SAGA

Market Outlook

A monthly commentary by Gabriel V. Safdié
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2014 : THE MOMENT OF TRUTH

Generalities (1-6)

1. 12 months ago, at the end of 2012, we wrote that "the present bull move (of equities), which started over a year ago, has obtained no respect from investors, who rather tend to view it as an eccentricity considering the world's problems. However, this usually indicates that the present trend should not only continue, but that it could even accelerate in a rather surprising manner".

2. And that is what happened in 2013, with a 21 % increase of the FTSE World Index in USD.

3. But unlike 2012 when the increase was fairly widespread, this time only stock markets of developed countries performed well. Among the best returns we have the Nasdaq (+38 %), the DAX (+31 % in USD), the S&P (+29 %), and the Nikkei (+28 % in USD). Regarding Japan, one can notice that the rise in the last 7 months has only been of 2 % in USD; therefore, the whole performance was made at the beginning of the year.

4. At the bottom we find Brazil (-26 %). But Russia (-5 %), India (+2 %), China (-5 %) or South Africa (-2 %) also had disappointing performances, thus illustrating the end of the BRICS concept.

5. Overall, the MSCI Emerging Markets index fell 7 %.

6. And, contrary to the expectations of many, this bull market did not come from the expected great rotation from bonds towards equities. Indeed, a rotation did happen but it was from government bonds of developed countries towards high-yield bonds. The evidence is as follows : if the 10-year US government bond yield climbed from 1.76 % to 3 % at the end of the year, which translates into a loss (coupon included) of about 8 %, the iBoxx USD Liquid High Yield index meanwhile increased by 6 %. Therefore, there has been a narrowing of yield spreads between the different types of bonds.

IN THIS ISSUE

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Generalities (7-9)

7. In the foreign exchange market, if the decline of emerging equity markets also resulted generally in a fall of the currencies of these countries against the US dollar (-21 % for Turkey, for example), the star of the year was the euro, with a 9 % increase of the euro index, against only 0.8 % for the dollar index. This is mainly due to the fact that if the other central banks of developed countries continued to increase significantly their balance sheets, the ECB has on the contrary reduced its own by more than 25 % since August 2012.

8. In relation to the US$, the single currency moved up from 1.32 to 1.3750, while on the contrary the yen fell from 86.7 to 105. This means that in the last 17 months, the euro has increased by over 50 % against the yen.

9. Finally, with a drop of 4 %, the CRB commodity index remains in bear market territory, with the decline from the top of March 2011 to the present bottom of November 2013 reaching 26.5 %. In 2013, of the 19 components of the index, only 7 were up, led by natural gas (+31 %) and cocoa (+24 %), while corn (-39 %), silver (-33 %) and gold (-27 %) were the leaders to the downside.

Equities (10-17)

10. If we wrote indeed a year ago that the equity rise could "even accelerate in a rather surprising manner", we immediately added that for this to happen, better world growth would be needed.

11. But it was exactly the opposite which happened as global growth in 2013 - at less than 3 % - has been considerably lower than the 3.5-3.75 % which was expected a year ago.

12. Thus profits' growth has been rather low and the equity increase in 2013 can be explained only by the fact that investors have agreed to pay more for their shares. It was in a sense a sigh of relief that the market's worst fears were not going to happen and that the recovery was to continue.

13. Based only on facts this year increase is thus exaggerated, but as noted Dale Carnegie : "When dealing with people, we are not dealing with creatures of logic. We are dealing with creatures of emotion".

14. And this rise of the price/earnings ratio revived in the press discussions regarding whether or not a new bubble has been created in this market. This is not (yet) the case. Indeed, one can argue that with this move up the US stock market just erased its undervaluation and that the current level is justified given how low interest rates are.

15. But this also means that any further increase must be based on better economic figures. And indeed, it was because the latest figures raised the odds of growth acceleration that the US stock market finished the year at record levels with an increase in December of 2.4 % for the Nasdaq and of 2 % for the S&P.

