SAGA

Market Outlook

A monthly commentary by Gabriel V. Safdié
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A SURPRISE IS COMING

Generalities (1-8)

1. The aggressive monetary policies of the central banks of the United Kingdom, Japan and Europe, coupled with the fact that the market expects the FED to take its time before raising again its benchmark interest, continue to favor risk taking among investors.

2. Obviously, one of the main beneficiaries is the bond market, which is collecting this year record amounts. Thus for example, in the American bond index funds only, over USD 60 billion have already been invested, far exceeding the subscriptions for the entire 2015.

3. This allowed the Bloomberg High Yield Corporate index, whose yield was above 10 % in mid-February, to fall to 6.4 % at the end of August. And if the yield of the 10 year US sovereign bond rose to 1.58 %, we are still far away from the average of the past five years which currently stands at 2.1 %.

4. Emerging bond markets have also profited from this situation with more than USD 5 billion of subscriptions in the seven weeks following Brexit in the various funds that invest in bonds of debtors from these countries. Therefore, the yield of the Bloomberg USD Emerging Sovereign Bond decreased to 4.25 % and this index is now up 14.9 % for the year.

5. And mechanically the currencies of these countries also rose, with the JP Morgan index of emerging market currencies up 10 % from the low of the year. The parities between the main currencies were quite stable in August with the dollar against the euro at 1.1150 and at 103.40 against the yen.

6. Emerging countries stock markets also took advantage of the situation, with the MSCI Emerging Markets index in USD up 0.9 % for the month. And it should be mentioned that with Chile, Brazil is one of the big winners this year, as it is up 64 % in USD after a 40 % fall in 2015. This rollercoaster performance reflects a correlation with the evolution of commodities which are also presently in a clear recovery phase.

7. Indeed, the CRB Commodity Index increased by 16 % from the low of the year and it seems that the bear market in this sector has ended. The best performances came from oil (+7.5 %) and sugar (+5.3 %), while cotton and wheat both fell 11 %.

8. Finally, developed countries stock markets were quiet in August with : +2.9 % for the S&P 500, +1 % for the Nasdaq index and in Europe +2.5 % for the Dax and +1.1 % for the Euro-Stoxx 50.

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Bonds (9-22)

9. So investors are convinced that it is not possible for bond yields to move up because of the easy monetary policy of central banks, the absence of inflation and the current low economic growth.

10. Yet, the yield of the 10-year US sovereign bond went up by 1.5 % in just four months in 2013, while its equivalent in the Eurozone rose 0.8 %. And this move occurred at a time when US growth had slowed to 1 % and Europe was just coming out from one of its many crises.

11. But the most interesting aspect is that this happened while the FED's monetary policy was in full expansion. This episode proves that it is therefore quite possible for yields to move up even when central banks are buying bonds. A similar episode, but on a smaller scale, also occurred at the beginning of 2015 despite the aggressive quantitative easing policy then followed by Japan and the Euroland.

12. Another belief of investors is that inflation cannot rise in the current environment; a sentiment which is in phase with the central banks' deflation fears.

13. Yet in the US on average every month about 200'000 jobs were created in the last five years and thus a situation of full employment is not far away. This is beginning to lead to wage increases - finally, some would say - and this trend should amplify in the coming months.

14. Now, this evolution is occurring at a time when inflation is on the rise. As we already mentioned in our last monthly report, when excluding volatile components such as energy and food, since the beginning of the year US inflation is above 2 %.

15. Of course, when adding those two elements inflation is still at 0.8 % over the last twelve months. But how long will it take, if oil prices remain around USD 50.- per barrel, with rising wages and lower productivity than in the past, for the 2 % level to be reached ?

16. If this were to happen, the risk of a rapid and violent adjustment exists, as it is an element that is not integrated in the current yields.

17. The third factor that reassures investors is the low level of growth, which for the US is currently at around 2 %. The problem is that the level of jobs' creation is more consistent with growth at 3 % than at 2 %. Much has been written about this discrepancy and in particularly some experts believe that measures of GDP have difficulties integrating the technological advances of recent years.

18. Thus the GDP number should be used with caution and it is important to also take into account other economic indicators to assess the real situation.

