SAGA

Market Outlook

A monthly commentary by Gabriel V. Safdié
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OF BUNNIES AND FOXES

Generalities (1-7)

1. Thanks to the FED's announcement that it now planned to raise its interest rates only twice this year, the US stock market rose strongly in March with an increase of the S&P 500 index of 6.6 %, ending the quarter up 0.8 %. For the Nasdaq the numbers were respectively +6.9 % and -2.7 %.

2. Europe followed the move but with a lagging since the Dax rose only 4.9 % and the EuroStoxx 50 2 %. For the year both indices remain significantly down respectively at -7.2 % and -8 %. This is also the case for the Nikkei at -11.9 % for the quarter.

3. Emerging markets confirmed their recovery in March as the MSCI Emerging Markets index in USD increased 13 % and 6.4 % for the quarter. It can be noted that this sector has stabilized in the last six months.

4. And it is also interesting to mention that oil, despite all the negative expectations, ended the quarter only down 13.2 % to USD 37.91 a barrel. As for the Bloomberg Commodity Index, with the 3.8 % rebound in March it is virtually unchanged for the year.

5. This was not the case in the bond market where yields clearly declined. For example, in the quarter the yield of the US sovereign 10-year bond moved down from 2.27 % to 1.77 %, while its German equivalent fell from 0.63 % to 0.15 %. Regarding the Japanese one, having spent all March with a negative yield, it ended the month at -0.03 %.

6. In relation to currencies, the announcement that increases in US interest rates will happen at a slower pace, favored the euro against the dollar as it rose in the quarter from 1.0860 to 1.1380. The move was even greater for the yen against the dollar, despite the decision by the Bank of Japan to introduce negative interest rates, as it rose from 120.20 to 112.60.

7. Finally, the fact that investors' sentiment has become less negative after a difficult start of the year also favored the Bloomberg USD High Yield Corporate Bond index. Its yield, which rose above the 10 % level in mid-February ended March at 8.45 %, which is lower than the 9 % at the start of 2016. The Market Vectors Emerging Markets index fund in local currency but quoted in USD also improved as it climbed 10.4 % in the last three months.

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Equities (8-16)

8. As the Catholic Church during the Council of Nicaea in 325 decided that Easter will be on the first Sunday after the full moon following the spring equinox, the result is that in 2016 the Catholic Easter was celebrated at the end of March, while both the Orthodox and Jewish ones will take place a month later instead of the usual small divergence of a few days.

9. This is why James Paulsen, chief investment strategist at Wells Capital Management investment fund, wrote an article a few days before the Catholic Easter and just as US indices had recovered their losses from earlier this year, in which he described the stock market as being in a bunny market. This is obviously a reference to the fact that a rising stock market is traditionally linked to a bull (bull market) given the tendency of this animal to head straight on and a falling one is usually represented by a bear (bear market), as it hibernates in a cave during the cold season.

10. And he writes with reference only to the US stock market: "Most investors wonder if the recent rally in stocks marks a resumption of the bull market or whether it simply represents another temporary respite from an unfolding bear market. However, perhaps the rest of this economic recovery will be characterized not by a bull nor by a bear, but rather by a bunny! Unlike an enthusiastic bull or a scary bear, a bunny market hops about a bit but really does not go anywhere and bunnies have often dominated the stock market during the later stages of past economic recoveries".

11. His theory is based on the fact that since he believes that US recession risks remain low, a sustained bear market is unlikely. On the opposite a bull move will be restrained by the fact that the FED is now in a monetary tightening phase and this at a time when earnings growth is lower than at the beginning of an economic recovery.

12. Another interesting point in relation to the deflationary fears which we mentioned last month is the fact that Mr. Paulsen believes that inflation will surprise on the upside in America. He believes that commodity prices have stabilized and that therefore this source of disinflation has now dried up. Moreover with the economy near full employment, wage pressures will increase. This is why he believes that inflation will be close to 3 % by the end of the year.

13. Thus surprised by this development, both the FED and investors will have to adapt to a faster than currently expected normalization of US interest rates, which of course will have a negative effect on the valuation of assets.

