

A monthly commentary by Gabriel V. Safdié  
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## 2015 : ARE WE ALL TO BECOME JAPANESE ?

### Generalities (1-6)

1. Looking only at the US stock market, the year was good, exceeding our expectation that by the end of 2014 the S&P would be at 2014. This would already have represented a respectable increase. But in the end, the result was even better, since being far above 2050, the index is up more than 10 %. And the technology index - the Nasdaq - had a similar performance.

2. This good result was due to the acceleration of US growth, which, as we indicated 12 months ago, was an essential element for this rise to happen.

3. And it is the unsatisfactory outlook for growth in the rest of the world which explains the non-performance of the other equity markets.

4. Indeed, if in Japan the Nikkei index rose nearly 10 % in yen terms, the result is visibly negative in US dollars terms, at around -5 %. In Europe, the major European indices such as the DAX and the Euro Stoxx50 remained almost unchanged in 2014. This was also the case of the emerging markets' index in USD, even if in this case it did hide significant divergences of performance with, in dollar terms for example an increase of the Indian stock market above 25 % and a drop of the Brazilian one by approximately 15 %.

5. Globally, this led to an almost unchanged FTSE World index, a fair image of a world where growth exists, but in a quite anaemic way.

6. For the commodities market, this sluggish growth led to a fall of around 15 % for the Bloomberg Commodity Index bringing it back to its 2002 level. Of course, it is the dramatic decline for the year of close to 40 % of the price of oil that caught the attention at the end of the year. But silver (-20 %) and copper (-15 %) also suffered. Regarding rises, coffee (+40 %) and nickel (+9 %) painted some bright colours in this bleak area.

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### Generalities (7-9)

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7. In relation to currencies, the good US news also favoured the dollar, with an increase for the year of 15 % against the yen at around 120 and 11 % versus the euro at around 1.22.

8. For high yield corporate bonds if the first half of the year was positive, with a yield decrease for the Bloomberg USD High Yield from 5.90 % to 5 % at the end of June, the second half - and particularly December - was much more difficult, with the yield strongly moving up to close the year close to 7 %. The change was less dramatic for the index in EUR, since the yield only moved up from 4.10 % to 4.20 %, after falling to 3.20 % in June.

9. But the biggest surprise of the year came from the behaviour of developed countries' sovereign bonds, where even in the US the yield of the 10-year Treasury bond fell in 2014 from 3 % to 2.20 %, despite the expectation of rises of the FED's prime rate in 2015. The Japanese equivalent ended the year close to 0.35 % and the German one close to 0.60 %, i.e. a level never reached previously in both cases. And even countries with little growth and a high indebtedness level, such as Italy and Spain, can now finance themselves for a decade at less than 2 %.

## Equities (10-14)

10. Clearly, such a move in sovereign bonds indicates that investors believe that a Japanese style deflation is looming over the heads of developed countries' economies and that even the US will have difficulties avoiding it.

11. One should remember that at the peak of its speculative bubble, both in the stock market and in real estate, Japan was both the economic model to follow and the bogymen which would conquer all. It held in the Western imagination the place currently occupied by China.

12. But this was a long time ago, so long that it could almost be a tale. Once upon a time, 25 years ago, Japan was THE reference in technology and Sony was in the position of Apple today. The Japanese bureaucracy was then celebrated for its ability to position itself in the long-term and it seemed inevitable that the country could only win all thanks to its strategic vision, so different from the American short-termism. In summary, the praises given then are similar to what one hears today in relation to China and its "command economy", where it is the government and not the free

market which establishes the investment policy. Then as now, by its rapidity in decision making and its clear targets, this kind of planned economy seems to be significantly more efficient than the more anarchic ways of free competition.

13. We will see if the Chinese method will continue to be as effective in the future, but in Japan, once the bubble - which had been encouraged by state officials - burst, the market gradually realized that the bureaucracy was unable to adapt to the new situation it was facing.

14. And in particular, when the country entered into recession, the fall of interest rates was done too slowly and always too late in relation to the downwards evolution of the economy, so that it had virtually no beneficial effect. Therefore, in 1995, the country found itself in deflation and because of its rigid operational structure it found itself unable to get out of this trap. It is only since December 2012, with the arrival of Mr. Shinzo Abe as prime minister, that the country is seriously trying to fight this disease.

