SAGA Market Outlook

A monthly commentary by Gabriel V. Safdié
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ACTIVE OR PASSIVE

Generalities (1-5)

1. The main event in May was the rise of more than 0.5 % of bond yields, both in Europe and the United States.

2. Thus, the 10-year German sovereign bond rose in three weeks from a yield of 0.07 % on 20 Arpil 2015 to 0.72 %, before ending the month of May at 0.49 %. The US equivalent climbed up to 2.29 %, and finished at 2.12 %. However, the Bloomberg USD High Yield Index was virtually unchanged at 6.20 %.

3. The bond correction also led to a retracement of the dollar rise against the euro, which after reaching 1.05 in March, moved back to 1.15 two months later, before finishing May at 1.10. Regarding the dollar/yen parity, after remaining stable at around 120 for almost six months, the yen dropped in the last days of the month to 124.15.

Performances were quite divergent for equities. The best came from the Nikkei, up 5.3 % thanks to the fall of the yen, while in the US the S&P 500 gained 1 % and the Nasdaq 2.6 %. On the opposite, in Europe, the DAX move down 0.35 % and the Euro-Stoxx50 1.2 %, while the MSCI emerging markets fell 4.10 %.

5. Finally, the Bloomberg Commodity Index dropped 2.7 %, led by lower prices for industrial commodities such as aluminium (-10.7 %) or nickel (-9.7 %).

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Bonds (6-17)

6. The real surprise regarding this bond markets' fall is that it took so long to happen. Indeed, it was only when 25 % of the sovereign bonds issued by the Eurozone countries traded at a negative nominal yield and that the real yield on the 10-year German sovereign bond dropped to -1.3 %, that the move finally started.

7. Of course, the drop was quick, but it was neither extravagant, nor shocking. It should in fact be seen just as a warning, since it is unlikely that the trend will continue. Indeed, in the US, the latest economic figures have disappointed and, for the fifth consecutive year, the same scenario seems to recur : at the beginning of the year economists expect growth to be at 3 %, and then, unfortunately, this forecast has to be substantially revised downwards during the year.

8. Thus, the US economy remains stuck in that soft growth area, neither too good, nor too bad, but which de facto constitutes a powerful brake to any eventual aggressive rise in interest rates by the FED. And, logically, this also limits the increase in bond yields.

9. And this is also the case in Europe, where the European Central Bank (ECB) has reconfirmed its intention to continue unaltered its massive bond purchase program.

10. This episode must therefore be considered just as a preparation exercise for the real earthquake. Then, the economic situation, far from acting as a brake, will instead be an accelerator, since the normalization of the economic situation will go hand in hand with that of interest rates. And one should then expect an extraordinary volatility as the move gains speed.

11. But there will be at least one point in common with the current action : the decline will happen as was the case. this time, by surprise and without notice, with investors running to catch up with events

12. And one can have an idea of the damage that the bear market will cause by the fact that just this simple increase of 0.5 % of the 10-year yield is equivalent to a loss (from the lowest yield level reached) of four years of income on the US sovereign bond and of twelve years on the German one. Given the low level of interest rates, the impact in real terms is thus significant.

13. This episode illustrates the fact that, as we have being mentioning for a long time, the risk in the bond sector is disproportionate in relation to the potential gain.

14. However, it is excellent news from an economic perspective. For over a year, the biggest fear was that the developed countries' economies could end up in a deflationary spiral as in Japan.

15. And this fear was reflected by an interest rates curve which had strongly flattened. In a healthy situation, the difference between short-term interest rates and long-term ones is relatively high, as investors expect that, given the good economic health, the central bank will gradually raise its key interest rate.

16. Conversely, on the eve of a recession, the curve will be inverted, with a higher yield for the shorter term debts in relation to the longer ones as the market expects that the central bank will have to start a series of rate cuts.

17. Therefore, when during 2014 the yield of the US 30-year bond moved down from 4 to 2.5 %, while the 3-month one remained unchanged, it was a source of concern, since such a tightening between rates should not have happened if the economic situation was really that good.

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Bonds (18-19)

18. From this point of view, the increase of the 30-year bond's yield should therefore be interpreted as a sign that, on the one hand, deflationary pressures are declining and on the other, that economic growth remains on track.

19. This also makes more likely a first increase of the FED's key interest rate, the prime rate, during the second half of the year and this is likely to maintain bonds under pressure in the next months.

Equities (20-30)

20. However, it is good news for equities as the slowdown observed since the beginning of the year in the US appears to be transitory.

21. Furthermore, as was our expectation a few months ago, economic growth in the Eurozone has now improved, to the point that the contrast with the United States has become noticeable, with, in annual terms, an increase of 1.6 % during the first quarter of the year in Europe against a fall of 0.7 % in the US.

