Market Outlook

A monthly commentary by Gabriel V. Safdié
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DISCREPANCIES

Generalities (1-7)

1. So, the New Year has started as a continuation of the bull move of 2012, amid growing investors' conviction that the central banks reflationist policies is beginning to bear fruits.

2. Therefore, the FTSE World Index in USD rose by 4.5 % in January, but only by a third in EUR : 1.5 %. In local currency the increase was general for developed countries : Euro-Stoxx 50 : +2.5 %, Nasdaq : +4.6 %; S&P : +5.0 %, and Nikkei : +7.1 %.

3. However, the MSCI Emerging Markets index in USD had a poor behavior : -0.3%.

4. If sovereign bond yields rose again - from 1.32 % to 1.68 % for the 10-year German government bond and from 1.76 % to 1.98 % for its American counterpart - the risk premium towards investment grade corporate bonds fell again from 117.4bp to 112.6bp for the Europeans and from 94.6bp to 88.8bp for the US ones.

5. Despite the premium reduction, this sector was slightly down in absolute terms but this was not the case for high-yield bonds where, since the beginning of the year, new bonds have been issued at levels below 5 % for maturities of 7 years or more, i.e. the lowest coupons ever recorded. This is what the market calls "dash for trash".

6. Regarding the foreign exchange, if the dollar index remained virtually unchanged (-0.7 %), the euro index continued to rise by 2.9 % and since Mr. Draghi's speech in August it has moved up by 8.4 %. This can be explained by the fact that in January the yen continued to depreciate versus the dollar from 86.75 to 91.7, while at the same time the dollar fell from 1.32 to 1.3580 against the euro.

7. Finally, the CRB/Thompson/Reuters commodities index moved up 3.0 %. Cotton (+10.4 %) and nickel (+7.7 %) had the best performances, while sugar (-3.8 %) and cocoa (-1.4 %) experienced the largest losses.

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Equities (8-15)

8. Those who regularly read us may have been expecting that we would now be expressing some satisfaction in relation to the growing interest of investors towards equities, thus justifying our exposure to this sector. And as a matter of fact, our share allocation has never been as high as this in the last 10 years, even if it remains below what would have been our allocation in a traditional bull market, taking into account current bond yields.

9. And yet this will not be the case; firstly because all strategies which were not bearish have done quite well for the time being and secondly because some discrepancies have recently appeared which are a source of concern.

10. On several occasions we mentioned the fact that markets could go up just by the simple fact that the economic situation would not be as bad as expected. And this is what happened : the euro did not implode; Chinese growth has not collapsed and the consequences of the financial and real estate crash have been contained in the US. Thus, in 6 months, investors made a complete turnaround; previously they valued markets on the anticipation of deterioration of the situation and today on its improvement.

11. Therefore, in order for this bull move to continue, growth must not disappoint and be at a minimum at the level which is currently expected.

12. However, we can find a first discrepancy with China. Industrial metals only had a modest bullish reaction, coal price is unchanged and Brazil, the largest supplier of China, continues to have an anemic market (+1.95 % in January). Moreover, both domestic and foreign orders are not increasing. Finally, in the last 6 months the improvement on credit availability is only due to the growth of non-bank financing with quite high interest rates.

13. And to all this, it must be added the fact that in order to obtain deposits, banks are promoting what is called "wealth management products" where they offer a time deposit with an appealing interest rate which apparently is done with the bank. But in reality the investment is linked to the good repayment of loans that the bank granted to some of its customers. It is impossible to know how many Chinese investors are aware of this risk or even how many know about it but believe that in the event of a loss the government will provide the banks with the necessary liquidity to repay them with interests. However, the fact remains that this further complicates the equation.

14. Another discrepancy is in Japan. The promises made by the new Prime Minister Mr. Shinzo Abe to do all that is needed in order to bring inflation back to 2 % excited investors. But the stock market behavior leads us to temper this feeling. If in the last 6 months the Nikkei rose in yen by almost 30 %, in dollar terms the performance is identical to the US stock market (up by approximately 10 %), while for the same period Europe in dollar terms rose by more than 30 %. This means that investors believe that for the time being the yen depreciation will not really favor Japan in relation to its competitors. And this is even more interesting since the Japanese stock market has the world's lowest valuation. It is 40 % cheaper in relation to the others and the amount of cash held by companies currently represents 25 % of the Japanese market capitalization.