## Equities (15-26)

15. Because it is a disease, which can be illustrated by the fact that in the last 20 years the average real growth was -0.2 % per year. The figure being thus negative, it is the word degrowth which should be used instead.

16. If Japan can manage the situation without significant social consequences, it is thanks to the reserves it has accumulated during its after-war Chinese style growth phase. But this has a heavier and heavier cost as the country's debt now stands at over 200 % of GDP and the annual primary budget deficit (i.e. before the payment of interest) is expected to be above 4 % for the next five years.

17. For two years now, the country is trying to move out of deflation by following an aggressive quantitative easing (QE) policy as the US has done.

18. But, if this led to a significant decline of the yen versus the dollar from 80 to 120 - which mechanically generated inflation because of rising import prices - it has not yet had the expected beneficial effect on the economy.

19. This is not surprising, since the American example demonstrates that the QE policy by itself cannot stimulate the economy.

20. In the US one of the main achievements of the QE is that it has allowed the recapitalization of banks in an "elegant" way, i.e. without the public noticing it. It also led thanks to the massive purchases of bonds to a decline in interest rates, which favoured the rise of all assets. It must be remembered that in 2008-2009, when the program started, it was vital for the FED to stop the dangerous spiral of falling real estate prices, where a decline led to a further decline.

21. The calculation is easy to do. From an accounting point of view, the amount to pay in interest each year is the same if one buys a property for 1,000,000 at 4 %

or for 1'334'000 at 3 %. This spread of over 30 % makes all the difference when one needs to stabilize prices or to make more bearable the weight of a debt. And as a matter of fact, the decline in mortgage rates in comparison to the summer of 2008 reached 3 % in 2013 and remains at 2.5 % today.

22. However - and this was unexpected at the time QE was first implemented - it did not have a direct positive effect on the economy, since the amounts that the FED injected into the financial system were not invested in the economy, but simply re-deposited by the banks with the same FED.

23. Currently there is a debate in the US on whether or not, with confidence having been restored and the economy improving by the day, banks will be willing - in order to increase their profits - to lend these funds rather than safely deposit them at 0.25 % per year with the FED.

24. Meanwhile, since this money has not entered the economy, it is logical that it has not been able to influence inflation and this explains why, both the US with a QE and the Eurozone without one, find themselves with a core inflation rate (i.e. excluding food and energy) very close to each other under 1 %.

25. And if US real growth is at 2.4 % and accelerating while Europe is at 0.8 % and without a positive outlook, it is only because the Americans allowed their budget deficit to rise. Indeed, it has been on average since 2009 at 7 % per year against only 4 % for the Eurozone countries. Thus, by trying desperately to reach the Maastricht criteria of a 3 % annual deficit - and this regardless of the private demand's situation - Europe made an economic policy error.

26. An error severe enough for some to believe that it will push Europe into a Japanese scenario where the wrong kind of deflation, the one which leads to a decline of both demand and wages, will take root permanently. It could afterwards contaminate the rest of the world.

## Equities (27-37)

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27. In short, in 2015, we are going all to become Japanese.

28. And it is this fear which explains the significant fluctuations in December. The DAX index in Germany for example, fell 7.5 % in a week, before recuperating almost all its losses.

29. Fortunately, the worst is perhaps not inevitable.

30. We have already previously mentioned that gold is currently the most reliable leading indicator regarding the future evolution of inflation. Indeed, if inflation is up, the real return (i.e. the difference between the nominal interest rate and the inflation rate) which is currently already negative, becomes even more so. Thus, the attraction towards the yellow metal is naturally increased. Conversely, the decline of nearly 40 % of its price in 2013 was a warning sign that deflationary pressures were going to intensify and this is what we experienced in 2014.

31. Thankfully, the price of an ounce of gold at the end of 2014 is at the same level of the beginning of the year, around USD 1'200, which clearly indicates that deflationary pressures are not increasing. While it is possible that the oil's price decline will push the inflation rate in the Eurozone below 0 % for a few months, as soon as the price of energy stabilizes the move will fade and we should return to a positive number.

32. Obviously the safety margin is quite low and therefore any negative event from an economic point of view could push the zone into deflation.