14. Mr. Paulsen's report attracted our attention since when it appeared we had in mind to use the image of a fox to describe what is currently happening in the stock market. Indeed, this market seems to be using every possible trick to inflict maximum pain in turns to both bulls and bears and more generally, by the way, to those taking too many risks if one looks at the hedge funds' poor performance. And we know the saying : "Sly as a fox".

15. By using the image of the fox we wanted to draw attention to the fact that the current market does not let itself be easily tamed and when one thinks he has understood how it is behaving, cunningly it will then move in a very different way.

16. Anyway, whether US stocks will stagnate or not is thus linked to the speed at which inflation could return.

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Equities (17-27)

17. A last rising phase could occur if for example growth were finally to accelerate. And the move could be quite substantial if most of the increase in real wages, itself induced by the good economic situation, could be absorbed either by an increase in productivity or a reduction in profit margins, with the latter being offset by increased sales, or even a mix of both.

18. On the opposite, the sooner fears about inflation appear, the quicker we will enter in a bunny market. However one should be aware that a bunny market does not prevent shares to strongly rise or fall and this up to 20 % and for periods which could last several months. It is just that, sooner or later, a return to the equilibrium point occurs.

19. Another way of looking at the problem is that the stock market is generally considered to be at fair value when the price/earnings ratio (P/E) is at 20 minus the level of inflation. With currently 1 % annual inflation, this ratio should thus be at 19 and in fact the S&P 500 is currently at 18.45.

20. So, if by year end inflation rises to 3 % then the P/E needs to go down to 17.

21. However it seems difficult in the current economic environment that inflation could rise to 3 % without any growth acceleration happening. Where this to be the case however, we would then find ourselves in a new stagflation phase, i.e. little or no growth with inflation, as developed countries experienced in the decade of the 1970s, but of course with much higher inflation then.

22. But this scenario appears to be too pessimistic, as was also the case for the opposite risk of a sustained deflation mentioned last month.

23. If the stock market has stagnated for the last twelve months it is not only because of the possibility of interest rate hikes. There has also been a sharp slowdown in growth and a small fall in profits. And by the way, the currently mainstream view considers that this is just the trailer of a new market storm similar to 2008. One should recognize that doomsayers have been persistent since, from the moment the stock market started to recover in 2009, they have constantly believed that catastrophe is imminent.

24. In fact, one of the features of this bull market is that it is probably the least happy in history. And this everlasting pessimism is a sign that upside potential continues to be significant. But for this to happen, it is necessary that growth accelerates. By the way, most people are underestimating the impact on profits that a mere 1 % increase in economic growth rate could bring.

25. In any case, recent events have confirmed the risk we have been mentioning of significant volatility in the stock market since this bull market has to overcome all kinds of fears to progress. This explains why we advise to be invested in a reasonable manner in order to be able to ride this volatility.

26. In conclusion, it is most likely that the rise in the US stock market will be slower than in the past since monetary policy will become progressively more restrictive. But there still remains a quite interesting growth potential.

27. If the road is relatively clear for the United States, it is much less so in the Eurozone. From the low of March 2009 the US stock market has risen, on average per year, three times faster than the European one. The explanation for this is simple: from 2009 to 2014 if we add the accumulated deficits as a % of GDP, the US is at 39 % against only 26 % for the Eurozone.

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Equities (28-30)

28. In short, if Europe has lagged so much it is because its budgetary policy has been - because of the constraints linked to the euro - much more restrictive than the US. And indeed it was not until 2015 that the deficit finally became almost identical for the two blocks at around 2.5 % of GDP.

29. And now that the acute phase of budgetary restrictions is behind us and that growth, even if inadequate, has finally appeared, one can hope that the European stock market will rise faster than the US to catch up.

30. In fact, this is a hope that one could have had for almost two years, but until now the facts have proven otherwise since in the last twelve months the S&P 500 index is almost unchanged while the Eurostoxx 50 is down by about 20 %.

Bonds (31-36)

31. If Mr. Paulsen is right and that fears regarding inflation will appear in coming months, then the bond market is valued in a completely wrong way.

32. For example, the yield on the 2-year US Treasury bond is currently at 0.75 %, i.e. at a lower level than before the FED's interest rate increase in December. Clearly investors consider it as being more likely that US growth will slow rather than accelerate, in addition to fearing the possibility for this yield to become one day negative as is currently the case for the Japanese and German equivalent.