22. Certainly one quarter does not make a trend and it is very unlikely that European growth could be higher than in the US in the long run. But it is an additional sign that the road remains free for equities.

23. Therefore, we continue to recommend that the main risk in a portfolio should be taken through equities of developed countries while still favouring European equities, since they continue to have a catch-up potential in relation to the American ones

24. However, based on current data, it appears that for the last quarter of the year it may be necessary to equalize investments between these two markets, as European growth should then have reached its cruising speed and market valuations between these two regions will also be closer.

25. We remain underweighted emerging countries stocks, as they still have to finish digesting their strong past growth and also because the present low levels of commodity prices continue to weigh on many of these economies.

26. And it should be mentioned that the present bull market for Western equities could continue for still quite some time, as growth is sufficiently high to allow for an increase in corporate profits, but insufficient to create fears of a fast rise in interest rates.

27. But nothing lasts forever and one day interest rates will have to normalize. It will then be the end of the party as higher yields will pressure all assets of any type, since they will have to adjust to higher capitalization rates.

28. One example : a capitalization rate's increase on a property from 4 to 5 % implies a 20 % decline in its value, if rent income remains unchanged. At 6 %, the decline is 33 %.

29. The zero interest rate policy has enabled all assets to move up significantly above their historical levels and thus all of them will be vulnerable once monetary policy becomes more restrictive. This does not seem imminent at present, thus justifying our current equity exposure. But, when it happens, one would then need to be significantly overweight cash.

30. The challenge for investors will be to ascertain when monetary policy will become restrictive, and this compared to simple increases in interest rates that accompany an improvement of the economic situation. These simple increases certainly slow down a bull market but are unlikely to break it.

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Equities (31-43)

31. The change of speed by central banks will even be quite dangerous, as it is likely that it will be done abruptly. The picture is that of a stuck economy with a central bank ready to use any tool to release it. And since it is stuck more deeply than expected, the rescue operation is taking longer with the need to use bigger tools. But once it will have succeeded, the economy will accelerate in a surprising way.

32. This is why the returns forecast model for the next seven years from GMO, an US asset manager, is negative for most financial assets. This model, which has a rather good historic track record, expects today that the real return (i.e. after inflation is deducted) will be on average, per year for the next seven years, between -2.1 % and -2.9 % for US equities and between -0.4 % and -0.8 % for foreign ones. Regarding bonds, the yield would be -1 % in dollars and -3.5 % in foreign currencies of developed countries.

33. Only the emerging world should escape this curse, with +2.4 % for equities and +2.1 % for bonds.

34. And all these figures must be put into perspective with the historical real return on US equities which stands at 6.5 % per year.

35. Central banks are aware that the 0 % interest rate policy inflates in an exaggerated way asset prices, but they consider that this is an acceptable negative side effect of the required drugs they have to administer in order to cure their sick economies.

36. Another consequence of this situation is that it strongly favours passive investment in relation to active investment.

37. When everything moves up, to be selective is of little interest and it is therefore very difficult to outperform. Thus for example, in 2014 over 80 % of US equity managers underperformed their benchmarks. And this followed several other bad years from this point of view.

38. Those who distribute ETF funds consider that it is only the management costs of an active asset manager which explains this underperformance. And these costs are indeed higher than the commission on an index fund.

39. And now specialized newspapers are also "teaching" to their readers and that they need to leave active managers and only invest in index funds. The switch is already happening and the phenomenon will probably accelerate in coming months, as investors become more convinced that this is "The winning strategy".

40. Of course, reality is more complex than that.

41. Jeremy Grantham, founder of the aforementioned GMO, noticed that for the last twelve months to 09.30.2014, the S&P 500 outperformed by 10 % small US capitalizations as well as international equities and by 20 % cash. Consequently, an equity manager who would have invested outside the S&P 500, 5 % in foreign equities, 5 % in US small capitalizations and left 1 % in cash would already be behind 1.2 % on its benchmark.

42. In fact, in a long bull market like this one which started in the summer of 2009, an investor or a manager is never sufficiently exposed. Conversely in a bear market, it is the opposite : as low as the risk exposure is, it is still too much.

43. In the same way as a driver needs to adjust his speed to weather and traffic conditions, the asset allocator must adapt his strategy to the situation. And indeed, as long as central bank's policy continues to raise all boats as is the case today, active management will have great difficulty in bringing additional value.

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Equities (44-46)

44. However as soon as monetary policy becomes restrictive, the rules of the game will change. The normalization of interest rates may lead to a lost decade for assets in general, as their prices will have to adjust to higher capitalization rates. Furthermore one should expect roller coaster markets during this period.

45. And it is in such an environment, where one needs to know how to negotiate difficult curves, that the best active managers will be able on the long-term to strongly outperform their benchmark index, thanks notably to a judicious choice of the sectors to be favoured as well as a good control of risk exposure.

