Market Outlook

A monthly commentary by Gabriel V. Safdié
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A DISILLUSIONED LOVE

Generalities (1-8)

1. So, the expected stock markets' correction occurred a little earlier than forecasted since most of the analysts expected it in September with the first scheduled increase of the FED's prime rate.

2. An increase which, in light of recent events, could also finally be postponed. But this time, unlike previous delays, this could be negatively perceived by investors who could consider it as bad sign for the future evolution of the US economy.

3. Anyway, the fact remains that August was a very difficult for equities, which did not like the bad news coming from China. Thus, the MSCI Emerging Market in USD was down for the month 8.8 % and from its peak of a year ago the decline has now reached 26.2 %.

4. The big difference in relation to previous months is that the emerging markets' fall has started to impact developed countries, with strong declines in August. In Europe : -9.2 % for the Euro-Stoxx 50 and -9.3 % for the DAX. In the US, the S&P 500 fell by 6.2 % and the Nasdaq by 6.8 %. Finally, in Japan, the Nikkei dropped 8.2 %.

5. But the heart of the storm is in fact in the commodities market which brought back the Thompson Reuters Commodity Index to a level first reached in 1996 !

6. And, as has been happening for some time now with every stock market correction, the EUR rose against the USD from 1.10 to 1.16 before finishing the month at 1.12. As for the Japanese currency, it moved up 2.5 yens to 121 against the dollar.

7. Finally, in relation to bonds, the surprise was that the stock market sell-off only briefly and in a limited way pushed yields down on sovereign bonds of developed countries, so that in August the yield on the 10-year German moved up from 0.64 % to 0.80 %, while the US equivalent moved from 2.18 % to 2.22 %.

8. However, the lowest rated bonds suffered with the yield of the Bloomberg Corporate High Yield Index increasing once again by 0.5 % to 7.7 %. A rise also happened in the Bloomberg USD Emerging Sovereign Bond index which moved from 4.85 % to 5 %. And it should be mentioned that the Market Vectors Emerging Markets High Yield Bond ETF, invested in local currency and quoted in USD, is down 12.3 % since the beginning of the year.

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Equities (9-19)

9. The market was therefore shocked by the bad news coming from China, but one should be aware that they all need to be put into perspective.

10. First, there is the new decline of the Chinese Shenzhen Composite index by 15.2 % during the month. However, one should not forget that in the last 12 months it is still up 47.7 %. We were in fact facing a massive speculative move up, unjustified by the economic data, and which is now correcting itself with, in both cases (up and down), little impact on the real economy. The only truly strange thing is why did the Chinese authorities favor this bubble which between February and June 2015 saw the index rise 122 %.

11. Then we had the surprising 3 % fall of the renminbi against the dollar, thus bringing to an end a period of continuous rise of the Chinese currency since 2005. And investors are wondering if this is not a sign of panic by the authorities, suggesting that growth is in reality much weaker than the 7 % goal.

12. But there is another interpretation linked to the fact that China wants its currency to be considered as a reserve currency by the International Monetary Fund (IMF). However, to achieve this goal, the IMF is requesting that the exchange rate be more freely established by market forces, whereas until now it was set exclusively by the political authorities. Anyway, and regardless of the reason for the move, it is unlikely that the fall of the currency will exceed 10 % in total, which would then bring the rate back to its level at the beginning of 2014.

13. Another source of concern is the fact that Chinese manufacturing is declining at its fastest pace since 2009. Here again, one must consider the fact that China's trade balance still shows a record surplus of over USD 500 billion and that its share of world exports is growing steadily.

14. It is undeniable that Chinese growth is moving down, but one should be careful not to exaggerate too much the consequences. The Chinese economy is now in a phase similar to where the United States was in the early twentieth century, when growth becomes more volatile. At this point there are more booms and busts, but the latter are of short duration.

15. And from this point of view one can expect that the recent chemical accident in Tianjin will cause a strong tightening of safety standards in China, in the same way as the fire in 1911 in New York of the textile factory Triangle Waitshirt - which caused the death of 146 persons - was responsible for the implementation of some sixty safety rules between 1911 and 1913.

16. Finally, one must keep in mind that with USD 3.3 trillion of foreign exchange reserves, the government has the financial capacity to absorb all the bad investments that have been made in recent years and that therefore it has the means to keep the situation under control.

17. In conclusion, all this suggests that even if the Chinese slowdown were to be significant given the excesses of recent years, we are not in a Japanese type of situation. The economy is still young and flexible and therefore any slowdown will be short-lived.

18. At the world level, the negative impact of this situation can be overcome since it is occurring at a time when global growth is relatively good and therefore, as in a bicycle race, a relay is taking place, where China - who has been pulling the world economy since 2008 - is about to be replaced by the developed countries. And logically while this is happening it generates some tensions.

19. Western countries have digested the effects of the financial crisis of 2008 and their current growth - although unsatisfactory and even very unsatisfactory in Europe - is sufficiently established to prevent it from aborting spontaneously. While some sectors such as the luxury one will suffer from lower exports to China, most of the GDP in Europe as well as in the US comes from domestic demand.

