Market Outlook

A monthly commentary by Gabriel V. Safdié
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THE WIDOW MAKER

Generalities (1-6)

1. Fortunately, the World Cup is starting as traders are really bored; nothing much is happening and volume which was already weak continues to decline.

2. Markets are currently in a wait and see mode. They have priced an increase in economic growth which is taking its time to appear. But, at the same time the situation is not deteriorating, on the contrary. This prevents both bear and bulls to take the upper hand.

3. Concretely this resulted in a further decrease in bond yields, from for example 2.65 % to 2.47 % for the US 10-year Treasury bond. Its German equivalent also fell but less by 11pb to 1.36 %. But the main beneficiaries were high-yield bonds with the yield according to the Bloomberg US High Yield Index falling from 5.5 % to 5.25 %.

4. Regarding the forex market, Mr. Draghi's intervention threats continue to weigh on the euro which fell against the dollar from 1.3870 to 1.3630. Regarding the yen/dollar parity at 101.80 it remained stable for the fourth consecutive month.

5. This stability could also be found in commodities with the CRB index down 1.3 %. But this number hides in fact a disparity between the rise of industrial raw materials such as nickel for example (+5 %) and the decrease of agricultural products such as coffee (-12.6 %).

6. After hesitating during the whole month, stock markets were finally up in May : +2.1 % for the S&P, +3.1 % for the Nasdaq, +1.4 % for Euro Stoxx 50 and even the Nikkei regained some colors : +2.3 %.

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Bonds (7-17)

7. A few months ago the consensus among investors was that with U.S. growth well rooted and the Fed bound to end its quantitative easing policy we would witness the great rotation from bonds to equities, leading to both a rise in bond yields and equities. Needless to mention this has not happened yet.

8. But this expectation pushed up, in the last quarter of 2013, the yield on the 10-year U.S. Treasury bond from 2.5 % to 3 %. Five months later the rise has vanished with the yield moving back to its starting point and causing in the process significant losses, including for some hedge funds.

9. Furthermore, far from being worried by a rise in interest rates from the FED it is the specter of deflation which has become the talk of the financial community. This topic was the focus of discussions at this year's SALT conference; a conference which is for hedge funds the equivalent to the Davos conference for politicians.

10. And the fears that arise from the world deflation can be summarized by the following statement of Anthony Scaramucci, SALT's promoter and host : "Deflation is the dark star, the black hole that collapses the economy."

11. The only surprise we see in these discussions is that it took so long to happen. As a matter of fact, since 2009 we have been drawing attention to this battle between deflation and inflation and we regularly notice that these two forces continue to neutralize themselves so that, five years later, the combat has not been won by any of the two sides.

12. Normally deflation should have been a good thing because by lowering prices, it increases the purchasing power of consumers. Moreover, during the 19th century deflation was more usual than inflation.

13. Yet if today the market is concerned, to the point of considering deflation to be a threat, this is because it is lethal for developed countries which are over-indebted. It is the equivalent of a person who, having a mortgage on his house loses his job. She could try as much as possible to lower her spending but she will still be unable to continue to serve her debt.

14. This can be easily observed. The yield of the 10 year Italian sovereign bond has certainly reached in May a record low below 3 % but the Italian public debt continued to increase from 105 % of GDP in 2008 to 135 % today and it continues to move up. This deterioration is due to the fact that if the budget is in deficit year after year, GDP in nominal terms is at its 2008 level. And it should be noted that, with at 0.5 % annual inflation rate, Italy is currently not in deflation.

15. The difference of our analogy with an individual is that unlike the latter, countries can increase their debts. It Italy were to go into deflation it is not difficult to imagine that its public debt could easily exceed 200 % of GDP, as is currently the case in Japan after so many years of deflation. And this would be the same for any other country in a similar situation.

16. Of course the question that arises is whether debt of such a magnitude can be financed. Japan is showing that it is possible if domestic savings are big enough to finance it and if the population continues to trust its country's institutions. Italians have only harsh words for their political class, but at the same time they remain massive buyers of their own sovereign bonds.

17. But the Japanese case should not be a source of complacency because debt does not matter, until one day when it suddenly does. Trust is like a pregnant woman, either she is or she is not. There is not half-confidence and if an indebted country loses it, for one reason or another, bankruptcy will be as quick and sharp as a guillotine.

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Bonds (18-29)

18. It should also be noted that in Japan the low level of interest rates has been a poisoned chalice. The Japanese economic miracle was made possible by the fact that Japanese companies were created by men who experienced the sufferings of war. But they were later replaced by bureaucrats, unable to adapt to a changing world. The sad state of Sony is the best example.

19. And, from this point of view, the fact that even today 10-year Japanese sovereign bond are yielding only 0.6 % acts as an anesthetic, letting the country believe that there is no need for urgent reforms.

