Market Outlook

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REALITY OR A BAD DREAM ?

Generalities (1-8)

1. With the second worst beginning of year in Wall Street's history, January 2016 just ensured itself a place of honor in the statistics. And for investors the fall of 5.1 % for the S&P 500 index revives the painful memories of January 2008 (-6.1 %).

2. This sad result is firstly linked to the fears around the deceleration of China and the possibility that it could contaminate the whole world. And it can be illustrated by the fact that in January, among the 93 major stock indexes tracked by the Bloomberg financial information system, the Shanghai stock exchange index was in last place with a 24.3 % decline in USD.

3. Anecdotally, only 13 indices are positive in USD, led by Tunisia (+7.7 %) and followed by Slovakia and Jamaica, with no major economy index being in the green.

4. So, the decline was quite broad, with among the main indices in local currency : -8 % for the Nikkei 225, -7.9 % for the Nasdaq and -6.8 % for the Euro-Stoxx50. As for the MSCI Emerging Markets index in USD, it decreased by 5 %.

5. The second reason mentioned to justify the drop was the oil price decline, which at USD 33.6/barrel, lost 15 % in one month.

6. And at 166.75, the CRB Commodity Index broke the lowest level reached during the 2008-09 crisis (200) and is now heading towards 150, the lowest level recorded during the 2001-02 recession.

7. The developed countries' sovereign bond market benefited from this situation, with a decline of the 10-year US Treasury bond yield from 2.27 % to 1.98 %, and from 0.63 % to 0.40 % for the German one. However, one can notice that this decline is relatively modest when compared to the stock market fall.

8. On the opposite and without surprise, junk bond's yields continued to rise, reaching 10 % during the month for the Bloomberg USD High Yield Corporate Bond index and closing January at 9.4 %, up 0.4 %. But the Market Vectors Emerging Markets index fund in local currency but quoted in USD remained unchanged.

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Generalities (9)

9. Finally currencies remained quite stable since the euro (1.0830) and the yen (121) were unchanged in relation to the USD. It should be mentioned that the Dollar index - which represents the average of the exchange rates of the dollar against major currencies - has not been rising for three months now.

Equities (10-14)

10. At the beginning of 2016 the Great Confusion reigns in investors' minds. What should they believe ? Is the economy getting better or worse? Are we on the brink of disaster or on the opposite are we seeing the end of the consequences of the 2008 crisis?

11. This is what we wrote one month ago when the FED, by raising up its key rate by 0.25 % for the first time in over a decade, indicated its confidence in the strength of the US economy.

12. But in January, the market responded in the clearest possible manner by starting to price equities for a recession.

13. These conflicting views are linked to the image of the glass half empty or half full that we have been using for some time in relation to the world economy as there are solid arguments in favor of both sides.

14. The problem is that the combination of the two creates a lousy environment which can be illustrated by the following table of 2015 performances in USD for the major asset classes :

2015 Performance Table

Benchmark	**% Return in 2015 (in USD)**
S&P500	-0.73 %
Dow Jones	-2.23 %
MSCI World	-2.74 %
Eurostoxx50	-6.74 %
Footsie 100	-10.10 %
CAC40	-2.54 %
DAX	-1.61 %
VWO (Vanguard Emerging Mkts ETF)	-18.27 %
IBOVESPA (Brazil)	-13.31 %
Russian RTS	-4.30 %
LQD Index (USD Inv. Grade Bonds ETF)	-4.52 %
Bloomberg USD High Yield Index	-3.49 %
Gold	-10.59 %
Crude Oil	-30.47 %
EUR	-10.20 %
GPB	-5.44 %
CHF	-0.59 %
BRL	-32.90 %
CAD	-16.00 %

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Equities (15-23)

15. It is extremely unusual for equities, bonds, gold, oil and currencies to all fall simultaneously.

16. This chart also highlights the fact that the events of January are only a continuation of a move that began in August 2015 when appeared the first concerns regarding China.

17. And the Chinese authorities' behavior since August has only added to investors' fears. In recent years, many have praised the merits of China's dirigist economy, where officials are able to quickly take decisions and implement them. And they even considered that this system was more efficient than the slow decision-making process in democratic countries with all the inevitable compromises that go with it.

18. In a way, we have here the same fascination that the keiretsu exercised during the Japanese economic miracle. A keiretsu designates a set of companies with interlocking business relationships and shareholdings. These conglomerates - such as Mitsubishi, for example - should have given a decisive advantage to the Japanese, as they were supposed to allow for a long-term strategic vision compared to the Western excessively short-term mentality.

19. Today, these keiretsus have become the symbol of inertia and of a very inefficient bureaucratic approach in a world where one must constantly innovate.

