A monthly commentary by Gabriel V. Safdié
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HALF FULL OR HALF EMPTY ?

Generalities (1-5)

1. October enabled European stock markets to recover more than half of their August and September losses with for example the strong increase of 12.3 % for the DAX and 10.2 % for the Euro Stoxx50. And in the US, where the decline was milder, the indexes are again quite close to their highest of the year, thanks to a rise of 8.3 % for the S&P500 and of 9.4 % for the Nasdaq. In Japan the Nikkei 225 climbed 9.75 %.

2. Emerging markets also benefited from the rebound, with a 6.4 % increase of the MSCI Emerging Market Index in USD. The better mood also helped the Bloomberg USD High Yield Corporate index as its yield moved down from 8.4 % to 7.8 %, but it still remains quite distant from its late May level of 6.2 %.

3. US sovereign bonds moved in the opposite direction with the 10-year yield rising from 2.04 % to 2.14 % while the German one remained at the low level of 0.52 %.

4. Regarding currencies the euro fell back to 1.10 against the dollar at the end of the month, following the declaration by the president of the European Central Bank (ECB) - Mr. Mario Draghi - that he was ready, if necessary, to increase its bond purchases within the quantitative easing policy. As per the yen, it remained almost unchanged against the dollar at 120.50.

5. Finally, the Thompson Reuters Commodity Index stabilized in October with a slight increase of 0.9 %.

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Equities (6-18)

6. Usually, among the twelve voting members of the US central bank - the FED - only its chair, or eventually its vice-chair, speak in public. But this rule was clearly broken in October.

7. Indeed, two of them have clearly expressed in the media their opposition to a FED's rate rise. Lael Brainard - an economist - fears that the international economic environment could bring additional downward pressures on US inflation. And Daniel Tarullo - a lawyer by training - expressed great dissatisfaction regarding the interest rates increases forecasted by the FED since he considers that inflation is too low.

8. And if one adds the fact that Vice-chairman William Dudley - who unlike the two others, has a great experience in this field - declared that the fall in growth was due to a rising dollar and a reduction in investments, it appears that a rise in interest rates this year has become very unlikely.

9. Indeed, in addition to these three members, a fourth one - Charles Evans – who belongs to the moderate camp, should most likely also oppose a rate increase. This means that if Chairwoman Janet Yellen were nevertheless to decide to implement the rise, she would need to accept 4 votes against her.

10. However, traditionally, central bankers try to achieve a consensus and if presidents can accept one, or even two dissenting voices, four is unheard of.

11. Logically she should therefore give more time for a consensus to appear, thus postponing the first rate increase to 2016.

12. Certainly at the last FED meeting at the end of October she kept alive the possibility of a rate rise in December linking it to further signs of strength - in particular in the jobs market - to "bolster" the confidence that inflation was set to return to its 2 % target. But, with the current growth rate, it would be surprising if this could happen in the next month and half before the next meeting.

13. It is also interesting to mention that one must go back to 1993 to find for two members to publicly speak so clearly against a rate hike. At that time, the United States had experienced a recession and 1993 was the first full year of economic recovery. And then the FED did delay its first increase until February 1994.

14. In fact, the difficulty facing the FED, as well as a matter of fact the market in general, is that depending on how the situation is looked at, the glass is half full or half empty.

15. In the late 1970s, US economists were used to calculate what they called the "misery index", which consisted in the addition of the unemployment rate and the inflation rate. It peaked in 1980 at 22 %. Presently it stands at 5.1 %, i.e. a level not seen since the 1950s.

16. But if the number in the index is the same, the mood is completely different. In the 1950s, both the economy and real incomes were in full growth and everybody saw the future as an opportunity. Today, growth is soft, real incomes are stagnating and the future is perceived as a threat.

17. There is therefore today a general perception that everything is quite fragile and that the slightest bad news could push the economy into recession.

18. Hence the uncomfortable situation of the FED. Objectively, things are going rather well and if real incomes were to increase, the situation could be considered as close to ideal as possible. There should therefore be no reason to maintain the interest rate at 0 %, which is a crisis level.

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Equities (19-33)

19. But on the other side, growth appears to be slowing at a time when inflation remains well below the 2 % target, the percentage of the population working is at a level that should be considered as too low from a historical perspective and real incomes are still not rising.

20. And now for the first time, globalization is forcing the FED to take into account the international situation in its analysis.

21. Indeed it cannot ignore the Chinese slowdown and in particular the recession it brought to many emerging countries with, as one consequence among others, a substantial fall in the value of these currencies against the dollar, thus exporting deflation to the United States.

22. Furthermore if the US raises its interest rate, the upward move of the dollar will further accelerate creating serious problems for many emerging countries' debtors who heavily borrowed in dollars in recent years.

23. And this is why the World Bank warned that the FED might trigger "panic and turmoil" in emerging markets and advised it to wait until the global economy is on more solid footing.

