Market Outlook

A monthly commentary by Gabriel V. Safdié
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TO RAISE OR NOT TO RAISE ?

Generalities (1-7)

1. Compared to January, the month was less volatile, with in particular buoyant equity markets. This enabled both the S&P500 and the Nasdaq - respectively up 5.6 % and 7.1 % - to recover their losses from the beginning of the year.

2. In Europe, the psychodrama around Greece did not prevent a repeat of last month's performance, with an increase of 7.4 % for the Euro-Stoxx50 and of 6.6 % for the Dax. The advance for all the Eurozone's markets, with the exception of Greece, exceeds already 10 % in just two months.

3. Regarding Japan, the Nikkei's progression was 6.4 %, while the Msci Emerging Markets index in dollar rose more modestly by 4.4 %.

4. Regarding bonds, as a reverse mirror of what the US stock market did, the US 10-year sovereign bond's yield, which had dropped in January, moved up in February from 1.64 % to 1.99 % but without going back to the beginning of the year's level (2.17 %). The yield of the Japanese equivalent bond moved from 0.28 % to 0.34 % and only the German one remained relatively stable (0.33 %).

5. On the opposite, the yield clearly dropped for the Bloomberg USD High Yield Index to 6.3 %, i.e. a decrease of 0.7 % from the start of the year.

6. Regarding commodities, after seven months of consecutive declines, the Bloomberg Commodity Index finally recorded a modest increase of 2.6 %, mainly due an increase of the price of oil (+14.8 %) and of its derivatives. As for declines, let's mention in particular those of nickel (-7.2 %) and gold (-5.2 %).

7. Finally, the foreign exchange market had an uneventful month with the dollar rising against the euro by 1 cent to 1.12 and by 2 yens to 119.7 against the Japanese currency.

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Bonds (8-19)

8. To raise or not to raise, that is the question that members of the US Federal Reserve Bank - the FED - must be pondering in relation to their main interest rate, the prime rate.

9. We already mentioned in our previous comment the existing divergence at the end of last year between the FED's members - who expected to have to raise several times the rate in 2015 - and the market - which was pricing no increases this year.

10. To understand the FED's dilemma, it is first necessary to remember that unlike any other central bank, the FED has a dual mission. It must not only aim for price stability, but it also needs to ensure full employment.

11. Let's quickly mention that this double mission seems to us more appropriate that the sole objective of price stability assigned to other central banks. Indeed, a risk exists - which has frequently appeared - that by favoring only price stability, a central bank adopts a too restrictive monetary policy. If, on the contrary, the goal of full employment is included, the central bank is then obliged to make a balancing of interests between two objectives that can be quite divergent.

12. US law does not define what is price stability, nor full employment; but the events since the 2008 crisis forced the FED to clarify its understanding of these two notions.

13. Thus, the FED now considers that price stability is achieved when inflation is around 2 %. It considered that choosing a lower target increased disproportionately the risk of falling into deflation, particularly during recessions. It has also given itself greater flexibility, by indicating that at its discretion, it could allow inflation to rise to a higher level if it had been too low previously. For example, if during 2 years annual inflation was only 1 %, it could then accept for 2 years an inflation of 3 % per year.

14. For comparison, the European Central Bank (ECB) defines price stability as inflation below, but close to 2 %. Therefore, it is more restrictive than the FED.

15. With regard to full employment, historically, the FED only took into consideration the unemployment rate, considering that full employment had been reached when this indicator was between 5.2 and 5.5 %. Below this level, it considered that wage inflation pressures would quickly appear.

16. Currently and in view of the improvement in jobs creation of recent months, the unemployment rate should be below 5.5 % in about 3 months.

17. But since 2008, the full employment's concept is also changing, since the FED indicated that it would now also take into account the total number of people employed in relation to the total amount of employable people, in order to consider those who are not looking for a job at a particular moment, but who could do it as the economy improves. Thus, the central bank now needs to estimate how much slack the jobs market has.

18. In addition, the FED is also questioning itself on the fact that despite the fall in unemployment, real income has not risen until now. And this is a risk for the continuation of the current economic expansion phase, since without a rise in purchasing power, spending cannot increase in a sustainable way.

19. And if wages did not increase at a time when full employment is at hand, this could indicate that the 5.2 to 5.5 % level set by the FED is too high in the current deflationary phase. It could therefore be led to review this figure down; some economists suggesting 4.5 to 5 %.

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Bonds (20-30)

20. But where the FED really finds itself in an unseen situation is that, if it is close to its full employment goal - and this much faster than what it expected - the goal of price stability is moving away, since the core inflation rate, which excludes the volatile components of energy and food - is only up 1.2 %.