16. Anyway, this rise, which started in 2009, is probably the most unloved stock market rally ever. This can be explained by the fact that for the majority of people in developed countries their economic situation has deteriorated over the last 5 years. Therefore, the rally is not happening with joy, but with pain.

17. Thus, if a market's decline were to occur during the first quarter, there will be plenty of reasons to explain it.

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Equities (18-29)

18. For example, James Grant, one of the best financial analysts, recently raised the case of Darden Restaurants. The fact that the average American income is lower today than in 1989 first impacts discretionary spending. Therefore, it is not surprising that between 2006 and 2012 sales in real terms of restaurants operated by this chain were down 25 %. And yet, the share value rose by 5.4 % per year between 2006 and 2013. The explanation for this miracle is the fact that debt has increased during the same period by 22.2 % per year. By repurchasing its own shares, Darden has been able to increase its earnings per share. And, as a matter of fact, repurchases of their own shares by US companies are at their highest historical level.

19. To indebt its business in order to increase leverage is a logical strategy for a manager whose sole interest is to push up in the short term, by whatever possible method, the price of its shares in order to receive an obscene bonus. But in the long run, it weakens the company and makes it more vulnerable when a future shock occurs.

20. Another negative factor is that until now the increase happened on very low volume and technically it remains fragile.

21. And then there is the fact that the crisis in many emerging countries seems to intensify.

22. Another reason could be the fact that by mid-December 103 companies of the S&P500 reported that their results for the 4th quarter of 2013 will be worse than expected, against only 9 providing guidance in the other direction. The market should have reacted to these figures, but it has superbly ignored them so far.

23. It should also be noted how strange it is that this is occurring just when growth is supposed to be in acceleration. Is this a manifestation of the new deflationary wave which has now reached the West ?

24. In our conclusion 12 months ago, we wrote : "Currently, the two camps - deflation and inflation - have found an unstable equilibrium, but none has succeeded in taking a decisive advantage. 2011 was a rather favorable year for deflationists and 2012 for inflationists".

25. And from this point of view, 2013 has seen a further decline in US inflation, which moved in 12 months from 1.8 % to 1.2 %, while Europe is close to deflation and if it avoids it in 2014 it will be mainly thanks to Germany.

26. In short, objectively, one must notice that the weather is not as fair for navigation as could have been expected by the 2013 equity rise. Thus, it is surprising to see that there isn't a single bear left in the market. After Nouriel Roubini, the last great bear, Hugh Hendry - manager of the Ecletica Asset Management fund - threw in the towel, because he considers that the available liquidity makes the current bull market unstoppable.

27. "In FED we Trust" is the new slogan of investors. And their belief could be : why worry about the economic situation, since no matter what the FED is here to save the day ?

28. In conclusion, the current optimism is understandable in the US, as a 3 % growth in 2014 is quite achievable, even more so that both the federal budget and those of the local states will no longer be in contraction. In addition, if the return of confidence in 2013 finally brings an increase in business investment spending, growth could even be higher than expectations, which would be a change of the downgrades of 2011, 12 and 13.

29. And this explains why, despite the rise, this asset class must still remain the preferred one in portfolios.

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Equities (30-31)

30. But it is also fair to ask for how long the corporate sector can prosper, with in addition margins which are at a historically high level, while their own customers are suffering from a stagnant or even a declining purchasing power. Both economically and politically, this subject is explosive. It is important that citizens start to begin to benefit from this recovery.

31. If exposure to equity is thus unavoidable, it still remains quite uncomfortable.

Bonds (32-43)

32. We approached 2013 being very negative on the fixed income sector and we have maintained that vision throughout the year.

33. But obviously one has to notice that investors are unable to abandon the fixed income sector, which has brought them so much happiness in the last 30 years. Thus, rather than choosing equities, they left quality bonds to take refuge in the high yield debtor's sector.

