# Market Outlook

A monthly commentary by Gabriel V. Safdié
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## ONE QUADRILLION

## Generalities (1-8)

1. For the first time since the events that led to what economists are starting to call "the Great Recession", August was a relatively quiet month, even if potentially dangerous tensions continued to appear.

2. Thanks to the prospects of an improving economic situation in the US and Europe, Western stock markets performed well until fears regarding Syria sent the markets down. Thus, the DAX and the Euro-Stoxx50 fell respectively by 2.1 % and 1.7 %, while the S&P decreased by 3.1 % and the Nasdaq by 1.0 %.

3. But where the situation continues to be worrying is in emerging countries, with a further fall of its index, which is now down more than 25 % from the April 2011 peak.

4. And the situation has continued to deteriorate further during the month as some countries had to raise their interest rate - such as Turkey - or to intervene massively in the foreign exchange market to support their currency - as, for example, Brazil. Only a relative improvement in recent economic figures published by China brought some sunshine.

5. And this situation is occurring while bonds are having one of their worst years, with losses which are even exceeding those of 1994, when the FED doubled its interest rates in 12 months. Thus the yield on the US 10-year government bond moved up to 2.89 % before ending the month at 2.78 %.

6. However, there is one good news in this sector and it comes from Europe, since the rise to 1.86 % of the German 10-year yield had no effect on bonds of the Southern Mediterranean countries and, for example, the spread between the German and Italian sovereign yield - currently around 2.5 % - is half of the 5 % level reached one year ago.

7. Regarding the forex market, the fall of the emerging countries' currencies continues to favor both the dollar and the euro, but it should be noted that the single currency keeps rising in value faster than the dollar (+6.1 % against +2.9 %). Thus, the euro is the overall best performer since the beginning of year.

8. Finally, the CRB Index rose 2.5 % for the month thanks to a rebound in precious metals. Therefore silver was up 19.8 %, thus reducing its loss for the year to 22.1 %. Regarding the decreases, they were mainly due to agricultural products (for example orange juice -4.6 %).

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## Bonds (9-20)

9. One quadrillion - i.e. 1 followed by 24 zeros - this is the amount of the Japanese debt which was just reached in August and even if it is expressed in yen, the figure by itself is extravagant.

10. This debt represents 240 % of the GDP - i.e. the world's highest - and it continues to grow by approximately JPY 45'000 billion per year because of a budget deficit forecasted at 10.3 % of the GDP this year against 9.9 % in 2012.

11. The bank Lombard Odier calculated that even if Japan would be able, as the government would like, to achieve a real growth of 3 % per year (a record level for the last 17 years) and assuming that yields remain around 0 % as is the case today, a budgetary adjustment of 6 to 7 % of GDP would still be necessary just to stabilize the debt level.

12. If, despite this delicate financial situation, Japan can continue to finance itself at a cost close to 0 %, it is due to the fact that its balance of payments is positive every year since at least 1985. This means that Japan is not dependent from abroad to finance its debt and that as long as its citizens remain confident, the government can find buyers for its new bond issues.

13. The problem is that since the Fukushima accident and the shutdown of its nuclear power plants, the country has to import its energy and thus the deficit of the trade balance could reach this year a record level of about USD 80 billion. Thus, the current debate turns around the fact of whether or not the surplus on investments will be sufficient to allow the balance of payments to remain in the black. As a matter of comparison, the annual balance of payments deficit of Greece at the beginning of its crisis reached 14 % of GDP. Regardless, the fact remains that the annual cash surplus available to the Japanese to buy their government bonds has melted like snow in the sun.

14. But the situation in Japan is only one of many uncertainties around the bond market.

15. The increased pressure on emerging economies is forcing some countries to sell a portion of their foreign exchange holdings in order to support their currencies. And since these funds were invested in government bonds of major developed countries, this contributes to increase the pressure on this sector.