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Equities (20-32)

20. In some perverse way, one can also consider that the fact that German exporters will suffer from the Chinese slowdown will make the country more attuned to the need of taking measures to favor growth in the Eurozone.

21. The situation is obviously much more difficult for other emerging countries which, due to weaker demand from China, are experiencing either a decline of the price of their commodities exports (Brazil for example) or will find themselves with Chinese rivals much more aggressive regarding pricing (India in this case).

22. But it goes even beyond that. We have reached a point where one can say that the great love story of investors towards emerging countries has become a disillusioned one.

23. The story telling was so far well-known : with developed countries supposed to be lethargic and unable to reform themselves, the rise of emerging countries was inevitable and any future growth would happen there.

24. Today, the Chinese slowdown exposes all the weaknesses of these emerging countries and they are the ones appearing as unable to reform.

25. A country like Brazil, for example used the commodities' boom to create social programs that made the former government of Mr. Lula da Silva very popular; but it never undertook the necessary reforms to make the country more competitive.

26. And this is true for all countries in this group. Now that hard times have arrived, their fragility becomes manifest. And investors who believed that the path was open for them to join the ranks of developed countries are therefore very disappointed by their lack of seriousness.

27. In fact, these countries are at a very delicate moment in their development. Their growth of the last twenty years allowed for the emergence of an educated middle class, having the same expectations as people in developed countries regarding the quality of services and of governance that they consider to be entitled to receive from their governments.

28. But this middle class remains a minority, which is moreover geographically concentrated around a few development areas. The rest of the population, poorly educated, is still under the spell of populist politicians whose only objective is to stay in power in the regions they control. This leads to an important waste of public resources and helps corruption remain endemic at all government levels.

29. And these populists generally enjoy the strong support of major companies of their country whose goal is to continue to benefit from their sheltered position and who do not want therefore to be confronted with increased competition.

30. The consequence of this balance of power is that these countries remain with very inefficient governments at the national and regional level, thus compromising their economic development which then leads these countries to over-tax their few productive sectors.

31. In the nineteenth century, Europe was able to overcome this phase because of the competition between major countries which obliged them to be as efficient as possible. Italy, for example, who did not have the geopolitical ambitions of France, the United Kingdom or Germany, did not experience this pressure and therefore did not feel the need to force the south of the country to make the necessary reforms, with consequences which are still being felt today.

32. In the US, it was civil war which allowed the north to impose its economic model to the south.

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Equities (33-37)

33. It should be noted that China itself is in a similar situation, with the developed coastal areas - where movements for better governance multiply - facing the much poorer interior of the country. It will be interesting to see if the will to make of China a great power at all levels will allow the country to overcome this hurdle.

34. Meanwhile, and despite the sharp decline, we continue to refrain from investing in the stock markets of these countries because the political consequences of the present recession are in front of us. With the exception of Brazil, no emerging country has a sufficiently strong democratic tradition to allow for a smooth change of government. One just needs to look at Turkey where Mr. Erdogan seems to want to follow the footsteps of Mr. Putin with a government which controls the media and assault its opponents.

35. This means that everywhere there is the possibility of a rise of populism because of the vulnerable individuals frightened by the economic crisis. The risk is even greater as many of these people do not have anything to lose. The average wealth per inhabitant in Greece is at least five times higher than in a developing country. Also Greeks manage their country far better in relation to emerging countries to the point that they could quote Talleyrand : "When I look at myself, I'm devastated, when I compare myself, I'm consoled."

36. Anyway, the fact remains that if during the boom of recent years these emerging countries were unable to create an adequate economic infrastructure (roads, ports, etc…), to improve their education and health system, to curb corruption, one really can't see how this could be done in the midst of turmoil and with much less financial means.

37. This being mentioned, one should not go from one extreme to the other, hating what was previously loved. The situation faced by these countries of a boom followed by a bust is not unprecedented - one might even say that this is their norm - and thus not all are destined to end up like Venezuela.

Bonds (38-40)

38. However, what is new is the indebtedness level of the private sector in emerging countries, which now exceeds USD 30 trillion. The debt has more than tripled in 10 years.

39. It is obvious that the low remuneration level pushed investors to buy bonds from low-rated debtors who, otherwise, would not have been able to finance themselves so easily. And this phenomenon was accentuated by the fact that the bulk of investments in the sector was made through bond funds and their managers, under pressure from the influx of cash, invested without much restraint or discernment.

40. What is now crucial will be to monitor the behavior of investors. If substantial reimbursement requests were to occur, the managers will have to sell bonds to obtain the necessary funds to honor the requests. And then the danger we have been mentioning for months - i.e. that it will be very difficult to find buyers given the poor market's liquidity - may appear.

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Bonds (41-42)

41. This would lead to an upward spiral of these yields with the emerging countries crisis taking then an even greater magnitude.