34. This will end badly, very badly. A crash in this area will occur sooner or later and it will be either because the economy improves faster than expected or, on the opposite, because fears of a return to recession would have reappeared leading to a possible increase in the risk of bankruptcies.

35. The 2008 crisis was such a trauma for many investors that the search of stability is the priority. They are therefore willing to accept anything but volatility.

36. And yet, in the current situation, this search is not only illusory but also dangerous.

37. For months we are advocating the fact that, for conservative investors, it is more appropriate to be invested 1/3 in quality stocks (or even indexed funds) and the rest in cash at 0 % rather than 100 % in bonds since the risk is lower for the same profitability.

38. Of course, on the short-term a portfolio with equities is more volatile. But it is the reed in La Fontaine's fable : it bends, but does not break. Quality equities may decline - and even strongly as in 2008 - but sooner or later they move back up.

39. Today, bonds are the fable's oak. At the next major storm, they will be uprooted.

40. Meanwhile, the situation is currently a little more complex for government bonds, since their current neglect could be of interest in the short-term.

41. Fundamentally, their return is still not very attractive, and if the expected growth acceleration is confirmed, the current 3 % yield on the 10 year bond - which is a very important resistance - could give in towards 4 %.

42. However, before this move occurs and insofar this sector is today the least liked of the market, the odds have increased that a more or less unexpected event could bring a surprising decline of these yields.

43. It could be of course a fall of the stock market. But for example UBS recently reported that 28 % of its clients holding large accounts remain presently mainly in cash. Given that the market expects that short-term interest rates will remain close to 0 % for a long time, they could be tempted to move back into longer term government bonds, especially if their inflation fears fade.

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Bonds (44-47)

44. Another interesting study from the UK family office Fleming indicates that among the ultra-rich only 2 % currently favors government bonds. But 92 % of them expect a continuation of the rise of real estate prices in London.

45. One should notice that there is a clear contradiction between the 2 % and the 92 %. Real estate is nothing else but a 30-year bond with an incorporated leverage effect. To believe that yields could rise without negatively influencing real estate is an illusion.

46. Meanwhile, for the first time in 3 years, the important rise of the stock market and the increase in yields could temporarily be favorable to government bonds.

47. Watch this space.

Currencies (48-56)

48. The continuation of the euro rise in 2013 was one of the surprises of the year.

49. This is explained by three factors. Firstly, the lull in the euro area intensified in 2013 and as a result funds invested outside the euro during the crisis returned to their base currency.

50. Secondly, as a majority of countries using the single currency are either in stagnation or in recession, the balance of payments for the entire area has become positive. This tends to favor the euro and even more so because the US balance of payments remains deeply in the red.

51. Finally, as we have already mentioned, the ECB is the most restrictive of the central banks.

52. But all this is a bit surreal given the economic situation in the euro zone.

53. For example, Greek banks are happy because the Greek parliament has just forbid them in 2014 - as it did in 2013 - to repossess homes valued at less than EUR 200'000.-. This protects 90 % of Greek homeowners. Banks do not support the measure by generosity, but because they know that a wave of evictions would push further down prices in the real estate sector. This would oblige them to make heavy provisions on their mortgage portfolio, but they do not have the necessary capital to take such a hit.

54. Incidentally, in a broader way, most of the banks of the area, including in Germany, remain dangerously undercapitalized. Therefore we will see how the market will react to the new stress test to which banks will be submitted and, this time it is promised, it will be done more seriously than the previous ones.

55. In Portugal, despite all the efforts of the country, the need for a second rescue package cannot be excluded.

56. Also, with the significant exception of Germany, too many countries are flirting with deflation. It is a deadly situation for indebted economies since for a country it is the equivalent of an individual with a mortgage who loses his job; as much as he tries to cut spending, he will still be unable to service its debt.

