SAGA Market Outlook

A monthly commentary by Gabriel V. Safdié
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LIFTOFF

Generalities (1-6)

1. It appears that 2015 ended well ahead of the calendar year for most hedge funds as the specialists believe that they have substantially reduced their positions already at the beginning of November, whereas they usually only do so around mid-December. With multiple and unpredictable moves up and down in markets, it has been a difficult year for them.

2. And this probably helped November to be a quiet month, with neither bulls nor bears able to take the advantage. Therefore in the US, the S&P 500 was unchanged and the Nasdaq Composite increased by 1.1 %, while in Europe the DAX rose 4.9 % and the Euro Stoxx50 2.6 %. And in Japan, despite a decline in growth for 2 consecutive quarters, the Nikkei moved up 3.5 %.

3. Once again this year, emerging markets went down with the MSCI Emerging Markets index in USD dropping 2.5 %.

4. Regarding bonds, if the yield of the 10-year German sovereign bond fell to 0.47 % at the end of the month - while the Japanese was almost unchanged (0.31 %) - the US equivalent climbed from 2.14 % to 2.21 %. As for the Bloomberg USD High Yield Corporate Index, after declining 0.6 % in October, its yield increased again to 8.3 %, just 0.2 % below the highest of the year. The index fund Market Vectors Emerging Markets, invested in local currency and listed in USD also remained close to its lowest level of the year and for 2015 it is down 17 %.

5. In currencies, the President of the European Central Bank (ECB) - Mario Draghi - continues by the content of his declarations to send clear signals that he wants a weaker euro. And the market fulfilled his wish with a decline of the euro against the dollar from 1.10 to 1.0560, while the yen against the greenback lost only 2.5 yen at 123.

6. Finally, a new 7.3 % decrease for the Bloomberg Commodity Index to its lowest of the year with once again a significant decline in industrial metals (nickel -11.7 % and copper -12 %), while at USD 42.-/ barrel, the oil price has lost almost all the ground gained since its August low.

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Equities (7-17)

7. The French humorist Pierre Dac had already observed : "Predictions are difficult, especially about the future". A month ago in our last commentary, we stated that it was unlikely that the FED would raise its key rate in December since, even if a majority was in favor, the necessary consensus among its 12 committee members was lacking. And indeed the market was giving then only a 20 % probability for this to happen. Today, this has risen to 90 %. So, what has happened ?

8. Last month the title of our report was : "Half full or half empty ?", to symbolically indicate that, depending on the point of view, the economic situation appears to be rather good or bad.

9. And one finds this divergence even among the economists tracking the FED's policy, since surveys conducted among them indicates that 50 % favor a rate increase, while the other half are against it.

10. In the days preceding the FED's meeting on September 17th, it was mostly those opposed who spoke. And their influence was quite important as markets had fallen sharply in the previous weeks because of the Chinese growth slowdown and of its consequences on other emerging countries.

11. Even though the FED announces immediately after its meeting its decision regarding the interest rate, the minutes of the meeting are made public only 3 weeks later. Thus the minutes of September 17th meeting (in which the FED had left the rate unchanged) were published on October 8th. And since then, the trend started to reverse and the FED has been attacked by those who favored the increase, as they considered that the central bank yielded to the market's pressures.

12. And their words were backed by the fact that the stock market strongly recovered in October. And so when the minutes of the following meeting held on October 28th were published on November 18th, it clearly appeared that the FED's committee was willing to raise its now famous rate at its next meeting, which will take place on December 16th.

13. The FED members have realized that the little game of "I raise/ I don’t raise" was beginning to impact the credibility of the committee. A consensus has thus been found which is to state that the important thing is not the first increase of 0.25 %, but rather the rhythm at which the following ones will come. And on this matter the FED indicated that "even after employment and inflation are near mandate consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rates below the level the Committee views as normal in the long run".

14. Thus, increases will be much slower than usual and this compromise seems to have satisfied the market. As with a space rocket which, when launched, remains motionless near the ground for some moments, the liftoff of the benchmark rate will be almost imperceptible.

15. Consequently, the whole question is whether the FED will be successful with this launch and able to gradually move the rate back to 2 %, i.e. a level that makes sense today given the country’s growth rate; or whether, on the contrary, as feared by skeptics, this period of rising rates will fail and economic weakness will force the FED to move down its rate as fast as a rocket crashes to the ground.