16. Furthermore, countries which have to increase their interest rates in order to retain investors also put pressure at the same time on their local debt market.

17. And finally, an excessive fall in their currencies against the dollar would increase insolvency risks for domestic companies having too much debt in foreign currencies.

18. And if a crisis were to appear on the emerging debt market, it would also have a negative effect on high-yield bonds leading at that moment to an increased risk of massive redemptions requests in the bond funds invested in this sector. And with the current lack of liquidity, the situation could deteriorate very quickly.

19. Uncertainty is also on for the Western countries' debt market. It is likely that the FED did not expect such a quick rise in bond yields and it is now facing a dilemma. It cannot now change its rhetoric without losing a portion of its credibility, but at the same time it is aware that an excessive increase would be negative for growth.

20. So, its hope is presently that investors will eventually find the current levels attractive and that therefore, through their purchases, yields could move down without having to intervene.



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## Bonds (21-23)

21. And it is here that we reach the limits of the injections of liquidity in the system. Because of the countries' high level of indebtedness, central banks cannot let yields move up too strongly or too quickly, as this could lead to a new recession. And if this were to happen, then the debt level in relation to GDP would deteriorate once again, frightening potential buyers. This could lead to further yield increases and therefore to a new deterioration of the economic situation, in a self-feeding negative spiral.

22. On the other side, if a central bank has to intervene by buying debt in order to prevent an excessive yield's increase, it could very quickly become the only buyer; with the risk of losing control of inflation.

23. As one can see, central banks are starting to have less room to maneuver and this at a time when investors have an almost religious faith in their ability to control the situation.

## Equities (24-31)

24. When the FED set up its first quantitative easing policy, we mentioned to investors that it was better to have a reduced amount invested in equities rather than a larger one on high-yield bonds as the risk exposure was much lower. Inversely, a rise on equities would allow for an adequate remuneration of the whole portfolio in a 0 % interest rate environment.

25. And this is what happened. But since the beginning of this year we became more cautious regarding equities, despite the fact - as we wrote then – that if there was just America, equities should have been favored in an aggressive way as growth, even a weak one from an historical point of view, is well established in the country.

26. By the way, the rise of the US stock market in 2013 is mainly due to the reduction of the risk premium on equities and therefore to a higher P/E, as investors have now integrated the fact that the recovery is well entrenched. And, as demonstrated with bonds, the 0 % yield level on short-term deposits allows this premium to be further reduced, which therefore could allow for a continuation of the present bull move.

27. And even more so as corporate investment spending could finally start to improve.

28. In addition, two other good news appeared. In Europe, since the weaker countries of the euro zone have reached equilibrium in their balance of payments, thanks mainly to a reduction of their imports due to their recessions, the economic situation has stabilized. And since the equity markets in the region suffered a lot during the euro crisis, they are relatively the less expensive ones, thus attracting investors.

29. Investors who also have high hopes that the more interventionist policy of the Japanese government will bring a significant improvement in their economic situation, thus providing a non-negligible boost to world growth because of the country's economic power.

30. But despite this good news, dark clouds have become even more visible in the sky.

31. Let's mention first that if the situation in Europe is not deteriorating anymore, there is no evidence that growth can approach in a sustainable manner the level of the US; and regarding Japan, there is not yet enough economic indicators to confirm a significant improvement.


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## Equities (32-34)

32. But the greatest source of concern in recent months comes from the emerging countries' situation, which, as we feared, has continued to deteriorate and is now reaching a delicate stage where the question arises whether the current slowdown will turn into crisis or not.

33. And now, one must also take into consideration the fact that the US stock market has to face more and more tail winds : a rise of the dollar due to the fall of emerging countries' currencies, higher yields with the expected end of QE, higher oil prices (+17.2 % since the beginning of the year) i.e. the equivalent of a tax increase, cuts in public spending with its effects on growth, weak increase in profits for the first half of the year, equities overbought on the short-term.

