Market Outlook

A monthly commentary by Gabriel V. Safdié
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SO MUCH WATER, SO LITTLE TO DRINK

Generalities (1-6)

1. A hat-trick for Europe : after January and February, March was also quite favorable to Eurozone's equities : +3.0 % for the Euro-Stoxx 50 and +5.1 % for the Dax. Conversely - and as it was also already the case since the beginning of the year - the US was relatively disappointing : -1.7 % for the S&P500 and -1.2 % for the Nasdaq.

2. No trend change either for the MSCI Emerging Markets index in US dollars, which remains close to its beginning of the year level.

3. But in Japan the evolution of the Nikkei 225 (+2.2 %) indicates a growing interest from investors who consider the Japanese stock market as one of the cheapest in the world.

4. Obviously, the question remains of whether or not one should hedge the currency risk. On this subject it can be noted that currently the yen against the dollar is stalling at 120 for the last 3 months. But the decline of the euro against the dollar continued from 1.12 to 1.0750.

5. In relation to sovereign bonds, the 1.92 % yield on the US 10-year maturity puts it in the high yield category, particularly when compared to the German equivalent which, at 0.18 %, is not that far from becoming negative. Regarding the Bloomberg USD High Yield Index's evolution, it rose from 6.3 % to 6.5 %.

6. Finally for commodities, after the slight increase in February, the Bloomberg Commodity Index resumed its decline (-5.4 %) with the fall of some agricultural commodities such as sugar (-13.4 %) or cocoa (-10.6 %) as well as that of oil (-12.3 %).

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Bonds (7-19)

7. Slowly, the memory of the 2008 financial crisis fades away. But there is something that will remain present for a long time : the ocean of debt it has created.

8. Between 2007 and 2014, the public debt in relation to GDP has increased significantly around the world. For example in Europe, it rose by 172 % in Ireland, 100 % in Portugal, 66 % in France, but only 8 % in Germany. And in China, it has moved up 83 %, exceeding now the US equivalent debt.

9. But it is not only the public debt which shot up; companies have also been very active. For example, just for the year 2014, US companies borrowed USD 1.43 trillion, i.e. 27 % more than in 2007 at the peak of the credit bubble. And this occurred while growth was relatively low in comparison to past standards.

10. In emerging countries, bond indebtedness of private firms rose from USD 250 billion in 2004 to USD 2 trillion at the end of 2014.

11. Thus, at constant exchange rate, the consultant McKinsey has calculated that the total amount of public and private bonds currently outstanding rose from USD 87 trillion in 2000 to USD 142 trillion in late 2007, reaching USD 199 trillion by mid-2014.

12. However, surprise, surprise, despite an indebtedness level that would have seemed unthinkable in 2000, rarely have lenders been so poorly remunerated. And in the case of negative bond yields, we are facing a historic event that even defies one of the most basic laws of finance which is "time is money".

13. Thus, investors find themselves in this strange situation where there is so much water, but so little to drink.

14. Obviously, this situation is due to the fact that inflation has virtually disappeared in developed countries. However, there is a school of thought that believes that if there is no inflation, this is because growth is too low; and if growth is too low, it is because the debt level is too high.

15. Let's reverse the flow and it becomes fascinating : the debt level is too high, thus growth is low, thus there is no inflation, thus the central bank must buy bonds to push yields lower and increase the money supply; but this then promotes debt's growth which then increases the debt level, etc., etc…

16. Others believe that it is the excess of savings which is pushing yields down. There are simply not enough productive investments for the amount of capital available worldwide. Thus, inflation cannot appear because supply will always be sufficient to meet demand.

17. If this hypothesis is correct, yields will remain at the current low levels for a long time. This is also the current market view since inflation-linked bonds are quoted at a level indicating that investors are expecting annual inflation in the US over the next five years to be 1.5 %.

18. Furthermore, as with any human activity, the market also has its fashions. And currently, it has decided that one of the most important figures to judge the future level of US inflation is the expectation that the market has today of the anticipation it will have in five years of the estimated inflation for the next five years. In simpler terms : if you believe in your psychic gifts, there is a financial instrument that you can buy or sell and which currently states that in five years - i.e. in March 2020 - the US annual inflation rate that will be expected by investors then for the period from March 2020 to March 2025 will be at 2.1 %.

19. According to rumors, the FED looks carefully at this figure and, apparently, as long as it will be around 2 % everything will be fine regarding inflation.

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Bonds (20-28)

20. Nevertheless, if indeed inflation remains at such a low level, it also means that central banks are going to keep for a long time the sovereign bonds they hold. And this leads to another paradox. Quantitative easing (QE) implies that one branch of the government, its central bank, repurchases the debt issued by another branch of the same government. Thus, we have in reality an identical creditor and debtor. Let's consider then the case of the most indebted developed country, Japan. If we exclude the Japanese sovereign debt held by the central bank and the state agencies, public debt in relation to GDP moves down from 234 % to 94 %. And as this percentage will fall further - since the Bank of Japan continues to buy bonds - Japan will eventually reach the European's magic criterióna of a maximum debt of 60 % of GDP. Seen from this angle, debt would no longer be a problem.