16. On the favorable side, the excellent employment figures in October probably sealed the increase. All aspects of the report were positive and indicated that not only growth remained sustained but that it could even accelerate towards 3 %.

17. And as we mentioned last month, if real incomes begin to rise, the US economic situation - growing without unemployment or inflation - would be close to ideal.

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Equities (18-27)

18. From this point of view, there is therefore no reason to keep the interest rate at a crisis level.

19. Pessimists see the situation in a completely different way. They consider, firstly, that the rise since July 2014 of almost 20 % of the trade-weighted dollar (index calculated proportionally to the volume of US trade with its partners) already corresponds to an implicit tightening of monetary policy by 2 %. And the dollar's rise could even accelerate if interest rates increase.

20. And, secondly, this tightening of monetary policy will be happening at a time when emerging countries are in trouble, which not only weighs on global growth but also remove a lot of pricing power from companies.

21. Thirdly, the fall in the price of oil is also a powerful deflationary factor. And indeed gold, which is today the best leading indicator regarding inflation, has fallen 5 % since the increase in interest rates has become virtually certain. This is a sign that inflation - which has been only at 0.2 % in the last 12 months - could come again dangerously close to 0 %, thus increasing the risk of deflation. Therefore, the question is : why increase the interest rate when inflation is so far below the 2 % objective established by the FED itself ?

22. They further note that both consumption and profits growth remain anemic, a sign that the economy is running out of steam.

23. This also puts the stock market in danger. And one of our regular readers attracted our attention to the fact that the 1 % rise of the S&P 500 for 2015 at the end of November was only due to about ten stocks such as Amazon (up above 100 %), Google (+40 %) and Facebook (+35 %). Therefore, the rise is very narrow, which is not a good sign.

24. Finally, the DJ Transportation index is down 10 % this year, despite the decline in oil prices which should have strongly increased the profit margin of this type of business. How can this be explained if the economic situation is that good ?

25. Those who regularly read us are familiar with this debate which started in 2009. American growth is strong enough to allow for a slow and steady improvement of the economic situation but it is uncomfortably weak, keeping alive the fears of a relapse which always appear to be imminent.

26. We continue to be - as it has been the case since 2009 - on the optimistic side, because without a negative exogenous factor, growth is self-reinforcing. But as we are quite aware of the dangers, our optimism is moderate.

27. Furthermore, one will now have to monitor the effects of the expected interest rate rise in December, then of those coming in 2016, since historically it is the accumulation of these increases which ends up breaking the bull market.

Bonds (28-29)

28. Regarding bonds, all the attention is now focused on debtors of emerging countries, because of the slowdown - or even recession - experienced by many of these countries.

29. In mid-November, The Economist made its cover with the title "The Chronicles of Debt", illustrated by three big books ready to fall like dominoes. The first volume was called "The Great American subprime crash 2007-2009", the second one "The Euro crisis 2010-2012" and the third : "The Emerging market bust 2015-?"

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Bonds (30-37)

30. And on November 17th, the Financial Times published a study from which three main elements emerged :

- Private debt in emerging markets is higher than in developed markets before the 2008 financial crisis.
- Some estimate that USD 7 trillion of quantitative easing (QE) has been invested in bonds of debtors coming from emerging countries.
- A portion which is difficult to estimate of this USD 7 trillion has been invested using leverage.

31. In short, the concern is that, as has happened with some banks in 2008, a few companies will be unable to refinance maturing bonds thus leading them to insolvency. And then, there will be a significant risk of an almost complete closure of the market for new issues from emerging countries debtors, with a consequent major crisis which would be felt around the world.

32. For now the rise in yields remains within acceptable limits. But the situation could become tenser with the first US interest rate hike - followed by the next ones - as this would increase the attractiveness of the US market and thus the possibility of a capital flight from emerging countries to the US and this at a time when QE has ended.

33. On the opposite, these fears are favorable to sovereign bonds of developed countries debtors, who benefit from their safe-haven status. This is also why the rise in US yields has been quite modest so far. For example, the yield of the 5-year Treasury bond stands at 1.6 % only.

34. In our view, this yield is insufficient; but compared to Europe, it is a feast. For the same maturity, the yield is negative in Switzerland (-1 % per year - representing a guaranteed loss of 5 % of the capital invested during the whole period) and in Germany (-0.2 %). In France, it is 0 % and in Italy only 0.3 %.

