Market Outlook

A monthly commentary by Gabriel V. Safdié
Written on August 2nd, 2013

A TOP IN VIEW ?

Generalities (1-7)

1. After June's sharp market correction, July saw a strong recovery following the reassuring words of Mr. Bernanke indicating that the end of the quantitative easing policy by the Fed would be gradual and based on the evolution of the economic situation.

2. Thus the FTSE World Index in USD rose 4.80 % during the month and virtually all major indices advanced in these proportions, with the exception of Japan (-0.10 %).

3. But once again it should be mentioned that emerging markets underperformed, with the MCI Emerging Markets Index up only 1.30 %, with Brazil lagging in particular (-1.60 % in USD).

4. Regarding the yield of the Bloomberg Global Investment Grade Corporate Bond Index, it fell from 2.83 % to 2.65 % while the Bloomberg Global High Yield Corporate Bond Index after having risen from 4.60 % on May 9 to 6.90 % June 25, moved slightly down to finish the month at 6.00 %.

5. Nevertheless the bond market is much more volatile than what was previously the case. For example, the yield of the 10-year German sovereign bond started the month at 1.73 %, it moved down to 1.51 % on July 22 but then back in just two days to 1.65 %, to end the month at 1.67 %. The evolution was similar to its American counterpart which ended July at 2.58 %.

6. In the forex, the dollar / euro continued to bounce inside the 1.28 - 1.34 trading range in force since February. It ended the month at 1.33 and at 97.90 against the yen which remained in the 90 -100 trading range.

7. The month was quiet for raw materials with an increase of 3.02 % of the CRB Index, with in particular oil moving up (+8.80 %) to 105.-/barrel. At +7.25 % gold corrected its previous strong decline and even industrial commodities rose, with copper for example increasing by 2.20 %. And declines were mainly due to agricultural products, in particular corn (-26.55 % !).

IN THIS ISSUE

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Equities (8-16)

8. Thus, the first significant downward correction this year took place between May 21 and June 24, with a decline of 5.6 % for the S&P. In fact the fall was global: the MSCI EAFE Index, which covers developed countries in Europe, Oceania, Israel and the Far East, declined 10.1 %, the MSCI Emerging Markets 15.3 %, the CRB Commodity Index 3.6%, the 10-year U.S. Treasury bond 4.4 %, the German equivalent 5.2 %, the Bloomberg Emerging Market Bond Index 8.7 % and gold 6.8 %.

9. This widespread decline surprised many investors as it is rather unusual for volatile assets such as stocks and assets considered as safe heavens such as bonds to fall simultaneously.

10. But this is an event that will be less and less rare in the future because all assets without exception, including real estate and art, are valued on the basis of a nominal long-term return of 2 %. However, as and when the market will decide that the long-term rate should be higher, a strong downward pressure will be exerted on all assets.

11. A good example comes from the real estate sector. Just an increase in the mortgage rate from 3.5 % to 4.5 % requires that the potential buyer of a property, if his purchasing power remains unchanged, to pay 20 % less than before the rise, if he needs a 100 % mortgage. This is due to the fact that since the available amount for his mortgage commitment remains unchanged, an increase in interest rates must be offset by a decline in the amount of capital due, so that the monthly payment remains the same.

12. Thus, a small increase of 1 % of long-term rates can have significant consequences.

13. Finally, it should be noted that the present rise of US real estate prices is primarily due to financial investors who are buying to rent for a return that they compare to the 2 % mentioned above. Currently only 29 % of sales are made to first-time owners against an average of 40 % over the past 30 years. Therefore, the rise of property prices does not mean that there has been a significant improvement in the financial situation of families. Also, this trend will also come to a stop as soon as the return will not be attractive enough, as financial investors will turn from buyers to sellers.

14. Usually, in such an environment, shares are the best performing asset since, after an initial decline, they resume their bull move as the normalization of interest rates is synonymous with good economic growth which brings rising corporate profits that more than compensate the effects of the interest rates rises. The trouble for equities generally begins when the central bank starts to push up interest rates to slow down the economic activity.

15. But today we are not sure of anything. We know that the goal of the Fed with its quantitative easing policy was to raise asset prices, in particular real estate. To the extent that a holder of a mortgage in the U.S. does not give his personal guarantee, he has the option of simply giving the property to his creditor to be released from any commitment. And so there was a risk that the more property prices fell, the greater the temptation for owners to get rid of a loan that had become superior to the value of their home. This would have increased the number of properties in foreclosure, thus increasing the downward pressure on prices in a spiral that would have fed itself.

16. This strategy has been so far successful, but a rising tide lifts all boats, and therefore other assets also benefited. Critics of this policy believe that these increases are artificial and linked to a dangerous experience by the Fed which could end badly.