21. The great danger today is that investors are extrapolating current trends because they feel they reasonably "know" what could happen, while as recently demonstrated by the case of oil, the world is made of ruptures.

22. At the bond market level, rupture could come for example, from the bankruptcy of a well-known debtor. This hypothesis is currently being considered in the context of bonds issued by private debtors located in emerging countries as stress has sharply increased there with, on the one hand, a severe slowdown, or even a recession for many of these countries and, on the other hand, the rising dollar which greatly increases the debt burden.

23. Thus, if this were to happen, we could then have a Greek-style situation; as the market suddenly "discovers" such a "shocking" event, it huddles itself in a foetal position refusing to lend to this sector, as it happened then with the sovereign bonds of weaker countries of the Eurozone. In such a scenario, yields would take off, thereby increasing stress.

24. Another possible rupture could come from bond funds, which have seen their assets move up exponentially since 2009. Just in the US, for example, they rose by USD 1.2 trillion. However, the current low yields mechanically imply that returns in coming years will be lower than in the past. If investors in growing number request the redemption of their units, these funds will be under pressure since they quickly need to sell bonds to be able to make the repayments. And with the present low market liquidity's level, yields could then swiftly move up.

25. Paradoxically, a source of disruption could come from the regulatory measures taken against the banks after the 2008 crisis. These are so numerous that the CEO of Nordea - one of the largest Nordic banks - said : "It can't be that the only purpose of banking is to stop banks from going bankrupt".

26. Many consider that risk in finance is like energy and that the Lavoisier Law also applies to it : "Nothing is lost, nothing is created, and everything is transformed". In this case, it is conceivable that because of the increase in regulation coupled with the limitations imposed on financial institutions, risk has not disappeared, but has simply been transferred from the balance sheets of banks to the balance sheets of major investment funds, pension funds and insurance companies.

27. In view of this potential danger there is a demand for non-bank financial entities of importance to be subject to stricter regulations, since they should also be considered as "too big to fail". Hence, a new acronym may be increasingly used : "SIFI", which does not means "science fiction" but "Systemically Important Financial Institutions".

28. But rupture could also come simply from an unexpected acceleration in growth which could then force bond prices to a sudden and sharp adjustment.

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Bonds (29-32)

29. More likely, rupture will happen, as usual, at an unexpected time and place.

30. Anyway, sooner or later, a rupture will happen in the same way that, 30 years ago, it seemed as impossible for inflation, which was at the time at double figures, to fall than it is today for it to move up.

31. Meanwhile, it is business as usual. Europe just started its QE and all is quiet in relation to inflation. With no trend reversal in sight and with low yields or even negative ones, the maturity of new bonds naturally increases, with more and more new issues for 50 or even 100 years. Good luck to the buyers.

32. In conclusion, it is worth mentioning again that the mere fact that real bond returns are too low is not a sufficient reason to go short bonds. It simply means that it is advisable not to be too much invested, or in a too risky way, in this sector.

Currencies (33-41)

33. The big event in this sector is the continuous decline of the euro against the dollar from the 1.40 level of one year ago and which continued in March to the point that parity (1 for 1) between the two currencies seems imminent for a growing number of speculators.

34. Clearly, the market has decided that the European QE should lead to a fall of the euro similar to the yen after the Japanese QE. Thus, it is ignoring all the good European news, as well as the important surplus of the Eurozone balance of payments, in excess of USD 400 billion per year.

35. And of course, investors are also obviously attracted to the possibility of US interest rate rises.

36. But this creates another interesting paradox. The rise of the trade-weighted dollar of approximately 12.5 % since July 2014 is the equivalent of a monetary tightening of 1.25 %, should the dollar remain at the present level.

37. And, in the last weeks economic activity appears to have slowed in the US. This is considered to be temporary but may have contributed to delay a possible rate hike by the FED.

38. Admittedly, in its last statement, the FED removed the word "patience" it used until now to indicate that it would be patient before raising its prime rate, thus opening the door for a first rate hike in a decade. But, as the FED's president Janet Yellen also indicated : "Just because we’re not using the word patient doesn’t mean we’re going to be impatient".

39. The market was also surprised by a larger decline than expected from the FED's members of their expectations of rate hikes. This led to the largest daily movement in 15 years of the euro/dollar parity, with an increase from 1.06 to 1.10 on March 18th, before returning to its starting point on the 19th.

40. The US stock market is virtually unchanged since the beginning of the year and if the slowdown persists, equities could then start to fall. It would be a signal for economists that they should revise down their growth expectations. And thus, logically, a sustained campaign of interest rate increases would fade away.

