Market Outlook

A monthly commentary by Gabriel V. Safdié
Written on April 1st, 2014

THE METAL WITH A PHD IN ECONOMICS

Generalities (1-8)

1. Two events essentially influenced the behavior of investors in March : the crisis around Crimea and the slow-down more and more visible of the Chinese economy.

2. The evolution of the Ukrainian crisis remains unpredictable since it depends on the strategy that Mr. Putin will follow now that the annexation of Crimea took place. But it should be noted that usually any market impact of a political episode, which does not lead to a major conflict, is quickly erased.

3. However, the fact that the Hang Seng China Enterprises index officially entered into bear market territory (i.e. a decrease of over 20 %) is more of a concern, even if it had recovered by the end of the month. But this rebound is somehow perverse since it happened because investors are betting that the Chinese situation has now deteriorated sufficiently to oblige the government to act.

4. Anyway the U.S. stock market remained cool in relation to these two events with a performance in the month of 0.7 % for the S&P and -2.5 % for the Nasdaq. This was probably helped by the fact that the new chairwomen of the Fed, Mrs Janet Yellen, appeared to be relatively optimistic regarding the future of the U.S. economy to the point that the central bank seems to be open to an initial increase in interest rates in about 12 months.

5. Stock markets didn't move much either in Europe with the DAX at -1.4 % and the Euro Stoxx50 at +0.4 %, or in Japan where the Nikkei was unchanged.

6. Regarding the fixed income sector, the yield of the 10-year US Treasury bond government oscillated between 2.60 and 2.80 % to end the month at 2.72 %, while the German equivalent was at 1.57 %.

7. Things were relatively quiet in the foreign exchange market where after reaching almost 1.40 against the euro, the US dollar recovered thanks to the favorable expectations for the US economy, ending the month at 1.3770 and at 103.20 against the yen.

8. Finally, the CRB commodity index also remained virtually unchanged (+0.75 %). But this result concealed significant disparities.

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Commodities (9-20)

9. Indeed, virtually all agricultural products are rising in 2014 - from coffee (+ 70 %) to cocoa (+ 8 %) via butter (+20 %) - to the point that the Financial Times calculated that the cost of the traditional British breakfast has increased 24 % during the first quarter of the year.

10. In contrast, industrial metals are down with, in particular, a significant decline of copper : 11 % in the last 3 months. This is the worst start to the year for the red metal since 1988, when the futures commodity market was created.

11. Copper has returned to its 2010 level and it is important that it find here a support as was already the case in 2011 and 2013. As a matter of fact, from a technical point of view, if this level gives way the door is open for a new significant decrease.

12. In any case for the moment there is not a consensus regarding the consequences of the current fall. Historically the widespread use of copper in the industry made of copper such a reliable leading indicator as to the future evolution of the economy that it became known as the «metal with a PhD in economics". It therefore wears with distinction the title of Dr. Copper.

13. The question now is whether this degree remains valid today at a time when industry represents only 13 % of US GDP. Many believe that in an economy where services dominate, Dr. Copper is no longer reliable. From their point of view this is why equity markets have been so indifferent to the decline of the price of copper. For them, this metal is no longer a valid indicator for the global economy but only for China which is the main consumer. In other words, global growth can be good even if China is slowing.

14. For others "this time is different" are the most dangerous words in finance. One can remember that they were widely used during the buildup phase of the technology bubble at the end of the twentieth century to justify the rising prices.

15. Therefore they believe that the decoupling which has allowed the U.S. stock market to break records at a time when commodities are moving down is an illusion and that copper is correctly predicting difficult days ahead from an economic point of view.

16. Furthermore, the analysis of this move is complicated by the existence in recent years of a speculative operation in China around copper. With the Chinese government wanting to restrict access to credit given its excessive growth, it became more difficult for domestic companies to obtain loans. However it was still relatively easy to borrow in USD to import copper even if the metal wasn't needed for the company's activities. Once the import done, the copper could then be used as collateral to obtain cash which could then be used to finance business needs.

17. And the transaction was even more appealing because for many years China's policy was to allow for a controlled revaluation of the renminbi against the USD. This automatically reduced the cost of the USD loan for the debtor company.

18. But to the recent decline in copper which reduces the value of the collateral, one must add the fact that, for the first time since 2005, the Chinese currency moved down in March against the U.S. dollar. Analysts are now trying to guess whether it is an isolated event or if the exchange rate policy of the country is going to be substantially altered.

19. This is what some are advocating since they consider that, because of the economic slowdown, China needs to do a 180 degrees turn around and start a policy to push down its currency in order to increase the country's competitiveness.