Equities (17-30)

17. In this context an essential element for a happy ending is that the Fed absolutely needs that yields move up slowly, very slowly, so that asset prices are not put into undue pressure. Thus, it must have been shocked by the markets' reaction following its announcement of the gradual phasing out of its assets purchases and since then it is working to calm down investors' fears.

18. For equities, the low level of interest rates allowed companies to borrow at a very low cost in order for them either to repurchase their own shares or pay a dividend. Even Apple, despite its mountain of cash, chose this solution rather than to repatriate profits from abroad which would have been taxed in the U.S. Higher rates will inevitably slow this type of operation.

19. And many bond investors entered the stock market only for the dividends and they should move out once bond yields become more attractive.

20. Another essential element which has been very favorable is the constant rise of profits (for example +3 % in the last 12 months) and revenues (+4 % for the same period).

21. Thanks to these and other positive factors, the U.S. stock market has had an important rise this year and at a minimum it should presently be at fair value, with some having a more negative view as they believe stocks to be overpriced once for example earnings are adjusted to the business cycle.

22. Thus, unlike 2010, 2011 or 2012, where at this time of the year the US stock market (and others also) was reflecting an excessive pessimism, it is possible that presently expectations have become overly optimistic.

23. First it should be mentioned that the increased uncertainty regarding the future evolution of yields is a concern because as we know "the market hates uncertainty" and it tends to price assets lower whenever uncertainty rises (and vice-versa). Therefore investors need to be reassured regarding the pace of future growth. And they may be disappointed.

24. Indeed, in the U.S. domestic growth spending could be lower than expected, given the small increase in purchasing power.

25. And there is still no increase in the velocity of money, suggesting that credit demand remains weak.

26. Also, one must add the new deflationary pressures with a clear continuation of the decline in the GDP deflator, which is a way of measuring inflation by including only the price of all goods and services produced locally. On an annual basis, from a peak at 2.4 % in the third quarter of 2011, it has now come down to 1.5 % on June 30th this year.

27. Outside the US it should be noted that the economic situation of emerging countries continues to deteriorate and the longer it will last, the greater the impact in other countries.

28. This can be illustrated with an example. China's investment spending represents17.5 % of the world's global spending and it contributes in real terms to 4.5 % of the world's GDP. These are significant numbers and in size they are identical to the American ones.

29. So, as China's growth is slowing, inevitably capital expenditure will go down and even more so as many investments in recent years are not profitable and must be subsidized directly or indirectly by the state.

30. Since the beginning of the year, the MSCI Emerging Markets Index is down more than 10 % while the S&P is up nearly 20 %. This situation is somewhat reminiscent of 1997-1998 when the U.S. stock market was rising while the opposite was happening in emerging countries. Furthermore, as is the case today, commodity prices were also falling.

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Equities (31-33)

31. All this ended at the time with a brief but sharp fall in Western stock markets and the collapse of Long Term Capital Management.

32. In conclusion, there is a risk that U.S. growth will not be as high as desired by investors. This would then be an inverted mirror of previous years when because the news were not as bad as expected the stock market moved up, while today it is the peak for the year which could be in sight.

33. But for this to be the case it still takes an unexpected element to trigger the decline, which should then be larger than the May-June drop for the U.S. stock market.

Bonds (34-44)

34. Some argue that the long term secular bull market in bonds, which in particular enabled the yield of the 10-year U.S. Treasury bond to move down from 14 % in 1981 to 1.40 % in 2012, is over.

35. This is possible because even if, given the evidence presented above, the 10-year yield could fall back below 2 %, it will be difficult to beat the record of 1.40 % if there is not a high fear of recession. And this risk is currently quite low.

36. Also, a return below 2 % would not be surprising because a secular phase of higher yields is by definition a long one, and there will be moments where the main trend reverses. For example in four months, starting in July 1982, the entire yield's decline of the previous two years was erased.

37. Anyway, uncertainty has increased in this area. The Fed has been trying to calm things down since yields rose following its announcement that the policy of asset purchases would gradually be phased out and the central bank has communicated a lot to explain that even if it will be putting an end to its purchases, it is out of the question to sell bonds since its intention is to keep them to maturity.

38. This indicates that the Fed's analysis focuses on the stock of bonds while the market is more interested in the flow.

39. When the Fed began its aggressive phase of assets purchases Bill Gross, the best bond manager in the world, said bonds were a sell because who would replace the Fed once it stopped buying?

40. At the time he quickly reversed his position because the market has a saying that you should not fight the Fed and therefore since it was acting to lower yields, it was better to follow rather than to try to fight it.

41. But from the moment it will become clear that the Fed is close to stop its purchases, the law of supply and demand will be back on the driver's seat. And without the support of the central bank investors may be reluctant to buy if they consider the yield to be inadequate.