41. Then, the powerful wave of the rising dollar could retreat because the attractiveness of the greenback is relatively limited, as US stocks are more expensive than European ones and short-term interest rates are also at 0 %. Of course, a return of around 2 % for long-term US bonds is more appealing than the equivalent in euros, but one should not forget that yields can only move down if US economic prospects darken.

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Currencies (42-45)

42. And if, at that time, the dollar weakens too much, then the US economy would start to benefit again and a trend reversal may occur in stock markets with European equities beginning to suffer while US ones will become more cheerful. In particular, one should not forget that around 50% of the profits of the companies in the S&P 500 index are made outside the US.

43. This would lead to an improvement of the American economic situation, thus creating new expectations of rate hikes in the US, which would once again be favorable to the dollar.

44. The conclusion that can be reached is that, as long as short-term interests are close to 0 % and the US is the only country with satisfactory growth, it is possible that moves in the exchange rate, through its influence on the economy, will accomplish an important part of the work that, normally, would have been done by the FED. As a result, the FED's prime rate could move much less than expected.

45. For currencies, it means that one should be quite cautious regarding the dollar. The rise of the greenback has more fragile foundations than what it appears.

Equities (46-54)

46. And while the US stock market is languishing, it's "Champagne" for the Eurozone, with an increase of nearly 20 % since the beginning of the year.

47. Presently everything is favorable to the Eurozone stock market : oil and the euro are falling; budgetary and fiscal policies are less restrictive; the European QE; a cyclical recovery for the economies of the region.

48. The present difficulty is that in one quarter we had an increase that would have been more than satisfactory if it had occured for a whole year. A correction thus becomes possible and the old stock market saying "Sell in May and go away" could prove once again correct.

49. On the positive side, it must be remembered that competition from alternative investments is quite weak presently, that European stock markets have lagged in comparison to American ones and that if growth continues to improve, then profits can sharply rise.

50. In the United States, nervousness also exists because, not only is the bull market quite old - it will soon be the longest of the post-war period - but, furthermore, it is also currently the third longest period without a correction of at least 10 %, since the last one happened in October 2011.

51. A correction is always possible and the reasons to justify it have increased. But it is unlikely that this would be the beginning of a bear market (i.e. a drop of more than 20 %), as growth in the US is strong and it is also improving little by little in Europe.

52. And, as a matter of fact, we are far away from the stock market euphoria of the late 1990s. On March 2nd, the Financial Times, in a full page article asked : "Where have the good times gone ?" And it explained its thinking : "Equities are rallying to record highs, but bankers on Wall Street and in the City of London are finding few reasons to celebrate. Never has a bull market been so unloved".

53. Paradoxically, this is favorable to the stock market since it means that the current rise still has a rational basis and that in particular the number of potential investors is still quite high.

54. This is why we continue to believe that equities should be the main risk in a portfolio, but for those who are not yet invested, caution advises to spread the purchases over several months.

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Commodities (55-59)

55. If, as we have mentioned, all is going well in Europe, the opposite is true for emerging countries, where everything that could go wrong is going wrong.

56. Many are in recession or with sluggish growth. Excesses in the credit sector have led to a misallocation of capital and it takes time to absorb them. The rising dollar is a burden on companies which have borrowed a lot in foreign currencies.

57. Finally, we also have the commodity market which continues to fall and to fall. Furthermore, technically, the picture is not pretty. Prices have broken the 12 years' moving average, a sign that the bear trend has now become structural, suggesting the potential of significant new falls.

58. And after oil, industrial raw materials also broke important support levels, opening the trapdoor downwards.

59. In short, nothing justifies an investment in this sector.

Conclusion (60-67)

60. Even during the depression of the 1930s, never had bond investors so little to drink as today. And this is all the more frustrating with the downpour of debts around the world in the last ten years, since also never before has there been so much water as now.

61. Obviously, this is due to weak global growth. But it is also this continued sluggishness that allows monetary policy to remain very supportive for all assets in general, which also benefit from a decent economic situation in the US, with no inflationary risks on the horizon.

62. However, contrary to other assets, the rise of equity prices continues to happen in a rather uncomfortable way in the eyes of many investors as everything still seems too fragile.

63. In particular, emerging countries - particularly the commodities' producers - appear increasingly vulnerable to the emergence of a crisis similar to the one of 1994, which prevented them at that time to finance themselves in the international markets. This resulted in bankruptcies, major recessions and a dramatic drop in the value of local currencies. And some stock markets lost then more than 75 % of their value in dollar terms.

64. For the time being, fortunately, nothing like this is happening and it would seem that these countries are presently better positioned than at that time.

65. Anyway, this historical reminder is useful in remembering that, if during the 1994 crisis, Western stock markets did indeed also suffer a decline of above 10 %, once the crisis abated they fairly quickly moved up again.

66. Currently, the market has already integrated a lot of good things and a single unexpected bad news could be sufficient to trigger an equity fall. But with the elements in our possession at this time, the probability that it will put the long-term bull market in danger is low.

67. This is why we continue to be reasonably invested in equities and the more so as the current "luck" phase could last longer than expected today.

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