46. Regarding equities, one must therefore continue to focus for the moment on passive investments through indexes while being aware that the time will come when it will be necessary to increase the allocation towards active managers.

Currencies (47-55)

47. In our previous report, we mentioned several factors that could likely explain a possible decline of the dollar. And in early May it seemed that this move was going to happen against euro before the 1.15 resistance level blocked the counter-move.

48. Once again, the Greek situation, as well as quantitative easing (QE) in the Eurozone prevented a euro recovery.

49. The dollar also currently continues to benefit from investors' hopes that the FED will be raising its prime rate. But the waiting is starting to become quite long. One year has gone by since the dollar began its bull move and even just one interest rate rise has not yet come.

50. And, the more this is delayed, the greater the probability that the differential of interest rates between the dollar and the euro will be smaller as the expected monetary policy divergence between the US and Europe will also be shorter. The improvement in the European economic situation is already visible and the ECB could for example at the end of this year, if the 2016 prospects are good, revise downward its QE program.

51. In short, the window of opportunity for the dollar to reach and even cross the parity of 1 to 1 against the euro, as is currently expected by most analysts, remains open. But a fairly clear improvement in US growth in the next months is now needed and this at a time when they are signs that the past rise of the greenback is already negatively influencing the US economy.

52. One word regarding the pound sterling. Mr David Cameron's surprise victory allowed the British currency to rebound but it is interesting to note that if the country had been in the Eurozone, its economic fundamentals would be considered as very poor. Its public deficit for 2014 stood at 5.4 % of GDP and its balance of current payments was also heavily in deficit, at 5.5 % of GDP.

53. Thus, if the Conservatives really want to reduce the public deficit, they will have to implement a much greater austerity policy than what has been done since2009. This would then impact negatively on the country's growth.

54. And one must not forget that in the long-term the difference between the balance of payments of two countries is the main currency adjustment factor. Since the beginning of floating exchange rates in 1973, the dollar is structurally in decline versus the Deutsche mark and now the euro, because of the chronic deficit of the US balance of payments.

55. In conclusion, it appears that it may be difficult for sterling to continue its current bull move.

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Commodities (56-60)

56. At USD 60.30/barrel, oil has thus increased over 30 % from the level of USD 45.-/barrel reached two months ago. By the way, this has also contributed to the decline of investors' deflationary expectations.

57. But it is probable that in this case we are just having a typical correction within a clear bear market. Presently this rise could continue up to the 200 days moving average which currently stands at USD 70.-/barrel. However, the large quantity of oil currently stored will, sooner or later, halt this recovery.

58. But it is also a fact that the low level of a commodity price is the basis on which is built the next bull market since it forces. companies in the sector to reduce theirs investments

59. This is the case of copper for example. The price per ton has decreased by 40 % from the peak reached 4 year ago. This has led to a sharp reduction in spending, with projects that have been abandoned and others delayed. Furthermore, the investments needed to keep production units running are not made, resulting in closures. The consequence is that Citibank is now currently forecasting that, from 2016 onwards, there will be a production deficit of 61'000 tons per year.

60. In summary, because of their cyclical nature, commodities perfectly fit the Boom and Bust image.

Conclusion (61-67)

61. Passive management is presently favoured by investors. But one must be aware of its limits.

62. Apple, for instance, entered the Dow Jones only in March of this year replacing AT&T. If the change had taken place in March 2008, when the company was valued at only USD 100 billion and with only one year of iPhones' selling, the Dow Jones would now be above 22'000 points against only 18'000 today.

63. By the way, presently each active manager must make a stand towards Apple given its importance in the indices. Being over or underweighted this security in a portfolio will create a significant divergence in relation to its benchmark. Thus, after one year, the manager might well appear as a genius or a fool, even though it provides no reliable indication of his real capacities.

64. And when a bubble occurs, then a manager's job becomes even more difficult, since if he refuses to participate he takes the risk of underperforming for months, leading to significant investors' redemptions. Thus most managers will follow the move, thus inflating the bubble even more.

65. In such a scenario, management through indices becomes a trap and for example, active managers who had a low exposure to technology stocks when the Internet bubble exploded in 2000, significantly outperformed their benchmark.

66. For the time being, there is not an equity bubble, although US stocks are becoming expensive. If growth continues, the increase in earnings that will result should allow the bull market to continue. But one has to be aware that the safety margin has become quite low and therefore any negative change in investors' expectations will have a strong impact.

67. Hence we continue to give the same advice : one should be exposed to risk only at a level allowing positions to be maintained in the event of an unexpected storm and this without causing sleepless nights. Regardless that the management is active or passive, this is the only real protection for an investor.

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