20. If it is so difficult for a country to reform itself it is because the process is painful. To use an image, it would be like a person who, having a toothache would not go to the dentist until the pain he feels is much stronger than any "pain" that the dentist could do to him.

21. However, if that person takes an anesthetic, it could make the pain associated with this decaying tooth disappear for a long time. But in doing so, he has not solved the problem, on the contrary, as the infection may spread to other teeth.

22. This is what Japan is living for the last half century. Anaesthetized by rates which are too low it has allowed its economy to drift. Thus, 25 years after the collapse of its real estate and stock market bubbles, the Nikkei and land prices are still 65% below their peak level. And this situation leads to a Japanese population becoming more and more economically vulnerable. It has now been quite a while since Japanese tourists have travelled in vast numbers to Europe or the US. Also presently, at auctions, Japanese collectors are mostly absent.

23. This is why, beyond the quantitative easing measures implemented by the Bank of Japan (BOJ), the structural reforms expected from Mr. Abe are essential. Unfortunately we are still waiting for them.

24. In any case, deflation appears to us since 2009 as a big enough threat to justify a non-aggressive investment policy. And even more so that if deflation were to appear outside of Japan, it has yet to be proven that the consequences will not be more serious than the already difficult Japanese situation.

25. And for this conservative risk-taking, we prefer to do it through shares rather than bonds, simply because the risk remuneration in the fixed income area is insufficient.

26. A normal situation from an economical point of view would mean that the US prime rate should be on average at 2 % above the inflation level, as was the case during the 1990's. As inflation is currently at 2 %, the base rate should have been at 4 %. However, because of the fragility of the economy since the 2008 crisis, the real return has been of -1.4 %, following a period from 2000 to 2007 of only 0.3 %. Obviously the heyday was the 1980's decade with an exceptionally high level of 4% real return necessary to fight against the excessive inflation of the period.

27. Since 2009 it is this lack of compensation which explains our dislike towards bonds and not the belief that inflation is ready to pounce on the economy as a tiger on its prey.

28. And this is the reason why we have not recommended taking positions to benefit from a hypothetical rise of yields.

29. But, to their detriment, this is just what many have been trying to do, and for years now, in Japan. They consistently lost money at whatever yield level - 3 %, 2 % or even 1 % - they have entered the trade, to the extent that taking a position towards higher yields of Japanese government bonds has received the nickname of : The Widow Maker.

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Bonds (30-31)

30. The fragility of the global economy could cause the expected normalization of interest rates to take much longer than expected. Thus, the current situation could last for months or even years; and this as long as the scenario which has been going on for 5 years now, of an economic growth neither too strong, nor to weak, persists. Therefore, it is not impossible that other bond markets also become widow makers.

31. The difficulty for investors lies in the fact that any unexpected change in this scenario will bring higher yields and the move could be quite strong, since for months now we are showing that this market is ever more dangerous, with bond issues of increasingly questionable quality and lousy returns.

Equities (32-38)

32. But if from our point of view, the fixed income market has the biggest power to destabilize the financial sector, the irony is that mainstream newspapers are full of scary stories regarding shares. Like any bad general they are preparing to fight the last war.

33. For example, three days apart the British newspaper Daily Telegraph wrote: "The fall of the U.S. index of small companies (Russell 2000) shows we are heading for a major adjustment in the markets, and it is crucial that investors are prepared". And also : "Crash fears as experts warn stock market is overheating".

34. Others use historical valuation data to show that rarely shares have been so expensive and that, for this reason, a fall is imminent.

35. Some also believe that the recent decline in bond yields is anticipating a slowdown of the economy or even a recession.

36. Certainly the stock market is not as cheap as in 2009/10, a period when investors where valuing shares on the basis of an economic depression. But, at the present level of interest rates, it is not overvalued either. And compared to alternatives: deposits, bonds, real estate, art or wine, it is by far the cheapest one.

37. Thus, only should the U.S. stock market continue to rise faster than the increase in profits, could this sector overheat. But this seems unlikely for now, thanks to the fears disseminated by the popular press. After two steep declines in equities in less than 10 years the average investor has not returned to stocks because he considers that volatility is his worst enemy. And from this point of view, bonds appear to him to be a haven of peace and tranquility. Unfortunately it is likely that before the end of the decade he will be quite disappointed by its behavior.

38. We are not ignoring the risks related to equities, and this is why we advise a sensible risk-taking positioning; but we consider that the path of least resistance for the economy is towards a slow and continuous improvement. Until proven otherwise, any fall of the stock market should just be a correction, not a trend reversal.

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Equities (39-40)

39. Furthermore, as we come closer to the midpoint of the decade, it looks that the favorite among the assets for the best performance prize of the decade is the equity market of developed countries. And if it were to be the case, history might find that we were too cautious in our risk-taking, forgetting that, if in a chart, a six-months downwards correction may not seem much, one still needs to be able to keep his positions day after day during this difficult period.