15. In contrast, Europe is at the heart of another divergence. The stock market is moving up along with the euro, to the extent that in euro the Japanese stock market is unchanged over the last semester. This situation is unsustainable in the long run. Like Japan, globally the euro area has a positive balance of payments, which tends to strengthen its currency. But from our point of view, if the ECB does not pay attention to this euro rise, it may find itself in a Japanese deflationary scenario. And should this happen, the single currency crisis would not be over, implying that currently we are just in the eye of the cyclone.

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Equities (16-19)

16. Until now, the European equities' sharp rise reflects the sigh of relief which followed Mr. Draghi's speech. However in order for the bull move to continue, the economic situation needs to show concrete signs of improvement.

17. In the end it is only in the US where we have a clearer view, but it is one of a steady but quite moderate growth and it is too early to judge whether growth could accelerate in 2013. Historical examples of previous financial crises indicate that it takes on average 7 years for growth to return to its pre-crisis level. Could the aggressive US monetary policy accelerate this move ?

18. In conclusion, as far as these discrepancies are currently insufficient to make us change course, we remain invested. This position is reinforced by the fact that markets are not expensive and that there is a large mass of cash that could be invested. However, we are not married to this position and our exposure could be quickly reduced if necessary

19. For those who are not invested, we advise to space out the purchases over a relatively long period in order not to be too affected by a bearish corrective move which could be fast and violent if it were to happen.

Currencies (20-25)

20. One of our main themes is that markets in general have become much less liquid than before and therefore extremely dangerous to handle.

21. The latest example comes from the yen/dollar exchange rate. The yen took 3 years to move up from 90 to below 80 and 3 months to go back above 90.

22. But what is most surprising is that this occurred only on the basis of promises of Mr. Abe that he will take measures to generate inflation and in particular that the Bank of Japan (BOJ) would start a substantial monetary easing campaign. From this point of view, the market granted to Mr. Abe the same credit it gave to Mr. Draghi after his speech on the euro, i.e. that their words were sufficient, without investors trying to force them to act in order to prove their determination.

23. The problem regarding Japan is that the decisions announced by the BOJ in late January to implement the new policy are quite insufficient. Although it decided to increase its inflation target from 1 to 2 %, at the same time it declared that additional monetary easing will only begin in 2014 and at a lower level than expected. In addition, there was no indication of a willingness to buy foreign bonds to lower the yen.

24. The bond market clearly understood the message. The 10-year Japanese government bond yield which had moved up from its historical low level of 0.70 % to 0.85 % after Mr. Abe spoke, moved back down after the BOJ declarations to 0.75 % at the end of the month.

25. How is this yield compatible with a 2 % inflation which should be achieved by 2015 for the stated policy to be credible? Why is the Japanese stock market not outperforming ?

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Currencies (26-31)

26. Here again, we find an unsustainable discrepancy on the long run.

27. Finally, we must note that even if the Japanese trade balance deficit tripled in 2012 to USD 77 billion due to the closing of the nuclear power plants, the balance of payments remains largely positive. Furthermore, Mr. Abe is a strong supporter of the reopening of a vast majority of nuclear power plants. And it must also be remembered that without intervention the natural tendency of the yen is still to strengthen.

28. Regarding the euro, either its outperformance in relation to the other currencies quickly ends, or it is the stock market which will have to stop its progression. For example, what will be the effects on the European locomotive, Germany, after the euro increased by more than 30 % in 6 months against the yen, one of its major competitors ?

29. And even versus the strong currencies we hold, such as the Norwegian krone or the Singapore dollar, the euro rise is becoming excessive. Therefore, it seems to us that for those who wish to invest in these currencies and on others with solid fundamentals such as the Canadian dollar, the present moment is quite appropriate.

30. We should also mention in order to be quite open that this widespread rise of the euro against these currencies is costing us performance in the last 6 months, but this is the price to pay for having a solid portfolio.

31. As long as a move towards a normalization of interest rates does not happen and as long as we have not seen the consequences of such move, our goal remains to protect portfolios in real terms and not to maximize a potential profit.

Bonds (32-34)

32. What happened with the yen should light up one more red light regarding this sector. But as was the case in 1998/99 for stocks, investors continue to ignore the existing risks.

33. And as in 1998/99, the increase in bond prices leads investors to increase their exposure to a rising sector, with the risk that if they are temporary winners, the decline, when it will occur, will be done on a maximum exposure.