42. Since the 2008 crisis, the Fed has been able, in a unique way in modern history, to control long-term yields because with no inflationary pressures, it had plenty of space to buy whatever it wanted.

43. But once this phase is over, it is the market and not the Fed which will regain control over long-term rates.

44. And, from that moment on, the Fed will have to react rather than act. It will not be in command. Consequently, if for example one day the Fed wants to suppress an unwanted increase in yields, it may be forced - against its will - to intervene and once again buy securities. It would then be a new and unexpected chapter in the quantitative easing policy that would be written.

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Bonds (45-49)

45. In the meantime we continue to recommend great caution in this area. The decline in bond prices in May - June was the equivalent of a little tremor before a bigger earthquake.

46. And with only 2 % of withdrawals of the assets deposited in US high-yield bond funds and 0.6 % in US investment-grade bond funds, the consequences were already relatively severe.

47. This is not really surprising. We have mentioned already several times that the market's ability to cope with a sell move is much lower than before.

48. Here is another illustration. According to Matt King, an analyst with Citicorp, in 2007 it took withdrawals of 50 % of the assets in U.S. bond funds to force banks that provide a market to double their inventory. Today 5 % would be sufficient. Thus, the main uncertainty is who is going to be able to replace the banks.

49. As with any earthquake, it is impossible to predict when it will happen. It may be tomorrow or in two years. However bondholders are like those who, because a volcano has been dormant for a long time, came to live near it because the soil is very fertile. But not everyone will be able to save himself once the volcano wakes up.

Commodities (50-56)

50. In the field of the disasters of the year, nothing will probably beat the gold mining sector. A decrease of over 50 % since January for the stars of the industry such as Barrick Gold, Anglogold Ashanti and Gold Fields. Newmont Mining is currently quoted at its 2002 level at a time when gold was at USD 400.-/ounce. Never has the ratio between gold mining share prices and gold itself been this unfavorable for the companies.

51. Clearly everything that could go wrong has been going wrong. "Troubles never come singly" to quote former French President Jacques Chirac. And indeed, bad investments, higher extraction costs, lower gold prices: they weren't spared anything.

52. At present, with so many bad news priced in the shares, it is tempting to look into it.

53. But any eventual buying should be done little by little since, with the decline in the growth rate of emerging countries, deflationary pressures could continue.

54. Furthermore, any slowdown in India and China could adversely affect their consumer's gold demand. And because in 2012 these two countries represented 37 % of the total gold demand, a final sharp drop in gold and gold mining shares cannot be excluded.

55. In favor of gold there is the fact that speculators have bearish positions to a level that has not been seen since the beginning of the gold bull trend. They may be forced to close their positions at a loss if a small upward move appears.

56. In the long run, we are not convinced that the bull trend is over. A year's decline, even as big as this one, after 12 consecutive years of increase is not surprising. In fact, the answer to this question lies in the ability and willingness of central banks to provide or not a real return (after inflation) to bondholders.

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Currencies (57-60)

57. In this chapter we will now address a rather strange event.

58. Normally, when there is a phase of widespread sale of assets, as it happened in May and June, the dollar rises. But surprise, surprise, this time the dollar index fell 1.7 % and it is the euro index which rose 3 %.

59. While it is too soon to draw a conclusion, the strength of the euro in the last 12 months could mean that this is not an aberration and that the single currency could be in the process of replacing the Japan of before Shinzo Abe, with a euro zone that would fall into deflation.

60. And as a matter of fact, like Japan previously, globally the Eurozone has a large surplus in its balance of payments thanks to the strength of German exports and the recession in many countries of the zone which leads to a decrease in imports.

61. Furthermore, the lack of cross-border bank lending requires the weakest parts of the zone to be in deflation in order to lower their real costs, which also makes them more competitive.

62. If this Japanese scenario were to materialize, the current rise in European markets could not continue.

64. Also, as we have already mentioned previously, now that the balance of payments of each member state is close to equilibrium, the worst of the economic downturn is behind. It is therefore likely that, even if it will be feeble, growth will mercifully improve for the member states.

65. In this scenario the balance of payments' surplus of the zone will decrease and if the ECB does not make a mistake, the widespread rise of the euro should come to an end.

66. Furthermore, this is essential. Europe is too weak economically to sustain for a too long period an unfavorable exchange rate.

Conclusion (67-70)

67. From an excessive pessimism in mid-2012 to an excessive optimism in mid-2013 ?

68. We will know it in the coming weeks and as usual it will be the US stock market which will be commanding events. And it will be a worsening of this market which will lead us to reduce the exposure to equities.

69. Meanwhile, we remain cautious and this as long as we do not see signs that most of the slowdown in emerging markets is behind us.

70. And it should be mentioned that with all assets moving down together in the last selloff and with the dollar acting in a strange way, investors are in a rather uncomfortable position.

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