20. And so, for the last six months, the market is discovering that Chinese bureaucrats are in fact only bureaucrats like the others and that, as elsewhere, China's economic policy in view of the current slowdown is full of hesitations, turnarounds and incompetence. And from this point of view, one can speak of a disillusioned love, to quote the title of our August 2015 commentary.

21. The main concern regarding China is the credit explosion that occurred since 2009. The debt ratio compared to GDP of Chinese companies is currently over 200 % and is particularly concentrated in sectors such as industrials and manufacturing which are in deflation because of an excess in production capacity. Their ability to honor their debts is therefore increasingly questionable and some see in the magnitude of this problem the equivalent for the Chinese economy of a black hole that will suck in everything.

22. Others note that at 6-7 % per year Chinese growth contributes as much to global growth than the 14 % expansion in 2007, since its economy is today much larger. Thus they believe that the current pessimism is exaggerated, all the more so that Chinese reserves are such that the government has the capacity to manage the debt problem.

23. A new fear which appeared in January is that of a sharp devaluation of the Chinese currency, which admittedly would make the country more competitive, but would also export deflation towards the world economy at a time when the oil price decline is already pushing price indices downward.

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Equities (24-36)

24. Markets fear deflation as it can, on the one hand, lead to a sharp drop in corporate profits and, on the other, render ineffective the monetary policy of central banks.

25. It is obvious that the situation is not good for emerging countries and we have refrained for a long time from making investments there.

26. But developed countries are growing, even if at a still insufficient speed. And historically, a recession is caused by a nation's central bank tight monetary policy and therefore does not occur spontaneously.

27. The difficulty, as we have often mentioned, is that because since 2009 we are in uncharted territory regarding monetary policy, references to the past have much less weight and thus nothing can be excluded.

28. Nevertheless one should remember that America's exports to China are only the equivalent of less than 1 % of its GDP and therefore any Chinese slowdown should have a limited impact on US growth, even taking into account the negative effects on other trade countries' partners more exposed to China.

29. Investors are also concerned about the fact that, partly due to China, the US manufacturing sector is in recession (as is also the case in other countries) and that by contagion, the other sectors of the economy will be infected, as has often happened in the past.

30. However, the US economy has changed a lot. The manufacturing sector, including the natural resources industry, represents only 8.5 % of non-farm jobs. It is half the level of 15 years ago. Therefore, one can imagine that this activity, like agriculture, has now become small enough so as not to be able to lead the country into recession.

31. Also one must note that there are no major imbalances in the economy and that since banks are under tight supervision and with a greatly reduced risk exposure, a new financial crisis appears quite unlikely.

32. Regarding the markets' reaction in January which sheepishly followed the evolution of the oil price upwards and downwards, it looks to us as quite bizarre.

33. First of all, we know that the oil price is much more linked to the current confrontation between Saudi Arabia and Iran than a true reflection of what is happening with world growth.

34. Then, if the decline of the oil price is a bad news for OPEC countries and partially for Texas or North Dakota it is, on the opposite, great news for all of us consumers, as it is the equivalent of a tax reduction. Therefore, sooner or later, this can only promote growth.

35. Those are the facts that make us consider that the current pessimism is exaggerated regarding developed countries. The market has already discounted enough bad news to allow, simply if the worst does not happen, equities to move up. But a sustained increase will only come when the current uncertainties regarding the economic health of the world will have diminished.

36. Anyway, January's events demonstrate once again the need of being exposed to risk in a reasonable way in order to be able to withstand volatility.

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Bonds (37-43)

37. Another investors' fear is linked to the high yield market. We had repeatedly mentioned how insufficient the yield was in relation to the risk taken. Today, the yield has risen to a more correct level, but now there are doubts regarding the solvency of these debtors.

38. Of course, in America companies which got into debt in order to invest in the energy field are in trouble. However if the economy behaves correctly, the situation is much better for the other sectors of the US economy. Furthermore, if yields were to rise excessively, it is certain that the FED would then respond by effecting major purchases in order to stabilize the market and encourage investments by the private sector.

39. What is also important to mention is that the situation in the US high yield market is not comparable with the 2008 crisis. At that time, banks were heavily invested and leveraged in the sub-prime sector, while today these bonds are held by non-bank investors which can suffer losses, and even bankruptcies, without creating a financial contagion.

40. Regarding bonds issued by emerging market debtors, the problem is more complex as the situation in these countries continues to deteriorate. Moreover, it would not be surprising if a major debtor were to be in difficulty this year, which would then send a shock wave throughout this market.

41. But here again, even if things deteriorate further, it would only marginally increase pressure on emerging markets and the impact on the economies of developed countries would be even more limited.

42. In fact what creates the danger for the economy is that all the potential risks we have been mentioning eventually combine in a poisonous mix.

43. But if China-related fears were to decrease, a buying opportunity would arise as the great enemy of bonds - inflation - remains absent.