19. If bond investors may be too complacent they have nevertheless several allies.

20. First of all, central banks are on their side. Being more concerned about deflation than inflation, they will be late in relation to events. Thus it is likely that we will have a reverse scenario of what happened in Japan after the bursting of the stock market and real estate bubbles in 1990, or in the United States with the subprime crisis that started in 2007.

21. In both cases, central banks underestimated the seriousness of the situation and lowered their interest rates always too late in relation to the deterioration of the economy and this took away most of the expected benefits of a rate cut.

22. It should be mentioned that this was quite understandable, since central bankers were then mainly focused on the fight against inflation.

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Bonds (23-32)

23. Today, we are in the opposite situation, especially as presently a central bank like the FED doubts the reliability of the models it uses and therefore the guidance they provide. It will therefore be very cautious and it is likely that rate hikes will be late in relation to the improving economy.

24. Therefore this will be favorable, at least at the beginning, to bondholders.

25. Another argument in favor of bonds is the powerful deflationary wave brought by the technological advances and the integration in the globalized world of Asian countries, with their plentiful and less expensive workers than in developed countries.

26. Then there is the fact that banks continue to be under pressure from a regulatory point of view, particularly in the context of the so-called Basel III. This is a global agreement between developed countries to strengthen the banking system after the 2008 crisis. Between now and March 31, 2019, rules will be gradually introduced, increasing capital requirements for banks and reducing their ability to lend. A 2011 study of the OECD estimated that full implementation of the program would push banks to increase by 0.50 % the cost of their loans; which may seem an acceptable cost to make banks stronger.

27. But the danger is that this is accompanied by a significant side effect, i.e. a contraction of the amount of credit available, which would be a more or less serious handicap to economic growth depending on the size of the reduction.

28. Furthermore, if US banks are adequately recapitalized, it appears that this is not the case in Europe. Indeed, the most pessimistic estimates suggest that European banks need around EUR 900 billion of fresh capital. Even if this figure is exaggerated, the situation does not favor the expansion of credit in the region.

29. Another great ally of bond investors is what the Anglo-Saxons call "The Goldilocks economy". This expression comes from the fairy tale "Goldilocks and the three bears", in which three members of the bear family (father, mother and child) go walking in the forest while waiting for their food to cool in the wooden house where they live. A little girl called Goldilocks then enters the empty home - and after tasting the three bowls of porridge, feasts on the bear cub's one, which is neither too hot, nor too cold. In order to rest, she then tries the three seats breaking the bear cub's one, as it is neither too hard, nor too soft. Afterwards, tired and wanting to sleep, she tries the three beds and finally dozes off in the one belonging to the bear cub as it just fits her size. Needless to say, when the bears will come back, they will not be happy and, depending on the version, either they kill her or frighten her off the house, continuing afterwards their meal.

30. The notion of "Goldilocks economy" appeared in the economic literature in the 1990s in order to characterize the US economy which was then growing at an ideal pace - neither too quickly, nor too slowly - and this situation helped reassure equity investors. With hindsight, one can see that this excellent growth (on average above 4 % per year between 1995 and 2000) without significant inflation pressures in contrast to similar past episodes, was in fact the beginning of the deflationary pressures on the economy with, at that time, the entry of China in the global economic system thanks to the reforms of Deng Xiaoping.

31. And since 2009, bondholders are in a "Goldilocks nirvana". Pessimists were wrong, since the crisis has not returned, but optimists were also disappointed as growth never really took off. And this situation of low growth is ideal for the bond market : growth is sufficient to enable companies to meet their commitments, but insufficient for interest rates to rise.

32. The question it therefore to ascertain how long can this nirvana last.

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Equities (33-42)

33. And this is where we believe that a surprise is coming.

34. Indeed once the shock of the Brexit result was overcome, the stock markets' good performance was not only due to the decline of bond yields. It could also be possible that we are at the beginning of a synchronized upward phase of the global economy.

35. And indeed for the first time since 2008, monetary policies around the globe are expansionist.

36. Following the US, who has always followed this policy, came afterwards :

- Japan, where, for example, the Bank of Japan now holds 50 % of the total assets invested in index funds of Japanese equities.
- The Eurozone, where the European Central Bank policy of increasing its balance sheet is running at full speed.
- The United Kingdom who, post Brexit, increased its efforts to help the economy, including through a significant decline of its currency.
- Switzerland, whose foreign exchange reserves now amount to CHF 615 billion, up CHF 56 billion for the year, of which an increasing proportion is invested in equities.
- Canada and Australia who, following the oil price crisis, implemented easy monetary policies.
- China who until 2015 wished to moderate its growth, but has since fully reversed its policy and now uses all the weapons at its disposal to strengthen its economy.
- The recovery of commodity prices which gives back purchasing power to producing countries.
- Gradually, governments' budgetary and fiscal policies, which were restrictive since 2008, are becoming much looser under the pressure of populist politicians. What was until now acting as a brake for growth is on its way to becoming an accelerator.