21. This is an unprecedented situation for the FED. Historically, when the economy was approaching full employment, it feared more and more that wage increases would eventually be excessive and would then be passed too quickly on prices and thus on to the inflation rate.

22. Today, for the first time, it must wish that such a scenario unfolds, as anything that is likely to push inflation up is welcome.

23. Facing this conundrum the FED's next meeting, on March 17th and 18th, is therefore more important than usual for investors.

24. Will the FED revise its goal of full employment? Will it develop a strategy to push inflation back towards 2 %, now that its goal of full employment is practically achieved ? When will it raise its prime rate ? By how much ? At what rhythm will the following increases occur ?

25. In short, rarely has the FED faced so much uncertainty and this at a time when it had already moved into unknown territory with the quantitative easing (QE) program. The normalization of its monetary policy will be as difficult to achieve as had been its support to the economy after the 2008 crisis.

26. US sovereign bonds are currently torn between two opposite forces. On the one hand, there are those who believe that deflationary pressures will not decrease and therefore, sooner or later, yields will eventually reach German levels. Furthermore, they consider that given the countries' level of indebtedness, interest rates will have to stay at a very low level on a permanent basis as no national budget could bear a sharp increase of the interest payment's charge.

27. On the other hand we find those who expect higher yields as this is linked to the need for the FED to normalize its monetary policy, to the acceleration in credit demand which will now happen as the US economy is cured and to the fact that bonds are trading at overvalued levels.

28. No matter what one can expect in coming weeks that any statement by a FED member will be analyzed word by word in order to try to establish towards which direction it will move. This means that the level of uncertainty is bound to increase and with it market volatility, as investors hate uncertainty.

29. And the first sector to be impacted will be bonds as they are always very sensitive to anything related to inflation.

30. But of course, all other assets will also be influenced.

Equities (31-32)

31. Starting with US equities, which are also caught in a crossfire.

32. If the FED accepts the idea that the optimal level of full employment is below the current target, it increases the odds that wages will finally start to move up. But what is good for the economy is less so for equities, since it would push down profit margins and this at a time when they are at a historical high level. Indeed, it is unlikely that companies will be able to pass, at least initially, rising labor costs in their prices.

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Equities (33-42)

33. On the opposite, if the FED raises its prime rate, monetary policy will becomes more restrictive, while until now assets such as equities were the main beneficiaries of the quantitative easing policy.

34. Thus, in a scenario or the other, US equities could be under pressure in coming weeks, even if on the long run economic growth will allow these obstacles to be overcome.

35. Stock market investors will therefore also attentively follow the FED's March meeting and an important first indication will be to see whether the central bank seems to be ready to raise its prime rate in June/July as was expected at the beginning of the year or if, on the contrary, it will postpone it.

36. Two views are possible in this matter. Some FED's members may wish to wait until tangible signs of inflationary pressures have emerged, while others may want to be more preemptive.

37. Anyway, the FED has not forgotten the lesson of the 1937-38 recession, when the central bank tried to normalize its monetary policy too quickly after the Great Depression. At that time it was "saved" by the fact that with war approaching, the country started to massively rearm itself. With this episode in mind, it can therefore be expected that it will proceed quite cautiously.

38. However taking into account the momentum in job's creation and the acceleration of economic growth, the most likely presently would be for the first rate rise to be postponed to September, with a second one later in the year, thus bringing the prime rate to 0.5-0.75 % at the end of 2015.

39. What will be of great interest to the FED is the behavior of bonds in the days following an interest rate's rise. If thereafter the yield curve flattens - i.e. if the difference between the interest rate for 1-year and for 30-year decreases - it will be an important indication that the economy may have difficulties digesting the rise and the FED could then be led to slow down, or even to halt future increases. If, conversely, the curve becomes steeper i.e. the difference between short and long rates increases, it will consider that the dose is not too strong and that it can proceed with further increases.

40. As a reminder, historically when a central bank considered that inflation had become excessive, it will then aggressively raise rates to slow growth. And at that point the yield curve would invert itself with short-term bond yields becoming higher than longer ones. The market was thus anticipating the fact that once the slowdown occurred, the central bank would be forced afterwards to reverse its policy.

41. In any event, the normalization of the US economy is going inevitably to lead to more modest equity gains in the future than previously since on the one hand it is increasingly difficult to surprise the market positively and on the other, as FED's policy becomes more restrictive it will increasingly influence negatively investor’s behavior.

42. Quite different is the situation in Europe, since the ECB is just starting its own QE, growth should pleasantly surprise, and European equities are significantly cheaper than US ones. This is why, if we still consider that the main risk in a portfolio should be taken through equities, an overweight of Europe versus the US is advisable; emerging markets remaining underweighted.

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Currencies (43-52)

43. The foreign exchange sector is also waiting for the FED. It is currently strongly positioned long dollar against both the yen and the euro. The question is therefore whether the FED will be able to meet investors' expectations.