42. An interesting element to mention is that normally the present situation should have been favorable to sovereign bonds of developed countries which benefit from their safe haven status. And the Chinese slowdown should also have helped as it brings a new deflationary chock. But the surprise is that so far this has not happened which could be a sign that a trend reversal, leading to higher yields, is on its way.

Commodities (43-49)

43. The collapse of commodity prices strikes by its scale. The fall happened in all sectors and is visible in every major currency. This clearly signals that overall growth is slowing down. But one should also avoid becoming too pessimistic.

44. When prices drop and no important player wants to act as a regulator, the consequence is that producers increase their output in order on the one hand, to compensate lower prices by increasing sales and on the other, to strangle weaker competitors and make them disappear.

45. The reverse move obviously happens when prices are moving up.

46. Hence these extreme up and down phases that characterize the sector. No one can believe, for example, that the price of a barrel of oil can remain for a long period under USD 50.-. The level is just impossible to maintain as was the case when the price exceeded USD 200.- in 2008.

47. But this bear market once again contradicts those who since the 1960's tirelessly proclaim the end of the era of cheap commodities. Indeed, technological advances allow on the one side, the utilization of resources that were previously out of reach and on the other, the reduction of consumption through greater efficiency in the use of these resources.

48. Also we continue to argue that, with the exception of producers, this is good news since for consumers these falls are the equivalent of a tax reduction.

49. The risk of course is that the fall since the beginning of the year of 12 % for oil, 26 % for copper, 41.5 % for coffee or 50.5 % for nickel will end up leading to such a decline in production, given the collapse of investments that it will bring, that we are currently planting the seeds for a reverse move of identical intensity in the future.

Currencies (50-52)

50. For foreign investors, emerging countries are either heaven or hell, since an equity move is usually associated to a monetary move.

51. One can look at Brazil for example, where the stock market since the beginning of the year is down by 6.8 % in local currency, but 31.9 % in USD.

52. Thus, as is the case with emerging stock markets, it seems too early to take an exposure. These currencies are still not undervalued and historically, it is only then that a reverse trend can start since at that point all the bad economic news have been discounted by the market.

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Currencies (53-58)

53. Regarding the currencies of developed countries, the euro may benefit from a window of opportunity to move up. However, it will not be the start of a structural bull trend.

54. But, if the stock market correction continues, the probability of a rise in US interest rates will fade, thus reducing the attractiveness of the dollar.

55. In addition, if European stock markets keep moving down this would favor the euro, as foreign investors who had put in place strategies to protect themselves against a euro decline, would remove them as they withdraw from European equities.

56. And then, there is the (temporary ?) end of the Greek crisis. Mr. Tsipras' about-turn is impressive and he justified it by sayingthat he preferred to compromise rather than doing the Zalongo dance, which is a reference to the collective suicide in the nineteenth century, from a cliff, of Greek women and children wanting to escape the terrible Ottoman governor Ali Pasha.

57. Time will tell whether Mr. Tsipras' retreat is only a tactic one in order to buy time, or if he has now real development ambitions for his country.

58. Insofar as foreign exchange moves in coming weeks will be based on the behavior of stock markets, it does not seem appropriate to take large positions outside the base currency of a portfolio.

Conclusion (59-65)

59. Certainly we have not missed the irony of having stocks falling sharply while we regularly point out the structural dangers linked to bonds.

60. It is too early to fully understand what has happened but it seems that we have witnessed a self-reinforcing fall, driven by risk models used by market participants which are very much alike. Thus all of them called at the same time for a reduction in market exposure.

61. And as a matter of fact we have been mentioning in recent months the accumulation of signs indicating that stock market correction was possible. However, despite these elements we decided not to reduce our exposure to this sector.

62. This was firstly due to the fact that our exposure is limited to the developed countries' equity markets in which we are invested at a reasonable level. It is also our only significant risk taking, the remaining assets being invested in a secure way. And then there is the fact that it is almost impossible to time such corrections as can be seen by the speed of the fall.

63. But the main reason is that, so far, we have no signs indicating that there is a risk that America or Europe could enter into recession, and this even with China slowing down and many emerging countries being in a difficult economic situation.

64. Also it is rather unlikely that central banks will remain without reaction as they are quite worried of any deflationary threat. And one should not forget that central banks of developed countries still believe growth in their own country is too weak and their goal remains to help its acceleration.

65. On the opposite side, the main danger comes from the fact that if the stock markets' decline were to continue - particularly in the US, where we had three consecutive quarters of slowing sales and profits - companies could take it as a sign that they need to cut their spending and reduce their staff, thus leading to a sharp fall in growth and rising unemployment.

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Conclusion (66-69)

66. Also a significant rise of corporate bond yields would cause quite a lot of damages.

67. Finally, investors could overreact, as the painful memories of 2000 and 2008 are still vivid.

68. In summary, we may still have some difficult weeks until investors are sufficiently reassured regarding the prospects of US and European future growth.

69. In any case, the current episode reminds once again of the need to be invested at a level comfortable enough to be able to withstand the volatility of equities, which, although quite low in recent years due to the quantitative easing policies, should now move up to a level closer to its historical average.

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