37. In summary, everything is in place for an improvement in global growth. And even if it will be weaker than in the past, such an event is not expected by investors. By the way, we now believe that the main risk for markets is not anymore the state of the economy itself, but the consequences that could have on the economy the increasing various geopolitical risks.

38. And should this acceleration occur, the impact on corporate profits would be very important, as most of the sales improvement would be directly reflected on profits.

39. Profits that furthermore, unlike current beliefs, maintain a strong upside potential. Indeed, US earnings per share are still 13 % below their long-term trend since 1970. But it is in the rest of the world where the potential is the greatest since we are 39 % below this long-term trend.

40. Another interesting figure : if one adds the bond purchases of the Japanese, European and UK central banks as well as the reinvestment of the interest by the FED on the bonds it holds, we have USD 500 billion of extra liquidity injected in the financial system every quarter. And given that bond yields are increasingly negative, a growing portion of this sum will inevitably be invested in equities.

41. And one must not forget that both private and institutional investors are significantly underweighted in equities.

42. Therefore, the current situation leads us to maintain equities as the preferred asset class in a portfolio.

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Commodities (43-47)

43. If twelve months ago we wrote that "the collapse of commodities strikes by its scale" and that "this clearly signals that overall growth is slowing down", the recovery since February 2016 appears to be sustainable and therefore auspicious of better times ahead.

44. From the low of the year, oil, as well as aluminum and nickel have behaved well and only copper is still suffering.

45. Finally gold, the leading indicator of inflationary or deflationary pressures, increased by 15.5% over the last twelve months.

46. And this advance of gold is confirmed by the much larger increase of silver : +27.8 % over the same period. This is important since silver, being more volatile, needs, if we are in a real long-term trend, to amplify the move of gold, upwards or downwards.

47. This is why in 2011, when gold was at its peak, the gold/silver ratio fell to 32. Then, gradually during the gold's bear market from 2011 to 2015, the ratio rose to 83. It has now dropped to 70, indicating that the bull trend has legs.

Currencies (48-51)

48. As in Samuel Beckett's play "Waiting for Godot", investors wait, and keep waiting, for rate increases that do not occur.

49. Even worse, not only some members of the FED considered it possible that just a single increase in the interest rate will happen until 2018, but now others are questioning the 2 % inflation rate target currently set by the FED and are wondering if it may not be too low if one wants to avoid any deflationary risk. For them a 3 %, or even 4 % target could be more appropriate.

50. In this context, it is not surprising that the dollar has recently been struggling and one should not forget the perpetual deficit in the US trade balance.

51. In the last six months, the Euro-Dollar exchange rate has fluctuated around the current level of 1.12. One can therefore consider that any increase beyond 1.15 would put in jeopardy our expectation of an accelerating global growth. Conversely, a move under 1.09 would considerably strengthen it.

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Conclusion (52-59)

52. It is when the market has the greatest conviction that a trend reversal occurs.

53. Presently investors are convinced that nothing can alter the bond market's "Goldilocks nirvana".

54. Although deflationary pressures remain strong, if the surprise we are expecting - an acceleration of global growth - occurs, yields will move up from their too low current level and this will happen even if inflation does not accelerate.

55. And since many investors are overexposed to this sector, the yields' rise could be surprisingly large.

56. Of course such a move will at some point pressure the equities' bull market, but the acceleration of growth will allow the market to endure quite a lot before this occurs.

57. This is why we continue to advise that the main risk-taking should be done through equities, underweighting the US where the growth potential is the lowest, and even more so as the FED will remain for a long time the only one raising interest rates.

58. And if growth remains moderate, the bull equity move, despite the inevitable corrections along the way, could last for a very long time.

59. And maybe in 2034 we will be able to celebrate 25 years of uninterrupted growth in the US and elsewhere, as has just done Australia with an average growth of 3.2 % per year since 1991.

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