40. And if we are wrong, it is likely because either deflation or a major bond crisis has impaired the value of all kind of assets. In such a scenario the winner would then be cash but which is being remunerated at a level close to 0 % since 2008.

Currencies (41-48)

41. Will Mr. Mario Draghi, President of the European Central Bank (ECB) manage to repeat the summer of 2012 accomplishment ?

42. Then, when he declared that he was "ready to do whatever it takes" to save the euro and announcing, with the approval of Ms. Merkel, a program of bond purchases, the market believed his word and bond yields of countries under attack started to decrease without the ECB being forced to buy a single bond.

43. Today he would like to obtain the same result with respect to the exchange rate of the euro. By indicating at the last meeting that the single currency was too strong and that the ECB was ready to act at its next meeting in June, he hopes that the market will do the job without obliging him to take measures.

44. For the moment it is working as the euro is clearly below 1.40 against the dollar which was its level at the time of his announcement. It is also likely that for him this result is sufficient as his goal was never to substantially lower the value of the euro, but simply to prevent a continuation of its rise.

45. And it is possible that once again he will win his bet as investors do not seem ready presently to take aggressive positions and therefore to test him. But if he were to be challenged Mr. Draghi will be in a tight situation. At a time when the German Constitutional Court has expressed serious reservations about its "Outright Monetary Transactions" program announced in July 2012, it will be difficult to start a new one - which would be just as controversial in Germany - with the goal of following the United States and Japan in an aggressive quantitative easing policy.

46. Thus, it will be interesting to see what Mr. Draghi will do in June and the reaction of traders afterwards. Anyway, this is potentially one of the few places where one could find some animation in a lifeless sector.

47. Another possibility could arise from the dollar-yen parity which has stabilized since the beginning of the year but the equilibrium of which is unstable. This is due to the fact that the market is largely positioned towards a lower yen expecting further measures from the BoJ which will favor such a move. The danger is that if these measures, one cannot exclude a violent squeeze to oblige the closing of the short positions, thus quickly pushing the yen higher and the Japanese stock market down.

48. The good news in this sector is that the price of copper - 312.30 - continues to strengthen and therefore it is clearly moving away from the USD 300 level we had previously mentioned as an important resistance point and below which the price of the metal could significantly drop. If this had happened, then we would have had an important signal that the slowdown of Chinese growth was gaining momentum.

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Commodities (49-52)

49. Conversely, this rebound reinforces the idea that Chinese growth should stabilize at around 7 % per annum. This is certainly a level which is lower than in the past but it remains nevertheless quite respectable.

50. However, the fact that the rise in the price of gold was halted after its move from USD 1'180 to 1'390 early this year is a visible sign of the deflationary pressures on the world economy. Indeed, gold is the best advanced indicator regarding the direction of where inflation is heading to. For example, the current worries regarding the deflation's risk were announced a year ago by the significant 30 % drop in the gold's price.

51. What seems currently worrying is the fact that the downward trend in gold is intact since the last bull move died at USD 1'390.-below the USD 1'430.- level reached during the summer of 2013. This means that if there are no new support measures by central banks, the yellow metal could quickly drop from its current price of USD 1'249.70 towards USD 1'150.-, the level at which the fall was stopped twice, after the big drop of 2013 and again in March of this year.

52. And should this level be broken then the next target would be USD 1'000.-, i.e. a decrease of 50 % from the peak. But what would be quite serious with such a development is that it could be signaling that deflation is spreading and that world growth, far from accelerating, is in fact slowing down.

Conclusion (53-59)

53. In January 2012, Pictet Bank launched a short term high yield bond fund with assets of EUR 58 million. Today it has reached EUR 3.9 billion. And this just for one single fund.

54. Knowing that a downward trend is three to four times faster than an uptrend, who can believe that disinvestment in the fixed income area, can be achieved without major damage ?

55. Certainly yields can rise if the situation improves faster than expected but bonds, other than "safe heaven" ones such as American or German sovereigns, will also be at risk if growth were to reverse. In this case yields would rise at the same time that equities would be falling.

56. And this is where we are in an asymmetrical situation. If all goes well, at best the buyer will receive a low interest on its bonds while an equity investor will be much better compensated, if only by the fact that the dividend on shares is higher than bond yields. On the opposite, if everything goes wrong, there is a strong probability that not "safe heaven" bond prices will fall as fast as equities.

57. In addition, the situation is currently particularly dangerous since for a generation there has been no structural bear market in bonds, while just in the past decade there were two steep equity dives.

58. Thus, the natural tendency for the typical investor is to take increasing risk with bonds while neglecting stocks.

59. However it is also important to mention that if we believe that investors will suffer in the future in relation to their bond investments, the timing of when this will happen is unpredictable. Therefore, trying to anticipate the move without tangible signs announcing it, should continue to make many widows.

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