Market Outlook

A monthly commentary by Gabriel V. Safdié
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And there was a great calm

Generalities (1-5)

1. May was a month in which no sector shined either for better or for worse.

2. Equities moved up during the month but remained below the level reached in mid-April : in Europe 1.2 % for the Euro-Stoxx 50 and 2.2 % for the Dax; in the US 1.5 % for the S&P500 and 3.6 % for the Nasdaq. However, Japan with -2 % for the Nilkkei 225 and -3.7 % for the MSCI Emerging Markets in USD were lower.

3. Regarding commodities, oil rose again (+5.2 %) but at a slower pace than previously and the Bloomberg Commodity Index was almost unchanged.

4. This was also the case for sovereign bonds where 10-year yields were at 1.84 % in America, 0.14 % in Germany and -0.1 % in Japan. Identical situation for the Bloomberg USD High Yield Corporate Bond, which stabilized at 7.45 %.

5. Regarding currencies the dollar moved up from 1.1450 to 1.1130 against euro and from 106 to 110.75 against yen.

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Equities (6-17)

6. The fact that the FTSE World Index in USD fell 11 % during the first six weeks of the year and then immediately regained its loss over the following six weeks - and this while fundamentals were virtually unchanged - illustrates how nervous investors are.

7. And after all this useless agitation - since at the end of May the index was up 0.7 % for the year - what happened afterwards can be summarized by the title of the poem of the English writer Thomas Hardy : “And there was a great calm”.

8. Indeed the market is catching its breath and currently doubts of its ability to correctly interpret new data which, as a matter of fact, alternately blows hot and cold air.

9. And then there are uncertainties such as the Brexit or the evolution of short term US interest rates for the remainder of the year.

10. If the result of the British vote will be known on June 23rd, regarding the FED, matters are much more complicated. One month ago investors were not even sure that year and for example the probability of such a move after the FED’s meeting of June 15th was then considered by the market to be at less than 10 %.

11. Then came in May good retail sales, rising real estate prices and sales, an improvement in consumer confidence, minutes of the previous meeting of the FED more favorable than expected to such an idea, commodity prices moving up and finally, comments such as from Eric Rosengren - a voting member of the FED - saying that he was “almost ready” to vote for a tighter monetary policy.

12. Thus, at the end of May the market was scratching its head and raising the probability of such a rise to 30 % in June and 54 % in July; levels which seems to us in fact still too low.

13. For the FED presently everything turns around its expectations regarding the future evolution of inflation.

14. And on this matter, should we believe an eminent analyst to take wrote that inflation is beginning to take hold because of the 0.4 % increase in April, i.e. the largest monthly increase since February 2013 ?

15. Or shall we rather listen to this other eminent analyst who certainly acknowledges that inflation rose for the last twelve months to 1.1 % in April against 0.9 % in March, but who considers that what matters is to look at the core rate which excludes the most volatile components of the index - i.e. food and energy - and where inflation actually declined 0.1 % in April. From his point of view, the increase in April in April of the main index is in reality an echo of past growth and given the economic slowdown of recent months, inflation has reached its peak and will now begin its descent.

16. The name of these analysts is of little importance, as they both try to exploit the relatively volatile figures from one month to the other in order to boost their theory. But it is this kind of exercise - hopefully a little more sophisticated - that the FED has to do.

17. In fact, the decision is not easy to take since data has rarely been so ambiguous.

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Equities (18-27)

18. How can one raise interest rates with growth remaining so weak and with, for the fourth consecutive quarter, profits for the companies members of S&P 500 index globally declining? Granted that the fall was only 7 % over the past twelve months, but the last time this happened was between the fourth quarter of 2008 and the third of 2009.

19. How can one not raise interest rates when the country is so close to full employment and in its sixth consecutive year of growth while the FED's interest rate remains close to zero, whereas in similar previous episodes the rate was already above 3 %.

20. In fact we believe that the FED will base its decision on reasons other than economic ones and that it will be raising its interest rate by 0.25 % sooner than later. And this for two reasons.

