

Market Outlook

A monthly commentary on financial markets written on March 1st, 2016

TO DO THE "UNTHINKABLE"

Generalities (1-7)

1. If markets calmed down a bit in February, it was mainly because the US stock market performed better than the others. Indeed, if European stock indexes have lost around 25 % of their value since their April 2015 peak, the S&P 500 index is currently down only by about 10 % from its May 2015 peak.

2. This trend was confirmed in February, as the S&P 500 is down by 0.4 % and the Nasdaq Composite by 1.2 %, while in Europe the Euro Stoxx50 fell by 3.3 % and the Dax by 3.1 %. In Japan, the Nikkei lost 8.2 %.

3. However one can see the beginning of stabilization in emerging markets since the MSCI Emerging Markets index in USD fell only by 0.8 % thanks to a better behavior of countries like South Korea, Taiwan and Brazil. After a decline of more than 40 % from its top - recorded a long time ago in May 2011 - this sector seems to be trying to catch its breath. And a rebound in commodity prices could even launch a bull move.

4. Rebound which has indeed become more probable since, with a drop of over 70 % of the Bloomberg Commodity Index from the June 2008 peak, many commodities are now undervalued, while the consumption level remains elevated. Obviously much depends on the price of oil. If in February the price was once again down xxx %, for the first time since the beginning of this bear market the main producers are at least discussing and the price of USD 20. - per barrel expected by many is perhaps not that inevitable.

5. Meanwhile, the Bloomberg Commodity Index fell 1.6 % for the eighth consecutive month.

6. With investors' concerns growing and as a consequence the potential for higher US interests rates diminishing, the euro tried to move up in February against the dollar but with no success as it ended almost unchanged at 1.0870. The move failed because of expectations of further stimulatory measures by the European Central Bank (ECB), which should be announced at their next meeting on March 10th.

7. Regarding the exchange rate of the dollar against yen, after months of stability around 120, the Japanese currency moved up to 112.70, despite the decision of the Bank of Japan to introduce negative interest rates.

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Generalities (8-9)

8. Decision which lowered the yield on the 10-year Japanese sovereign bond to 0 % and with even a negative yield on some days. The German equivalent is now a microscopic 0.11 % and at 1.73 % the US is just 0.34 % from its lowest recorded in July 2012 at 1.39 %.

9. As for the performance of the Bloomberg USD High Yield Corporate Bond, after having moved above 10 % in the middle of the month, it closed February at 9.3 %, down 0.1 %. However, and for the second consecutive month, the "Market Vectors Emerging Markets" index fund, invested in local currencies but quoted in USD, remained virtually unchanged.

Bonds (10-18)

10. Who's afraid of the big bad wolf ? Apparently investors are, for whom deflation is the big bad wolf.

11. And indeed, deflation is firstly a threat for corporate profits. For example, an oil trading company that earns 1 % per barrel of oil sold had a gross profit of USD 1.- when the barrel was at USD 100.-. But today, it earns only USD 0.30. However, labor and operating costs associated with the delivery of a cargo remain virtually unchanged.

12. Let's also consider the case of a company selling 100 units of a product at a price of 100.-, i.e. a sales total of 10'000.-. If the cost per unit is 80.-, the gross profit is 2'000.-. In case of deflation, one can imagine a scenario in which the price decreases by 4 % and sales increase by 4 % thanks to the lower price. Gross sales remain almost the same (104 units at 96.- = 9'984). However, the profit will be lower because as the cost per unit remains unchanged at 80.-, the total cost is 8'320.-. Profit is therefore only 1'664.-, i.e. a decrease of 16.8 %.

13. Furthermore, in the above example, we took an optimistic assumption of a sales' increase proportional to the price decrease, which is quite unlikely. Anyway, confronted with such a scenario, the company will do everything it can to lower its unit cost, putting pressure on its suppliers and employees.

14. It is easy to imagine the devastation that would come from this situation. Here, we typically have the case of a bad deflation, where the price fall is not linked to technological improvements, enabling a reduction of the product's manufacturing cost, but to a lack of demand.

15. And what makes investors particularly nervous is the more and more widespread feeling that in the fight against this evil central banks' arsenal is now empty.

16. For bonds, this translates into an opposite trend between different types of bonds.

17. Indeed, the appearance of the big bad wolf makes investors run to what they see as the house that will protect them : sovereign bonds of developed countries. And figures are impressive : 28 % of all these bonds have currently a yield lower than 0 %, 36 % are between 0 and 1 %; 24 % between 1 and 2 % and only 12 % are above 2 %.

18. In contrast high-yield bonds have seen their yield increase to reach a level close to 10 %. This is not surprising since, as we have seen, deflation is a weapon of mass destruction for profits.

Bonds (19-26)

19. Moreover, as the 2008 nightmare is not that far away, concerns regarding the banks have resurfaced since any recession in such a scenario would result in a much higher number of bankruptcies than usual. And even without this dark scenario, it is easy to imagine the negative impact on banks' margins coming from negative interest rates in the Eurozone and maybe even one day in the US.

20. This is why bank equities collapsed. For example, the share of Credit Suisse is now at the same level as 30 years ago. The destruction of value that these so-called genius bankers have created is as unimaginable as the wages they have earned.

21. At the bond level, buyers of perpetual bonds issued in large numbers by the banks since 2008 are also suffering quite a lot. These bonds have the characteristic of transforming themselves into equities if the bank's fundamentals deteriorate too much. The market calls them Co-Co for "Convertible-Contingent". An example is the bond issued by Credit Agricole with a coupon, until 2021, of 6.5 %. In June 2014, it traded at 109 %. At its lowest, in mid-February 2016, the price had fallen to 86.5 % and the market lull has allowed a recovery to 94.4 %.