20. In short, China remains the main source of uncertainty for investors because it is very difficult to form an opinion on the current degree of vulnerability of its economy.

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Commodities (21-22)

21. Anyway, the situation has become even more complex for investors in the first months of the year with this opposite evolution in the commodities sector.

22. One small ray of sunshine : gold, up 6.7 % for the year but down 2.9 % in March. It is important that this rise continues as it would be a positive sign that deflationary pressures are receding, making an acceleration of global growth more likely.

Equities (23-30)

23. From a certain point of view the outlook for the global economy has not really evolved in the last 12 months. We wrote then that if there was only the United States, an investor could be aggressively favorable to equities, but that the situation in the rest of the world called for caution. And, as a matter of fact, this has now been confirmed as it has become obvious that the U.S. economy is improving while the opposite is happening for some emerging countries.

24. In the US, to favor stocks in relation to fixed income (which by the way continues to yield almost nothing) remains the best strategy and the fact that the Fed in March appeared more positive regarding the outlook for growth will reassure investors.

25. This does not mean that a significant adjustment (a decrease exceeding 10 %) cannot occur since the last correction dating from September 2011 is already quite old. However it would not be the end of the bull market.

26. Indeed, an acceleration of growth would allow profits to continue to increase thus pushing equities higher and even more so that the Fed will be very, very cautious in its interest rate rising policy.

27. In a speech in 2009 Mrs Janet Yellen declared "If anything, I'm more concerned that we will be tempted to tighten policy too soon, thereby aborting recovery. That's just what happened in 1936 when, following two years of robust recovery, the FED tightened policy because it was worried about large quantities of excess reserves in the banking system. The result ? In 1937, the economy plunged back into a deep recession".

28. Some also worry that the duration of this bull market has already exceeded the historical average of such moves. But we believe that it would not be surprising if the weakest post-war recovery resulted in the longest bull market in history. A bull market is not a runner who exhausts himself after some time. What kills it are successive interest rates rises which finally lead to an economic slowdown. Obviously we are not in such a scenario at present.

29. Others believe that the stock market is in a new bubble as illustrated by the acquisition of WhatsApp by Facebook for USD 19 billion, since WhatsApp was founded only in 2009 and has just 55 employees. In fact this deal illustrates on the one hand the fears of a sector where sudden death is a reality and on the other the saying related to money "easy comes, easy goes".

30. Admittedly the capitalization of Facebook itself - USD 170 billion with 6'300 employees - indicates that investors' exuberance is back but it is still limited to certain sectors. Even if the stock market is no longer cheap, current equity valuations are not shocking taking in consideration growth expectations and the level of interest rates.

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Equities (31-39)

31. General Electric has a market capitalization of USD 255 billion with 307'000 employees and they make thousands of useful goods. Facebook on the contrary is for the moment just a fad around a means of communication which is actually only one among thousands of options that humans have to communicate with each other. The Roman adage "Caveat Emptor" (Let the buyer beware) comes to mind. We are typically in a situation where a rise leads to another rise but an investor should be aware that what the market created in a short period it can also destroy it in a short period.

32. Healthy sectorial diversification is essential and shares with an attractive valuation should be favored even if they are less sexy.

33. In summary, at current levels, the key for a continuation of the U.S. bull market is for profits to continue to grow, which should be the case if economic growth accelerates as expected.

34. On the opposite side, skeptics believe that the negative impact of falling equity prices in emerging countries is too underestimated. They point out that China's growth has probably declined on an annual basis from 7.7 % to 7.1 % during the first quarter of the year and that the shock wave of this slowdown will therefore continue to impact the world economy.

35. Thus, once again, we are back to China and the fog around its economy.

36. Another example : Alibaba, the Chinese Internet company, launched nine months ago a money market fund which has today 81 million investors. In comparison there are 77 million active stock market investors in the country. Assets are currently at USD 81.5 billion, i.e. the fourth largest fund of its kind in the world. The reason for its success is that it pays 6 % interest per year and funds can be withdrawn at any time whereas a one year fixed term bank deposit remunerates only 3.3 %.

37. In a Western economy it is immediately clear that this can only end badly but in China ? Why has Alibaba been allowed to launch such a fund as authorities are trying to reduce the sources of credit outside the banking system (i.e. what is called the shadow banking) ? There is clearly here incoherence at the macroeconomic policy level.

38. The challenge for China is that it must try to redirect its economy without harming growth. This is a source of tensions and incoherencies which could result in costly mistakes.