21. First of all, it would reinforce its last December's decision to begin a tightening cycle. One should remember that the US central bank was widely criticized on this matter in January at a time when the stock market was falling. Thus, to tighten again would demonstrate that its analysis of the situation is correct.

22. Secondly the FED will want to avoid the painful exercise of the second half of 2015. In our November report we wrote that the FED was going to increase its rate in December because : "Its members have realized that the little game of "I raise / I don't raise" was beginning to impact the credibility of the committee. " Thus, it will be keen not to show too much indecision.

23. Furthermore, to quickly increase its rate will allow the FED to evacuate this issue until the end of the year i.e. after the elections. And this is not an insignificant factor.

24. However in reality it doesn't matter whether we are right or not as just the existence of a debate around a simple 0.25 % increase of an interest rate which remains close to zero, indicates how uncertain the future developments for the US economy are. Presently it appears very unlikely that a recession could spontaneously occur but an acceleration of annual growth beyond the current level of 1.5 to 2 % seems also quite challenging.

25. But there are reasons for hope. In the US, the export sector - which had greatly suffered from the rising dollar and the slowdown in developing countries - is now improving, which should positively contribute to growth. And news are also better elsewhere : growth is back in the Eurozone where it has now reached the same level as in America. And if commodities could stabilize at their current level, then the worst would be behind us for producing countries. Finally, the Chinese authorities have succeeded in stabilizing the annual growth of the country at the desired level of 6.5 %.

26. Little by little it looks as if global growth is becoming more synchronized and thus one can hope that this will eventually lead to its acceleration.

27. And this could greatly be helped if developed countries decided to ease their fiscal and budgetary policies. By the way, if traditional parties' leaders continue to oppose such a move then, sooner or later, they will be replaced by populists who will not hesitate to do so.

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Equities (28-30)

28. In conclusion, we continue to remain invested in a reasonable manner in equities as we agree with Lee Cooperman - one of the best Wall Street investor - who recently declared that the stock market should rise significantly before it become vulnerable. And quoting John Templeton - a pioneer of mutual funds - he added : “Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria. We are fluctuating between skepticism and optimism. I’ll debate anyone who thinks there is euphoria baked into the market”.

29. One can also notice that presently signs of skepticism are clearly visible in the market :

- Options’ premiums - either to be protected against a fall, or to benefit from such a fall - are at a high level;
- Equities’ fund managers’ cash allocation is above average;
- Major analysts, such as the ones from Goldman Sachs, have issued unfavorable opinions regarding the stock market;
- Investors have withdrawn over USD 100 billion from equity funds since the beginning of the year, i.e. the fastest pace since 2001, which is consistent with the fact that only 20 % of investors are optimistic regarding US stocks, i.e. about half the historical average;
- Finally, there are fears linked to political risks such as the Brexit, the coming elections in Spain and those in the US in November.

30. The positive element is that were these fears to diminish, equities present a rather interesting rising potential. Thus, it is not certain that the “summer of shocks” predicted by the Bank of America’s strategist Michael Hartnett will happen.

Bonds (31-34)

31. The situation is completely different in the fixed income sector where investors are convinced that nothing can push inflation up and where each fall in bond prices has become a buying opportunity.

32. Thus the yield of the 10-year US sovereign bond is today at a level 0.5 % lower than before the first increase of interest rates in December. The difference even rises to 0.75 % in relation to one year ago. Also, the entire rise in yields for junk bonds between November and February was erased in just two months by the end of April.

33. This is by the way the direct consequence of bond funds receiving large subscriptions. For example, global bond funds obtained USD 59 billion of new money since the beginning of the year, thus surpassing the record of USD 56 billion of the beginning of 2015.

34. And these amounts need be put into perspective with the fact that over 70 % of Swiss, Japanese and German bonds are trading with negative yields. For France or Belgium the figure is “only” 50 %.

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Bonds (35-41)

35. The consequence is that the yield on the Barclays Global Aggregate Index currently stands at 1.4 %, the lowest level ever since the inception of the index in 1973 and its current duration of 6.8 years is the longest one ever recorded.