Commodities (44-47)

44. Inflation and not deflation, as many fear. Like cholesterol, there is a good and a bad deflation. The bad comes from a price drop linked to an excess of capacity, such as for example, in China today in the manufacturing sector.

45. But, the reason to exist of capitalism is to find ways to produce more for less. Therefore, when, for example, the oil price declines, enabling lower production costs, this is good deflation which supports economic activity.

46. And from our point of view, this is the reason explaining why gold did not join oil in its decline in January. Instead, by moving up 5.3 % to USD 1'118/ounce, it is indicating that deflationary pressures are not increasing. It is a small trend change compared to the decline of the second half of 2015, but if it were to continue, it would be good news for future growth, since gold remains the most reliable leading indicator of inflation developments.

47. Nevertheless the fact is that the level of inflation remains uncomfortably low - as is growth actually - and this at a time when central banks are reaching the limits of what they can do through monetary policy.

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Commodities (48-55)

48. As we have already mentioned, what is lacking is a much more easy fiscal policy than is currently the case. When growth and inflation are so weak, governments should be determined to spend unrestrainedly to support economic activity.

49. But we live in masochistic times, where governments implement too restrictive fiscal policies, which are the equivalent for their economies of the bloodletting that was once done to the sick. The fact of taking out the blood of a patient weakened him even more, just like insufficient public spending in the current context does more harm than good.

50. The reason governments have locked themselves in this policy is a wrong analysis of indebtedness. They consider that their current level of debt is already too high and that therefore they cannot allow the deficit to worsen. And they often use the image of the responsible household who knows how to balance its budget.

51. But this comparison is completely wrong, since a country has an option unavailable to a household : it may at any time create more money to finance its commitments.

52. In fact a country debt level by itself has little importance. The only real limitation is when money creation ends up pushing inflation too high.

53. One day, a government will act "irresponsibly" and its success will be such that the others will follow, thus opening the way for a new inflationary cycle.

54. But until then, the danger is that economic suffering must increase further before such a course can occur. Therefore, one must hope that the current growth in developed countries maintains enough strength to remain self-sustaining.

55. A last word about oil. Like a beautiful summer day, one should take advantage of its low price as it will not last. The current oil surplus is two million barrels per day. However every year the industry must replace five million barrels to maintain production at a constant level. Obviously in the current situation, it will only do so partially. From excess to shortage, the road is in fact quite short.

Currencies (56-60)

56. Another disagreement existing between the market and the FED focuses on interest rates.

57. Even before the decline in January, investors were expecting only two rate hikes in 2016, while the FED foresaw four.

58. This expectation from the FED had been very supportive for the dollar last year especially as the European Central Bank was, and still is, expanding its balance sheet.

59. However, in the current context, it seems very difficult for the FED to follow its program and raise the interest rate in March as it had hoped. And it should also be mentioned that the market is presently forecasting that not a single rate rise will happen this year.

60. Thus the dollar begins to become more vulnerable and an interesting fact is that for several weeks now, the stock markets' fall and the reduction in risk appetite associated with it, did not lead to a dollar rise as had happened previously.

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Currencies (61-62)

61. Therefore, one can imagine that if the prevailing pessimism decreases, a counter-move could take hold, notably in favor of the euro, as Europe's stock market valuation is lower than that of its main competitors.

62. However, for the time being, we maintain the view that if it is too late to sell euros, it is too early to start buying them.

Conclusion (63-72)

63. Reality, or bad dream ? The truth is that nobody knows, because each side has strong arguments.

64. Indeed, growth is decelerating. But is it enough to propel developed countries into recession ? It is possible if the decline in financial markets changes the behavior of economic actors towards too much caution, but it is not inevitable.

65. And is the year already over for financial markets ? We had mentioned last month that traditionally the performance of the US stock market in January announces if the year will be good or bad. Looking at the historical data, we can see that this is true in about 75 % of cases.

66. But as we have indicated in paragraph 27 here above, the fact that monetary policy is in uncharted territory since 2009 does not allow for the exclusion of anything, the worst or the best.

67. During the whole month of January, the worst was mentioned. So, let us conclude with a positive scenario.

68. We tend to forget that in the last 12 to 18 months, the world economy benefited from strong economic stimulus. Firstly the fall of commodity prices by over 50 % is the equivalent of a large tax cut.

69. Then there is the fact that most bond yields around the world moved down, a sign of an expansionary monetary policy.

70. Finally, the dollar rose by almost 20 % which greatly promotes exports.

71. Therefore, today's totally unexpected surprise would be that all these elements combined allow for a synchronized and global growth rebound. 2016 could then be the reverse of 2015 which started well, but ended in the red.

72. n conclusion, when shooting is going on from all sides, wisdom is not to move. Therefore, we are neither increasing nor decreasing risk taking, which in fact had been calibrated to withstand events such as those of January.

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