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Currencies (57-60)

57. In addition, there is still the fact that the German constitutional court has not yet ruled if the ECB outright monetary transactions (OMT) program is constitutional or not. One remembers that it was the announcement of this program which goal is to buy, in the secondary market, sovereign bonds of member states which allowed 17 months ago the end of the crisis. The program was even more effective than expected since the ECB did not have to buy even a single bond. Indeed, the market has accepted, without testing it, the commitment of the ECB. Thus it bought, instead of the central bank, bonds of countries such as Italy or Spain, allowing the situation to normalize.

58. But, what is starting to become worrisome is that at the end of November the constitutional court once again delayed its decision. The announcement passed completely unnoticed, since everyone expects that it will find a way to declare that the OMT program is legal. But then why this delay ? Could it be that it is preparing to take a decision that will shock the market and that therefore it did not to make the announcement at a time when Germany was without a government ? This is pure speculation, but it illustrates the fact that the situation remains complicated in the Eurozone.

59. In conclusion, it is undeniable that the rise of the euro comes at the worst possible time for most countries of the area. In addition, the ECB is currently caught between a rock and a hard place, since the monetary policy it should follow if it considered only the situation in Germany is at the exact opposite of what it should be doing if it were to take only the needs of all the other countries excluding Germany.

60. Thus, if the situation continues to improve in the US, the dollar will end by rising against the euro. But the timing of such a move also remains linked to the way the FED will stop its bond purchases.

Commodities (61-66)

61. So, after 12 years of consecutive gains, gold finally fell sharply.

62. This is not entirely a surprise. A year ago, we wrote that "if investors become more convinced that the global economy does not risk to fall into a black hole and consequently the fear of bank failures - which continues to worry many investors still traumatized by the events of 2008 - decreases, then one could witness an acceleration of the decline of gold that could bring it up to USD 1'300.-/once, i.e. a total correction of a third since its peak".

63. And this is what happened. However, the way this decline occurred is worrisome, since it seems to have foreshadowed the arrival of a new deflationary wave on the global economy.

64. It could also indicate a limit in the effectiveness of the US quantitative easing policy since it has failed until now to accelerate the velocity of circulation of money which remains too weak.

65. Coming back to gold, sooner or later a strong upside move will appear. And it will be its nature which will indicate if the 2013 decline was just a correction in the bull trend which started in 2000 or if, instead, the rise is just a counter-move of a new long-term bear market.

66. As for the other commodities, one should expect most prices to improve if global growth strengthens.

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Conclusion (67-76)

67. If in the past three years our strategy was based on the fact that we considered that the market was too pessimistic, it is clear at the beginning of this year that it has now become quite (too ?) optimistic.

68. Such a consensus is a source of concern, but for now we give the benefit of the doubt to this long-awaited global growth acceleration.

69. But if our heart favors this optimistic scenario, our head continues to urge caution, since if the market is disappointed, its reaction will be violent.

70. It should also be mentioned that, contrary to the market, we made few comments regarding the end of QE, since for us it is a non-event. Neither the FED, nor the other central banks are ready to take any kind of restrictive measure and from this point of view liquidity will remain plentiful.

71. For some, this is more than enough to allow for a continuation of the bull market.

72. We believe that this analysis is flawed, since the situation is different from 2011 and 2012, when the market was positioned for the worst. But now that the situation has normalized, the mere fact that the road is clear will be insufficient to keep going. If the car has been able to move forward until now, it is because at first it was pushed by the FED, before reaching a downhill (the normalization), which allowed it to increase speed. But now it is on a flat road and it is therefore essential to have fuel in the car to continue the journey. And fuel, in our case, is growth.

73. Thus, it is necessary that the hopes which appeared in 2013 materialize during this new year, confirming in this way that the 2008 crisis and its consequences are essentially behind us.

74. From this point of view, it is also crucial that the citizens of democratic countries start to see the first signs of improvement in their financial situation, if not negative political events are to be expected.

75. 2014 has therefore become the moment of truth for the world economy.

76. We wish all our readers a very peaceful, healthy and joyful New Year.

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