44. Support for the dollar comes from the fact that the Japanese and European monetary policies are lax, while the US should now be heading in the opposite direction. In addition, US government bonds, with a yield of 1.5 % for 5 years and 2 % for 10 years have now become "high yield" securities in comparison to the Japanese and European ones.

45. Obviously, a rise in short-term yields would increase even more the attractiveness of the greenback.

46. On the opposite, one can consider that at current exchange rates the market has already priced in all the effects of the Japanese and European QE. Moreover, the drop in oil prices further increases the surplus in the balance of payments of these two economies and this just when the US trade deficit tends to increase with the acceleration of US growth.

47. Finally, one must take into account that European economic growth will improve in 2015 and 2016 - which should attract capital inflows - and in the case of Japan, the yen is massively undervalued against the dollar.

48. This situation should therefore lead investors to act cautiously. The market seems to have already priced most of what is favorable to the dollar to the point that there is presently almost no dollar bears. This opens the door to the possibility of a relatively powerful counter-move, even if only temporarily.

49. And one should keep in mind that so far we have not seen a significant increase in long-term US investments by foreign investors. Historically this was necessary for a dollar bull trend move to last beyond a few months.

50. There was no reason - neither economical nor monetary - for the rise of the euro against the dollar from 1.20 to 1.40 between mid-2012 and mid-2014. Similarly, the decline of the single currency under 1.15 also seems to be an exaggeration. In fact, it would have been better for both the US and the Eurozone, if the exchange rate had simply remained around its fair value of 1.25 during the whole period.

51. But the world is more complicated than that. Presently much capital is floating around because of the central bank's zero interest rate policy. To this one must add that liquidity went sharply down since 2008 and also that, following the financial crisis, a lot of investors have simply become trend followers. All this inevitably leads to moves much wider than what would have been justified.

52. One must therefore be aware that currency fluctuations have become even more uncertain than before. Whether the dollar continues to move towards parity against the euro or, on the contrary, it comes back to 1.25, the reasons explaining afterwards the move are already ready.

Commodities (53-54)

53. During February, we have seen a renewed interest from analysts towards gold.

54. And this is easily understood if one considers that according to JP Morgan, USD 3.6 trillion of sovereign bonds currently have a negative return. And those with a yield close to zero must be an exponentially higher number of this one.

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Commodities (55-60)

55. However despite this situation, nothing seems to have changed since the yellow metal is only 5 % above its lowest level reached in May 2014.

56. Here too, the future attitude of the FED will be significant. If it decides for example an increase of its prime rate in July already - even though there are no inflationary pressures - a further decline in gold will become probable.

57. In fact, the FED must move very slowly to allow a bull gold trend to establish itself.

58. Finally, it appears that a bullish counter-trend move has started for commodities. Obviously, it remains very dependent of the evolution of the price of oil. But it now seems technically possible that an increase of about USD 10 per barrel from the current level of USD 50 could occur in coming weeks.

59. Should this be the case, the price of the other commodities would be also pulled up.

60. Nevertheless, if such a move were to occur, it would only be a correction inside a long-term bear market.

Conclusion (61-67)

61. A certain number of analysts consider that there is currently the equivalent of a speculative bubble regarding the real capabilities of central banks. The mandarins who run these institutions benefit presently of an exceptional level of credibility, illustrated for example by the docility with which the market obeys the ECB President, Mr. Mario Draghi.

62. According to these critics, one should today “go short” on the credibility of central banks, as investors’ expectations are disproportionate in comparison to what they can really do. And this without taking into consideration errors in monetary policy. They mention for example, that Mr. Alan Greenspan - while he was chairman of the FED - let the equities’ bubble of the late 1990s develop and subsequently he allowed the creation of a housing bubble with its well know consequences.

63. Sooner or later they believe the market will turn against them with a vengeance.

64. From this point of view, the decision totally unjustified economically by the Swiss National Bank (SNB) to abandon the euro/swiss franc peg could be the first crack in the central banks' armor. Indeed, by taking this decision the SNB not only lost all credibility towards investors, but, furthermore, imposed an important deflationary shock to the Swiss economy, which according to Bank Pictet is equivalent to an increase of 3.5 to 4 % of the interest rate.

65. But one can also consider the negative current yields on some government bonds as an indication that investors do not believe in the central banks’ abilities of these countries to stimulate their economies in a sustainable way.

66. And since the US seems to be the only developed country relatively far away from the threat of deflation, one can measure the weight on the FED’s shoulders : it must to find the narrow path that will allow the US economy to continue to growth in a healthy way and thus remaining the indispensable economic locomotive for the world.

67. Bubble or not, we all need the FED to succeed.

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