectives.

58. It is interesting to mention that the Swiss National Bank - which buys quite a lot of foreign currencies to prevent the Swiss franc to appreciate - is increasingly investing these purchases in equities. They now represent 25 % of its assets - i.e. USD 120 billion - and this percentage, steadily rising, is noteworthy since before 2008 it did not hold equities.

59. And from now on central banks will be helped by an essential element for growth : much easier budgetary and fiscal policies than previously.

60. Indeed, for example in Europe the European Commission authorized Portugal and Spain to have in the coming years a higher budget deficit than the 3 % required in the Stability Pact. And in the US the only common point between Donald Trump and Hillary Clinton is that both are favorable to large infrastructure spending.

61. Regarding Mr. Trump, we cannot resist the pleasure of quoting him in a 1987 interview with Business Week magazine in which he said : "The final key to the way I promote is bravado. I play to people's fantasies. People may not only think big themselves, but they can still be excited by those who do. That's why a little hyperbole never hurts. People want to believe that something is the biggest and the greatest and the most spectacular. I call it truthful hyperbole. It's an innocent form of exaggeration - and a very effective form of promotion".

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62. If after the Brexit it is not anymore possible to declare that the "salesman" Donald Trump has a personality that makes him ineligible, in finance things have not changed and this time is not different : the bond bubble will burst like all the others.

63. In fact, the real difficulty is to know when it will happen, since as the US economist Kenneth Rogoff said : "In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could".

25B bd Royal L-2449 Luxembourg

Tel: +352 47 24 85 Fax: +352 47 23 81 www.sagaselect.com