33. A second reason that makes us more optimistic than the consensus is that, unless there is an exogenous shock,

European growth will be better than expected in 2015. This is due to the fact that the negative pressures exerted by lower public spending coupled with brutal tax increases are behind us. In other words, with fiscal policy being less restrictive, growth will mechanically improve. And from this point of view the oil's price fall is equivalent to a very welcome tax cut.

34. Certainly the fact remains that this growth will be nothing to write home about it. But if it could be around 1 to 1.5 %, it will be a pleasant surprise that will push up the European stock market which is currently valued for a much darker scenario.

35. A third factor of optimism comes from the European Central Bank (ECB) and its President Mr. Draghi. The Japanese case is in all minds and Mr. Draghi has shown great creativity until now.

36. Currently, the market is convinced that the ECB will embark on a QE policy by buying sovereign bonds very soon. We remain sceptical, since besides the fact that this would be equivalent of waving a red cloth in front of the German bull, we do not see what benefit a US style QE would bring.

37. Indeed, the US example shows that QE does not help revitalize the economy since it has no influence on the offer and demand for credit. Then, with long-term yields already below 2 % for all Eurozone's countries except Portugal and Greece, QE will be useless from this point of view. And finally, with the euro having already fallen against the dollar in anticipation of a QE, the risk is high that - unless the ECB decides to buy humongous amounts as did the Bank of Japan - once the announcement is done by the ECB, the dollar will fall because of the old market saying of "buy the rumour, sell the news".

## Equities (38-41)

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38. Personally, we would prefer that the ECB be extremely easy in relation to its purchase criteria of asset-backed bonds, since this is where it can really make a difference. The more banks are confident that they can sell their loans to the ECB and the more strongly they will lend, thus reviving credit and growth.

39. In the United States, the debate lies elsewhere. With the now obvious acceleration of growth, will banks increase their loans using some of the large reserves they hold at the FED? Will the weak growth outside the US be likely to delay the first expected increase of the prime interest rate?

40. By the very nature of these questions one can see how the United States are in a much better situation than the other countries with its real growth expected to be above 3% in 2015.

41. The scenario is quite the opposite for emerging countries. Nothing is currently favourable to them and there is no reason at the beginning of the New Year to favour investments in this sector. And even more so since it is from here that could come some of the main negative impulses for the world economy.

## Bonds (42-48)

42. Can a new emerging bond crisis occur for example, similar to what happened in 1998?

43. This is not impossible and for three reasons: many of these economies are moving into recession, which reduces income; the currencies of these countries are still expensive and are thus prone to fall against the dollar therefore increasing the weight of the debt in foreign currency; debt which is much higher today than in 1998, since the 0% interest rate policy brought a sharp increase in demand from investors for this kind of bonds and this thirst was quenched by an increase of borrowing by these countries' debtors. For example, Brazilian companies have borrowed in foreign currency USD 175 billion since the fall of Lehman Brothers and the Russian ones USD 115 billion.

44. And even in the US, we are seeing an increase in tensions in relation to poor quality debtors, in particular because the fall of the price of oil brought concerns that many bonds issued by companies in order to exploit shale oil may not be reimbursed.

45. For a long time we have highlighted the dangers of the current situation where there is a significant exposure to junk bonds from individuals and this at a time when market

market liquidity has become much lower than before the financial crisis. The consequence is that we have seen strong price drops for some bonds in December on quite a low transaction's volume. In other words, yields are up on average 1% in December without investors having reduced their exposure.

46. The good news is that it is unlikely that this trend will continue for much longer as growth in developed countries should not fall in 2015. Furthermore, the fact that sovereign bond yields of developed countries have declined will attract sooner or later buyers wanting to take advantage of the spread which has widened between these two types of investments.

47. Nevertheless, one should consider such events as being an appetizer of what will happen when we will have to correct the excesses. An interesting test regarding the resilience of the junk bond market will come when a more or less known debtor will be unable to repay its loans.

48. In conclusion, we continue to favour developed countries' stocks - which have become even more attractive with the recent decline in sovereign bond yields - yields which are now in real terms above 1.5 standard deviation from their historical average.