24. And of course, an excessive rise of the dollar would bring on the one hand, a sharp slowdown in US exports thus impacting growth and on the other hand, lower profits in dollars for US multinational companies which would be harmful to the stock market.

25. The FED is thus stuck between a rock and a hard place and its hesitation is therefore not surprising.

26. And if the picture is so full of contrasts in the US, the country which is relatively doing the best, it is understandable that some investors over-react when bad news appear in other countries.

27. But beyond short-term events, it is important to keep in mind that as long as nominal growth (i.e. including inflation) in developed countries remains above 2 %, central banks' easy monetary policy will continue to favor economic growth and thus corporate profits.

28. Currently the main danger comes from China. For example the analyst Marc Faber believes that the measures taken by the Chinese authorities after 2008 to boost growth have led to a credit bubble and that the current slowdown in the economy is leading to a situation where a growing number of companies will be unable to service their debts.

29. Nonetheless the consensus is that the Chinese authorities have the financial resources to keep the situation under control, even if this difficult phase could last for quite a long time.

30. And one must also take into consideration that the economic situation of some important emerging countries will continue to worsen.

31. Finally this environment reinforces the cautious approach by companies in relation to their investment policy.

32. But for the time being and despite these menaces, if the situation in emerging countries slows growth in developed countries, it has not destroyed it. And as long as it will be the case one should expect that, despite the inevitable volatility, stock markets will structurally remain in a bull trend.

33. However and contrary to what happened in recent years, unless there is a move towards a bubble situation, the rise should no longer come from a faster increase of the price in relation to profit, but essentially from profits' increases, which would then enable the price/earnings ratio to remain stable, or even to decline.

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Equities (34-35)

34. Unfortunately if this were to be the case, then the average increase in coming years should be more modest than previously.

35. In summary we continue to advise that equities should be favored in portfolios rather than bonds.

Bonds (36-45)

36. And as a matter of fact, a new danger is appearing for bonds in 2016.

37. Previously, we have often mentioned the risks linked to low-rated bonds, in particular the insufficient yield in relation to the risk taken. Citigroup, for example, recently warned that three Brazilian banks - Banco do Brasil SA, Itau Unibanco SA and Bradesco SA – have issued USD thirteen billion of subordinated bonds. Given the fact that these banks have lent quite a lot during the last bull cycle, if the Brazilian recession were to worsen, losses linked to these loans could reach levels that would eventually require capital increases, which would then put these subordinated bonds in the line of fire. And the American bank believes that this possibility is currently not priced in the value of the securities.

38. The new danger that this sector will face in 2016 is the fact that the United States have returned to full employment. Indeed historically, once the 5 % unemployment level is reached sooner or later yields move up. The main exception was between 1995 and 1998 when yields fell thanks to the strong increase in productivity.

39. But one must not forget that after having abstained to act in 1993 - as we saw in paragraph 13 - the FED went into full combat mode in 1994 with a total increase during that year of its base rate of 2.5 %.

40. Of course with globalization it is possible that even a 5 % unemployment rate will be insufficient to bring an increase of real incomes; but one can also imagine another scenario.

41. The strong recovery of stock markets in October suggests that the damage caused by the slowdown in emerging countries is insufficient to derail the economic recovery train in developed countries. And now, the benefits for US consumers of lower commodity prices is beginning to appear in their wallets and they could choose to spend rather than to save this surplus, given that their level of confidence, which has been moving regularly up since 2009, has presently returned to its average of the past 30 years.

42. Growth would then move back above 3 % and it should then be sufficient to allow for an increase in real income, thus creating a virtuous circle of growth.

43. And since because - for weeks now - only the most negative scenarios have been considered, this return to normality would take everyone by surprise, including the FED, which could then feel the need during 2016 to accelerate the rhythm of its rate rises in order to remain in control of the situation.

44. This would be exactly the opposite of what happened in 2013, 2014 and 2015, when the FED was expecting at the beginning of each year that it would have to act several times in the year, before having to gradually back down as growth disappointed. Today, in light of past experiences, its expectations of rate increases for 2016 are much more modest.

45. Obviously, the bond market is not prepared for such an eventuality and the upward yields' adjustment would be brutal.

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Bonds (46-55)

46. And even more so as assets held by bond funds have tripled in the last decade and this in a period where liquidity has strongly declined. A recent article in the Wall Street Journal entitled "The new bond market : bigger, riskier and more vulnerable than ever" mentions that bond funds and ETFs are holding 17 % of all corporate bonds, against 9 % in 2008. The problem is that, according to the International Monetary Fund, more concentrated bond funds' ownership means a larger price fall in periods of market stress.

47. And then will appear the question which worries us since 2010 : during the next bear market, who will be the counterparty when bond funds, under pressure from reimbursement requests, will be in great need to sell ?

48. As the last structural bond' bear market ended over thirty years ago, the vast majority of market's participants have no idea of the amount of pressure that this will represent and they will have the feeling that their world is collapsing.