35. This pushes investors to take risks. And sometimes the danger comes from the most unexpected places. Deutsche Bank is the largest bank of the biggest European power. Nevertheless, the yield of its perpetual subordinated bonds recently climbed sharply and now stands at around 7.3 % per year. The reason is that the bank announced poor results and as a consequence it is halting the payment of dividends for the next two years. This means that under the terms of the loan, it may decide on its own to stop the payment of interest on these bonds as long as it does not begin to pay again a dividend.

36. Furthermore there is a risk, for the time being more theoretical than real, that, if losses were to increase, the bank unilaterally exercises its right to convert these bonds into shares. And the subsequent dilution of capital would push the price of the stock sharply lower.

37. In short, as soon as one moves out of the traditional investment grade bonds universe, it is essential to carefully study the prospectus to understand all the risks taken.

Currencies (38-39)

38. Mr. Draghi is a man with a mission : to bring down the euro.

39. As a former Goldman Sachs' executive, the president of the ECB understands the market and knows that mechanically traders position themselves short of the currency of a country ready to take new QE measures. He is also aware that the fall of the currency is the only positive element that QE can bring when interest rates are already so low, or even non-existent, as is the case today in Europe.

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Currencies (40-45)

40. This is why the ECB has been focusing in its recent weeks' announcements mainly on the weakest aspects of the European economy, ignoring the best ones.

41. Yet the Flash Markit index for the manufacturing sector of the Eurozone in November was at its highest in 19 months. And in its comments, Markit declared that all indicators showed a significant improvement. For example, we had the biggest gain in order books since April 2014.

42. In short, we believe that the glass of the European economy, which was rather empty, is filling itself a little faster than before.

43. It is also possible that the ECB is being negatively influenced by its physical location in Frankfurt as one knows that the emerging countries slowdown is mainly negative for Germany with a much lower impact for the other countries of the zone.

44. Anyway, the current price of the euro-dollar already integrates the prospect of US interest rate hikes in coming months, as well as a relatively large increase in the European QE. A disappointment in one and/or both of these expectations would likely bring, given the speculative long dollar positions, a significant counter-movement in favor of the Euro.

45. This situation leads us to consider that if it is too late to sell Euros, given the will of Mr. Draghi it is also too early to be a buyer.

Commodities (46-51)

46. One of the reasons why the pessimists are expecting that the only locomotive of global growth, the US, will weaken is the fall this year of more than 25 % of the price of copper, bringing its decline since the peak of 2010 to over 50 %.

47. Historically, the widespread use of copper in the industry made of it such a reliable leading indicator as to the future evolution of the economy that it became known as the "metal with a PhD in economics."

48. We consider that this indicator is still valid, but no more for the United States, which, like Europe, is in a post-industrial era. Today, it concerns China, the great industrial world power.

49. In March 2014, we mentioned that copper was then at a critical level at around USD 300.-/25'000 pounds and that if this support gave way, the door was open for a new and significant decline. And the break actually occurred in October 2014 with the price falling this month to just USD 200.-.

50. Thus, the Chinese slowdown which is now visible to all has been correctly announced by Dr. Copper. Time will now tell if the red metal will be able to stabilize itself at the current level. But the second largest producer in the mining sector, Rio Tinto Group, still expects another 2 or 3 difficult years.

51. Regardless, the evolution of copper strengthens our current view of avoiding emerging markets. On the opposite, when the trend on this metal becomes positive it will be a strong signal for a return to these countries' stock markets.

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Conclusion (52-57)

52. Rightly or wrongly, for credibility reasons, the Fed considers itself obliged to raise its key interest rate by 0.25 % in December. And the recent market behavior indicates that this should not be a problem for investors.

53. Thus it is the next moves which will be more challenging. The next months will show whether US growth can withstand them or if, on the contrary, vital signs of the economy will be damaged.

54. But to these strictly US internal elements, one must also add external factors such as the dollar exchange rate, the evolution of emerging countries' economies as well as the credit situation of their companies.

55. And as if this was not enough, geopolitical risks have been rising sharply not only in the Middle East but also in the China Sea, where the Chinese presence is becoming increasingly more assertive. For the time being this danger has been completely ignored by investors.

56. In the same way that one should be surprised every day to be healthy considering the quantity of diseases threatening us; since 2009 despite all the dangers, developed stock markets are in good shape, even if they catch a cold from time to time. And for the moment we believe that this should go on, explaining why our main risk taking continues to be taken in a reasonable manner on equities, mainly in Europe and the USA.

57. Today more than ever, the saying that bull markets must climb a wall of worry appears to be valid.

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