39. In conclusion, we continue to advocate once again the same strategy : the main risk in a portfolio should be taken through equities but always with a substantial margin of safety given the economic uncertainties.

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Bonds (40-45)

40. And one of these uncertainties is related to the credit bubble. Morningstar indicated that since 2009 USD 700 billion were invested in U.S. bond funds. Goldman Sachs calculated that for the same period globally around the world USD 1.2 trillion has been invested in bond funds while only USD 132 billion went into equities.

41. And a new study on the bond market by the Chicago Booth Business School, which confirms by the way the figures mentioned above, has established that since 2008 there has been a sharp increase in herd behavior. Indeed, since the manager of a bond fund is judged in relation to its peers, when others start buying he must follow quickly, whatever his beliefs, since he cannot afford to underperform. And of course, the opposite happens in relation to sales. Historically, this phenomenon was visible for equity funds but the need today for bond managers to invest in junk bonds has made them presently more skittish than equity managers.

42. At the moment bond funds are benefiting from a positive loop where lower yields allows funds to post a gain, thereby attracting new investors and the new subscriptions permits new purchases resulting in a further decline in yields, and so on. It is therefore not a surprise that junk bond issuance hit a record last year and Moody's warned that the almost desperate search for yield has pushed investors to purchase instruments with fewer legal protections than ever before.

43. In short, when the trend reverses there will be a lot of damage in this area. And one should remember these words from Warren Buffet in his 2000 letter to investors : "But a pin lies in wait for every bubble. And when the two eventually meet, a new wave of investors learns some very old lessons. First, many in Wall Street, a community in which quality control is not prized, will sell investors anything they will buy. Second, speculation is most dangerous when it looks easiest".

44. One last important point : an interest rate rise will also negatively influence stocks. If the sell-off happens quietly equities should be able to hold their ground but not if it happens in a panic. The big difference is that, unlike bonds, investor will have the necessary liquidity to sell their shares.

45. In short, the situation in the bond market is another reason for our positive but cautious stance towards equities.

Currencies (46-47)

46. For the first time, the President of the European Central Bank (ECB) Mr. Mario Draghi declared that the exchange rate is "increasingly relevant in our assessment of price stability". In less diplomatic terms, the euro is too strong to his liking.

47. Thus, the question is at what level will the market force the ECB to intervene. Indeed, with a positive balance of payments for the entire zone, just a statement may be insufficient to push down the euro. In addition, it seems unlikely that the central bank is ready to act at a lower level than 1.50 to the U.S. dollar and even more so because of the particular nature of the euro - one currency for several countries - each intervention is much more problematic than for other central banks.

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Currencies (48-50)

48. The ECB may just be hoping that the expected improvement of the US economy will eventually be favorable to the dollar.

49. By the way, we are facing an asymmetric policy by the ECB. If inflation were to be far above its 2 % target, the ECB would not hesitate to take action to bring it down. But when the opposite happens as it is the case today, with inflation at 1%, instead of taking steps in order to bring it back to the target level, the ECB considers that it is not necessary, even as it expects that inflation will be only at 1.5 % by the end of 2016. It is a rather surprising attitude and even more so as the necessary measures to achieve this goal would have brought a welcome breathing space for the weakest countries of the zone. But it is also true that this would have probably displeased the Germans.

50. Meanwhile, currencies remain in a low volatility area. For traders it is the equivalent of a boat in calm waters : it rocks enough to make you seasick but not sufficiently to move forward. This explains why most foreign exchange funds are facing a fourth year of decline.

Conclusion (51-55)

51. The situation in China is starting to worry investors since the economic downturn is happening after credit increased substantially from 130 to 200 % of GDP since 2009. Historically, in the West the debt reduction which followed such moves has always been extremely painful for creditors as well as for the economy in general because it involved a painful recession.

52. And this is where Dr. Copper is facing its most serious challenge. If the situation in China deteriorates to the point of threatening the global recovery, thanks to its decline early this year, Dr. Copper will have demonstrated once again his talent and the doubts about its capabilities will be silenced. Otherwise he will have to retire as it will not be anymore a reliable leading indicator of the economy.

53. The "black box" that China is should encourage investors to be cautious even if for the moment the Western recovery does not seem to be in danger and therefore there is no need to reduce equity exposure.

54. However, a further decline in copper prices jointly with gold would justify a reduction of risk in the portfolios. Higher bond yields for emerging countries' debtors, which could eventually happen if the stock markets of the region remain weak, would also require taking a similar action.

55. In conclusion, if for the moment the U.S. stock market is behaving quite well, it would be unhelpful if the increased uncertainties which appeared at the beginning of this year continued for too long.

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