49. In fact, while writing these lines we, as a money manager, can only hope to be wrong and that the rise in yields will happen in an orderly way. Otherwise, it would be illusory to believe that equities - or other less liquid assets such as real estate - will not be subject to a lot of stress and one could even have a year in which all assets would fall.

50. And this is even truer because the correlation between different types of financial assets, which historically was around 45 % and had risen to over 80 % during the financial crisis, is still presently standing at 70 %. This is why it is so difficult to protect a portfolio through the diversification of investments and therefore the best option in such a situation is to keep a relatively large allocation in cash.

51. In recent years increasing inequality has become a major topic of discussion. But rising real incomes coupled with a decline in asset' prices would quickly reverse this trend.

52. By the way, it would not be the first time that an improvement of the economic situation paradoxically leads to a fall in the value of assets.

53. Of course, we are still quite far from such a scenario; but it is a reminder that we are not for ever condemned to this sluggish growth.

54. Going back to the short-term, those who believe that the economy will continue to slow down or even be in danger of falling into recession, should buy 10-year US sovereign bonds since it is likely that its yield will decrease from the current level of 2 % to below 1 %.

55. Those who consider that growth will remain soft and that 2016 will look like 2014 or 2015 may look into some low rated bonds, as their recent rise in yields brought them back to their historic spread level in comparison to better quality ones. But one should note that in this case, it would be possible to obtain the same return through a smaller investment in equities.

Commodities (56-57)

56. The question which needs to be asked in this sector is whether there is still a bull investor.

57. Pessimism is such that a lot of bad news is already priced in. This means that, unless an economic catastrophe comes from China, this market could stabilize even if it will still remain volatile for quite some time.

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Commodities (58-62)

58. In this case the positive impact that lower commodities' prices had on inflation in developed countries should gradually disappear.

59. Regarding oil for example, the inevitable fall in production should allow the market to find an equilibrium which, from our point of view, will be above USD 50.-/barrel. The current price of USD 46.5 seems to us as temporary as was the level above USD 150.- of a few years ago.

60. Unfortunately this is also the view of the market, since the price of oil in the futures' market for a delivery in twelve months stands at USD 52.-. Thus, it is enough that the price remains unchanged in 2016 to provide a loss to an eventual investor of 15 %.

61. This is therefore a different situation than in the foreign exchange market, where the future price relative to the spot one depends only on the difference in interest rates between the two currencies in that particular time frame.

62. This explains why commodities' markets are appropriate for speculation and not for investment.

Currencies (63-70)

63. It is surprising to see that for several weeks now, the ECB seems to be too negative regarding the Eurozone. Indeed, not only does it not seem to take into consideration the strong domestic recovery of the European economy, but furthermore, as Mr. Draghi declared recently, it argues that the risks are skewed to the downside.

64. We consider that, as with the United States, the market is going to be pleasantly surprised by the economic behavior of the Eurozone countries and all the more so as expectations are quite low.

65. First of all, with the exception of Germany, the direct consequences of the Chinese slowdown on the other countries of the zone are quite small. And the impact on Germany should push the country to become more flexible concerning measures to boost domestic demand as it will be one of the main beneficiaries.

66. Secondly, the banks of the zone are finally properly recapitalized and they are not anymore an obstacle to growth. Surveys show that it has become much easier to obtain a credit

67. Also the euro is undervalued which favors the competitiveness of European companies.

68. Finally, consumers' purchasing power has been improved thanks to the lower oil prices.

69. Admittedly, the dollar could still move towards parity against the euro if the FED raises its rate, but the window of opportunity is becoming narrower as the ECB might change its tone and its policy faster than what is expected today.

70. From this point of view, it seems to us too late to be long dollar, but still too early to be long euro.

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Conclusion (71-78)

71. So the glass of the economy is half full or half empty, depending on how it is observed.

72. Recently the market focused on the half empty glass in particular because of the growing pessimism regarding the Chinese situation which after having pushed the emerging economies to recession could eventually also send developed countries in a downwards spiral.

73. For the time being it hasn't happened. And if the Chinese situation doesn't increase its pressure, we believe that – regardless of short-term volatility - nothing else seems to be able to prevent the glass to continue to fill up - even if too slowly - for a long time.

74. And this therefore continues to justify a reasonable exposure to shares as they would be among the main beneficiaries.

75. In the longer run, now that US unemployment has dropped back to 5 %, the risk is that the glass eventually even overflows.

76. Admittedly, this is a danger which does not exist in coming months; but it should not be excluded, especially if real incomes begin to grow.

77. It is a risk that would then need to be managed because with an overflowing glass, the stock market will suffer more frequent falls, yields will structurally be up and the annual return of these two asset classes will greatly diminish.

78. In short, to paraphrase Churchill, if the return to full employment does not mean the end of a bull market, historically it marks the beginning of its end.

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