36. Finally, governments of countries such as Ireland or Italy have understood the message and are beginning to borrow with ultra-long maturities. What is quite surprising is that they have not done so in a more massive way, taking into consideration the very low cost. Belgium, whose debt levels are among the highest in the European Union, recently issued a 100 years' bond with admittedly a positive yield, but which presently stands at 2.1 % only !

37. Very logically this cash influx encourages all debtors, even the worst ones. A country like Argentina, which has regularly defaulted on its debt, successfully placed USD 18 billion of 30-year bonds with a yield which currently stands at just 7.5 %.

38. It should also be noted that the indebtedness of emerging countries' debtors has sharply increased in recent years. The rating agency Fitch estimates that the debt to GDP level in the private sector is now on average 78 % for the seven largest markets : Brazil, India, Indonesia, Mexico, Russia, South Africa and Turkey.

39. Moreover, this situation is not limited to developing countries. UBS credit analyst Matthew Mish notes that the number of issues having a CCC rating – i.e. the most speculative bonds – increased from 430 in 2007 to 1'350 today, i.e. 40 % of the market value.

40. And he considers that more than a trillion dollars of debts could be in jeopardy, one way or another, in coming years. This figure may seem high, but just for the United States USD 10 trillion of corporate debt will mature in the next five years and will have to be refinanced.

41. It is therefore without surprise that we continue to dislike this sector.

Currencies (42-44)

42. The quietness in the forex market was only disturbed by the Brexit risk with a 10 % fall of the pound at its lowest in mid-April. And volatility should increase as the referendum approaches, since if in a normal situation voters tend to act conservatively and thus in favor of the status quo, the rise of populism brings an unpredictable factor into the equation.

43. The FED's decision on interest rates in June is another element which could also make currencies move.

44. On the longer run the fact that the European Central Bank will continue its quantitative easing program for another year while on the opposite the FED will tighten its monetary policy should be favorable to the dollar since the interest rate differential between the two currencies will increase. However in percentage term the rise will be significantly lower than the one which happened from the 1.40 level.

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Currencies (45-46)

45. But the great unknown remains the Bank of Japan (BOJ). Because its governor had publicly announced that it would take further measures the market was shocked by the bank's inaction at its last meeting and this at a time when inflation remains at 0 %.

46. Economists are asking that it takes new aggressive measures but history shows that, contrary to the FED, it is unable to act boldly. However if it is forced to do so, then it would be another favorable factor for the dollar.

Commodities (47-51)

47. In May, oil and gold moved in opposite directions. Up 5.2 % for the black gold and down 6 % for the yellow metal.

48. The fact that oil moved back to around USD 50.- / barrel is not a surprise since, taking into consideration the current level of growth of the global economy, any significant fall below this price is not sustainable in the long run. But for the same reason, any clear increase above it seems also hardly sustainable in the present environment.

49. And by the way industrial metals such as copper (-8.2 %) or aluminum (-7.8 %) decreased during the month.

50. The situation of gold is more interesting, as we are still at a crossroad. After its strong first quarter rise it remains at USD 1.215/ounce - i.e. above its 200 day average - thus keeping intact the bull move.

51. And it will be very interesting to see how it will react to the FED's decision.

Conclusion (52-55)

52. So May has not provided the clarification we were expecting in our previous report regarding where financial markets could go after the flip-flop of the beginning of the year.

53. This is due to the fact that we live in an economic world where the ambient temperature is certainly fresh - to the point of sometimes being annoying - but without being icy.

54. The most frustrating thing is that on several occasions one was able to glimpse at the sun between the clouds, looking ready to tear the veil and warm the atmosphere. However, the process was always interrupted by the arrival of more or less threatening new clouds, such as the euro crisis or the recession in many emerging countries.

55. This situation has been favorable to the bond market, since the lower yields orchestrated by the central banks favored the indebtedness of all kinds of debtors and this all the more easily as investors are much more favorable to bonds than to equities.

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Conclusion (56-57)

56. Today the great calm prevails, with the volume of transactions in free fall as investors are unable to decide towards which direction the economy is going.

57. And in order to know what would likely be able to increase conviction among investors, we could provide a similar answer to the one that British Prime Minister Harold Macmillan gave to a journalist when asked what he feared the most : “Events, dear boy, events”.

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