33. Thus, if investors were to be obliged to look in the opposite direction, one can imagine the earthquake that would happen as a result. And by the way, it should be mentioned that this market has already become much more volatile.

34. Indeed, professionals in this area have noticed that hedge funds are much more present than in the past. For example, they were the largest buyers of Treasuries last year. The problem is that they are much less stable investors than, for example, foreign central banks.

35. And this influence can already be felt. According to the firm TD Securities, since the beginning of 2016, daily moves of the yield on the US 10-year Treasury bond which exceeded one standard deviation occurred 39 % of the time. If this were to continue for the remainder of the year, the record of 35 % which dates from 1975 would be beaten.

36. Anyway, the low yield levels of investment grade bonds continue to make them dangerous in a cost / benefit analysis.

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Commodities (37-42)

37. Surprise, surprise, the star of the quarter in this sector was gold with an increase of 16 % in USD. It is in fact the best performance among commodities.

38. Given its role as an advanced indicator regarding the evolution of prices, one can consider that deflationary risks are currently being exaggerated.

39. But it is also difficult for the moment to consider that this increase confirms Mr. Paulsen's 3 % forecast. Indeed, the velocity of money, which measures the rate at which money changes hands, has continued to slow and is at its lowest for 60 years.

40. In fact, an analysis of the futures market indicates that for the moment this increase appears to be mainly due to the closing of short positions.

41. This seems also to have been the case for oil prices with the approximately USD 10 per barrel increase in 45 days. Clearly the fear that an agreement could be found between OPEC and Russia to stabilize the price of black gold has played a role.

42. Of course these players now need to prove that they can discipline themselves.

Currencies (43-48)

43. Very often for easiness one uses the changes in interest rates between two currencies to explain the evolution of the exchange rate between them.

44. But in reality it is the changes in the growth rate between the two countries that justifies it.

45. Thus for example the euro fell against the dollar in 2014 when the US economy was improving while the European one was going nowhere.

46. Obviously these divergences in economic performance end up having an impact on interest rates and explains why for example the FED is presently looking to tighten while the European Central Bank remains in an easing mode.

47. The future evolution of the euro/dollar is thus directly dependent on the increase or, conversely, in the reduction of the growth differential between the two blocs. The difficulty is that we are currently in uncharted territory regarding this matter. The reduction in interest rates has not brought the expected increase in growth to the point that some wonder if the current level is the best that can be hoped.

48. We therefore lack the tools to forecast in a reasonable manner how growth will evolve. And this uncertainty, where one can imagine the worst as well as the best, coupled with vast amounts of money waiting to be invested given the low level of interest rates, urges caution and invites us not to take aggressive currency positions.

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Conclusion (49-56)

49. Certainly Europe could do with an easier budgetary policy than the one it has been following since 2009. But the American example shows that even low growth is sufficient to have a significant positive impact on the stock market.

50. We remain therefore favorable to equities as they are one of the few asset classes to still represent a sufficient profit potential in relation to the risk taken. And as we are suspicious of the tricks of the current fox market, we are not trying to be too clever by changing our strategy according to short-term events.

51. Since 2009, being invested in developed countries' equities through thick and thin was the best strategy even if Europe has been a relative disappointment so far.

52. Mr. Paulsen is right and a bunny market will come but it seems to us that it is still too early. What is required is that the FED switches to a higher gear. But for this to happen, investors need to be convinced that growth is real and sustainable.

53. However when this will happen, then all assets will have to adapt to the higher interest rates environment and this means that regardless of short term moves, prices will need to stagnate to allow for this adjustment.

54. In such an environment asset management will have to become much more active with frequent changes in the equity allocation and with investments in well-defined sectors rather than in global indices.

55. And we will then witness the discovery of a new generation of star equity managers who will perform significantly better than the indices.

56. Thus the bunny market will herald the end of indexing, a strategy which investors have now become convinced is the only sound one, and thus the resurrection of the active asset manager choosing carefully the shares for his portfolio. Resurrection : isn't it the central tenet of the Christian Easter ?

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