34. Let's take an example to illustrate the situation. An investor has a capital of 100. The first year he invests 10 and gets a 10 % return. He therefore has 11. He then adds another 10 and gets another 10 % profit at the end of the second year. Do the same exercise twice and at the end of the fourth year he has invested 40 and received a gain of 11.05. We then come to the fifth year and he adds another 10 and therefore has an exposure to the market of 61.05. However, this fifth year is a down year and it would then be sufficient for the market to correct by 18 % to erase all the gains of the previous four years. This is why the speculative move on technology shares hurt so many and why the current one on bonds could also lead to substantial losses. In this latter case, moreover, it will be with the compliments of central banks, which by artificially manipulating rates pushed investors to take too many risks in this area.

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Bonds (35-43)

35. Meanwhile, let's add a few more items to our prosecution file.

36. Another discrepancy which appeared during January is the fact that while bond yields on sovereign debt rose, those on high yield bonds continued to decline, thus reducing further the risk premium on the latter. And this reduction is the reflection of the massive purchases done by investors.

37. Indeed, index bond funds (ETF), almost unknown before 2008, are currently holding USD 33.3 billion in junk bonds - sorry - in high yield bonds, and this at lower and lower yields, to the point that these high-yield bonds have nothing high but their name.

38. In addition, these ETFs have created a rather interesting phenomenon as noted by Bloomberg. Insofar as they wish to have liquidity, the major players are only buying bonds from issues larger than USD 400 million. And the consequence is that their average yield is 125bp lower (1.25 %) than of the smaller issues.

39. It should also be mentioned that globally, funds which invest in this type of bonds received USD 72.4 billion of new subscriptions in 2012. By the way, this is only a fraction of what is placed in investment grade ones.

40. Regarding these investment grade bonds, one of the dangers comes from a sudden change in the financial situation of a debtor. A recent example was Dell. Until now the company had a rating of A-. But a group of investors announced it would make an offer to buy the company, which is a public one, by using the usual method to finance itself, i.e. by saddling the company with debt. Thus, if the share gained nearly 30 % on the announcement, the price of the 7.1 % bond with a maturity in 2018 moved down from 125 % to 100 %. And the loss was not bigger only because the company has a right of early redemption which kept the yield close to 4 %. Without it, the loss would have been more than double.

41. What we fear is that what happened with Dell is only an appetizer and that such a scenario could eventually occur for the whole market, even if the decline will be for a different reason. Indeed, it should be noted that the 25 % decline in the value of the Dell bond corresponds to an increase of just 3 % of the yield.

42. As a matter of fact, it is not so absurd to imagine that this could happen if we consider that, for example, the 21 key participants in the US bond sector have reduced by 70 % their commitments to this market from the 2007 peak because of regulations which limit their ability to act on their own behalf as well as new minimum capital requirements.

43. To whom all these people will sell their bonds when subscriptions turn into redemptions that is the question.

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Commodities (44-46)

44. The inability of this sector to rise is a discrepancy that we have already mentioned in the equities section. It should be noted that in the last twelve months this sector is down 2.7 %. And if some agricultural commodities are up, all the industrial metals with no exception are lower, with notable decreases for nickel (-11.9 %) and aluminium (-6 %).

45. One more discrepancy : if all the announced new monetary easing measures were having such a large impact, why is gold down over the past twelve months by 4.4 % ? Currently, every country is trying to reflate its economy. And if these policies were successful it should have resulted in an increase of gold. The inability of the yellow metal to move up could be a sign that the monetary policies which are being pursued are either still insufficient, or inadequate.

46. Another disturbing signal is in the ratio gold mines/gold. Yes, the managers of the gold mine companies have destroyed a lot of capital in recent years, through bad investments which can be illustrated by the fact that in 2011 and 2012 gold rose while the gold mining index fell. And this has led since 2008 to a 50 % decline of the price of the gold mines index in relation to gold. But, it is the fact that there has been no rebound of the gold mines index from the current depressed level which is worrying, as all the bad news regarding them have already been discounted in their share prices and therefore it would have been normal that they outperform gold if we were in an reflationnary environment.

Conclusion (47-52)

47. The positive elements mentioned in our previous reports remain valid.

48. However, we are starting to wonder if the actual monetary policy is effectively helping the real economy as much as investors have started to believe it.

49. The accumulation of all these discrepancies is a warning signal and they should not last too long, because if not this will imply that the economic situation will not be as good as investors are expecting.

50. And their reaction could thus be powerful as the market currently has a tendency to go from one extreme to another.

51. For the time being, we are maintaining our strategy unchanged, but we are in alert for signs that it would be time to reduce our equity exposure.

52. Flexibility, diversification and caution continue to lead our investment policy.

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