34. One therefore needs to be aware that if a certain number of the above mentioned elements do not improve quickly, a stronger correction than the one of May and June will become more probable. The current situation can be compared to a rubber band that is been stretched more and more : either this stops or it ends up by breaking.

## Currencies (35-41)

35. And one element to follow will be to see if emerging countries have bettered the management of their currency. From this point of view, the news from India are not encouraging, with the recent bad decisions taken by the government resulting in a further drop in the rupee, which has now reached 20 % since the beginning of the year.

36. Normally, emerging countries go through phases of flooding and dryness. When investors are positive, they flood these countries with liquidity in an excessive way, thus causing a misallocation of capital. Then, when the slowdown appears and bad debts need to be purged, they massively retire and the country is drained of cash.

37. And then follows the traditional scenario : banking crisis, collapse of the currency and risk of default.

38. Following the Asian crisis of 1997, emerging countries have learned the lesson and have built up large foreign currency reserves.

39. So, the question now is whether this will be sufficient to enable them to keep the situation under control and therefore prevent an undervaluation of their currency which could be just as harmful to their economy as the previous overvaluation.

40. And while attention is focused on emerging countries, the exchange rates between major currencies continues to move in a rather narrow band, even if the euro is attracting investors given the interesting valuation of its equity markets compared to those of its competitors.

41. Finally, the yen seems to have stabilized below 100 yen for 1 dollar and therefore a new strong impetus from the Bank of Japan will be necessary in order to bring it further down, otherwise the closing of short yen positions could allow the currency to move up. And this situation reflects the current paradox concerning the country. On the one hand, a fragile financial situation which requires a return to a strong level of growth and thus a rather weak currency, and on the other, the yen in terms of purchasing power parity is currently undervalued against the US dollar by 20 to 30 %.


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## Commodities (42-47)

42. Firstly, it is interesting to note in this area that the deterioration of the political situation in the Middle-East has not influenced, for the time being, the oil price in a meaningful way, since at current levels it does not include much of a political risk premium.

43. Otherwise, the evolution of prices in this sector remains dependent on the Chinese situation. If, as some think, the worst of the downturn is behind us, then base metals can strongly rise and the more so as most of them are currently priced below their cost of production, forcing producers to reduce their output.

44. If, on the contrary, the signs of stabilization in Chinese growth are only temporary and therefore the problems linked to credit will continue to weigh on the economy, then there will not be a rebound.

45. In fact, we find in the commodities sector the paradox of the global economic situation. As there is in the world an excess of production capacity, which is highly deflationary, it is countered by an unprecedented increase of liquidities in the system. Thus, since the Great Recession the combined increase of public debt and of the balance sheets of the major economies' central banks has reached USD 25'000 billion.

46. And if for the moment these two forces are neutralizing themselves, the instability that the situation creates is real. To take an image previously used, we are in a game of tug of rope, where two teams pull on a rope to force the other either to pass a line or to fall. To an outside observer, at the beginning of the game the rope appears motionless and stable, as both teams neutralize each other; then, gradually, a team takes the ascendancy and the end is brutal with an almost instant victory of one side.

47. And it is this source of potential instability, with the economic imbalances that it could generate, which continues to justify an allocation in gold.

## Conclusion (48-52)

48. The question for investors now is whether the stability which appeared 12 months ago – favorable to risk-taking and unfavorable to safe havens such as gold - will be maintained.

49. There are indeed many unknowns regarding not only economic growth outside the US, but also on how the liquidity injected into the system could be drained without creating excessive disturbances.

Currently, investors are rather optimistic regarding the evolution of the global economic situation and this has allowed markets to behave well, even despite August's events which have rather brought heightened tensions.

51. However, in order for investors' hopes to be rewarded, it is now necessary that the pressure decreases, since the more time passes and the higher the risk of a correction.

52. Fortunately, a return to recession is not to be feared. But in the same way that previously the stock market moved up when the worst did not happen, the opposite is now possible.


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