## Currencies (49-55)

49. Contrary to what many believe, the euro has not been weak in 2014. In fact, the euro-index – which shows the relative strength or weakness of the single currency against a representative basket of currencies - has declined during the year only by 1.7 %.

50. In fact, it is the dollar which has strengthened against all currencies, thus reflecting the favourable growth prospects for the US economy; the dollar-index having rising by more than 8 %.

51. Nevertheless, if the direction of the move USD/EUR was not a surprise - we wrote 12 months ago "if the situation continues to improve in the US, the dollar will end up rising against the euro" - the move was much larger than expected as the market started to price a QE by the ECB.

52. However, a continuation of the present trend with more weakness of the euro in relation to the dollar in coming weeks is not that obvious.

53. First, the market is already clearly short the single currency. Then, recent market tensions and fears of a global slowdown will make the FED even more cautious regarding an increase of its prime interest

rate. And there is the fact that the ECB needs not only to decide to do a QE, but, furthermore, it must allow for an increase of its balance sheet of at least EUR 1 trillion in order to meet the minimum market's expectations. Finally, one must always keep in mind that the balance of payments' surplus of the Eurozone is USD 400 billion, while it is the opposite - a deficit of USD 400 billion - for America. This fact means that the dollar has to run quite a lot just to stay still.

54. However despite all these arguments, the recent introduction of a negative interest rate on the Swiss franc indicates that the Swiss National Bank expects to face additional pressure on its 1.20 cap of the euro/Swiss franc parity. This decision makes it difficult to take a position against the consensus, i.e. towards a rise of the euro against the dollar.

55. This case clearly illustrates the fact that since currencies tend to move according to the increases or not of central banks' balance sheets, it has become quite hard to be invested in this sector and this is also why so few were able to benefit from the decline of the euro. And this situation should not change in the first months of 2015.

## Commodities (56-58)

56. In this sector, one must first mention that the oil's price decline is not due to a decrease in consumption since indeed it has continued to increase in 2014, even if it was at a slower pace than expected.

57. It is in fact an increase in supply, mainly American, which explains the imbalance. And because Saudi Arabia declined to reduce its production as it usually does, the fall accelerated. Therefore, there is no need to panic, as this decline does not signal a sharp deterioration in global growth.

58. Certainly in about a year and a half commodity indices are down by about 20 %, but this move is simply gradually bringing back commodities inside their secular downtrend. As a matter of fact, in real terms, from 1800 until today, the price of all commodities, with the exception of oil, is down thanks to the impact of technology that boosts supply and reduces consumption.

## Commodities (59-60)



59. And even if oil performs better, in reality it has only been able to maintain with difficulty its purchasing power over the long-term. In other words, the real cost of a barrel of oil in the XXI century is identical to what it was in 1800.

60. For 2015, if global growth remains at current levels, it is unlikely that commodities in general have still much room to fall. However, there are also no reasons arguing for an exposure in this sector as the increase of supply of recent years will continue to be felt.

## Conclusion (61-68)

61. It is likely that the fears which arose in December will continue at the beginning of the New Year and we could therefore have a difficult first quarter, with the same kind of strong moves, upwards and downwards, as we have experienced since October.

62. But we should be able to avoid becoming Japanese in 2015 and even more so as central banks are quite aware of the danger.

63. In our view, the attractiveness of developed countries' equities remains intact, even if the ride may not be smooth. And one can even consider that the recent tensions in the bond market could bring more buyers to the stock markets.

64. Indeed, today's great paradox is that investors consider as safer a portfolio of junk bonds than a portfolio of stocks of large global companies.

65. And one also needs to take into consideration the fact that the dividend

paid by these companies is significantly higher than the current yield on sovereign bonds.

66. Admittedly, we are in uncharted waters with the current policy of central banks and also a debt level in developed countries that is too high. This explains why we suggest to structure portfolios by holding a reasonable exposure to stocks and the rest in risk-free investments which, if they do not bring much income, allow the capital to be properly protected.

67. And if the worst were to happen, the capital loss on the portion invested in these quality stocks would be painful but temporary, while on a bond portfolio which is typically totally invested in junk bonds - since they are the only ones to provide an income - the loss may be permanent and of importance depending on the magnitude of an eventual recession.

68. We take this opportunity to wish our readers a New Year full of sweetness, joy and in good health.