22. Another ugly duck is Deutsche Bank. For example, its 7.125 % perpetual bond trades below 70 %, while its issue price in May 2014 was 100.016 %. But it is true that for this bond, in addition to the conversion risk, Deutsche Bank also has the ability to suspend indefinitely the payment of the coupon. Actually it would be a lesser harm for the holders of the bond compared to a conversion into

shares that would be destructive because of the dilution.

23. This Co-Co market is not insignificant, since bonds for a value close to USD 265 billion have been issued. Another problem with these bonds is their heterogeneity : each of them has characteristics of its own. It is therefore necessary to study each prospectus carefully to understand to what a holder agrees to.

24. There is only one kind of Deutsche Bank equity, but the bank has more than 5'000 different bond issues. This makes the corporate bond market incredibly complex and also explains why it can be difficult to find a counterparty for a transaction. On the opposite, the sovereign debt market is much simpler as it is largely standardized.

25. Another danger for bonds is the leverage used by many bond funds. The International Monetary Fund has recently worried about this because since 2008 these funds have significantly increased the use of derivatives as yields moved down. And this phenomenon can be seen in the most important of these funds. The Financial Times has estimated that in 2014 leverage was 746 % (yes, seven hundred forty-six per cent) for the BlackRock Fixed Income Global Opportunities Fund, which has USD 8.5 billion in assets, 674 % for the Goldman Sachs Global Strategic Income Bond Portfolio Fund (assets : 6.3 billion) and 468 % for Pimco Global Bond Fund (assets : USD 650 million).

26. Insofar as the yield rise is due to fears about the economy, the loss on bonds is correlated with the one on equities. Thus, currently to hold high-yield bonds is to be bullish on equities.

Equities (27-37)

27. And from this point of view, much depends on the United States.

28. Despite the current stress, the US stock market is holding quite well. And the reasons which explain it are numerous : strong jobs' creation month after month, rising wages, an improving real estate market, a banking sector that is better capitalized than in Europe and a limited direct exposure to Asia and to commodities.

29. The danger is that the current market pessimism eventually rubs off on the real economy, first impacting the confidence of businesses and households, and then investments and demand.

30. This is what George Soros calls the theory of reflexivity, or the self-fulfilling prophecy, which in our case would be the fact that the decline of equity markets modifies the behavior of economic actors in such a way that it leads to a recession, thus justifying the market downturn.

31. For central banks, it is therefore essential to allay, real or not, investors' fears.

32. But, their actions in recent weeks have on the contrary rather worried investors. Japan is the first major developed nation to have decided to apply a negative interest rate and the phenomenon could spread. However investors doubt that negative interest rates are able to effectively help an economy. In addition, they found out that this measure has significant adverse side effects such as for example, on banks' profitability. And the fact that the FED's President Janet Yellen mentioned this possibility, even if she considered it as unlikely, has only increased pessimism.

33. From our point of view, it is time for central banks to go further and to do the "unthinkable" : monetize the debt.

34. This idea frightens many as it raises the specter of hyperinflation as experienced by Germany in 1923 or more recently by Zimbabwe where inflation in July 2008 was officially estimated at 231 million percent per year. But according to other economists, it was in reality at its peak close to 80 billion percent per month. Anyway since 2009, Zimbabwe does not have a national currency and transactions are done in South African Rand or US dollars.

35. However, it is a method that Ben Bernanke, the former FED's chairman, had mentioned during a speech in 2002, in which he considered that in extreme cases the fight against deflation might request increased cooperation between fiscal and monetary authorities. He then mentioned the possibility of a substantial tax cut, equivalent to what economist Milton Friedman had suggested when he imagined using a helicopter to drop money to the population in order to revive the economy. And it was following this speech that Ben Bernanke received the nickname of "Helicopter Ben".

36. Today, following the quantitative easing measures, the equivalent of that method would be that a central bank decides it will waive its right to the payment of interest and to the reimbursement of a number of sovereign bonds it holds. Thus, it would keep them in perpetuity meaning that de facto the debt has been canceled.

37. This debt reduction would allow a government to cut taxes and/or increase spending. In addition, it would boost inflation expectations of economic players leading them to use their cash.

Equities (38-39)

38. What is important to understand is that the central bank would maintain control of the process. It decides when and for how much it will monetize the debt. Thus, it can stop the policy at any time and even, if necessary, raise interest rates to cool any potential overheating of the economy. There is therefore no risk of hyperinflation.

39. Countries such as Switzerland and Japan, which are already in deflation, would greatly benefit from such a policy. But if Janet Yellen announced that she was ready, if necessary, to implement this policy on a large scale, it would likely be sufficient to convince investors that the FED (and by extension other ones) still has an effective weapon against deflation.

Commodities (40-44)

40. In fact we believe that the deflationary risk is being exaggerated since much of the recent decline in inflation is due to the fall of commodity prices the effects of which will naturally fade in coming months.

41. And one should not forget that players in this area frequently mention that the best reply to low prices is the low prices themselves, since by reducing supply and supporting demand, these low prices set the stage for a new bull market. The boom and bust in this sector is well alive.

42. Then there is the case of gold which is one of the stars of this beginning of year, with an increase in USD of 16.7 %. Certainly a portion of this rise is linked to

the worries which have reappeared in relation to the financial system. However, gold is also indicating that the deflationary risk is not increasing, on the contrary. Even if insufficient, the very lax monetary policy of central banks with the insignificant bond yields it brings has so far been able to contain this threat.

43. Thus, it would require a much bigger shock such as for example, a collapse of the Chinese economy for the deflation menace to become more pressing.

44. On the opposite, if investors could be reassured by the developments in China, one could witness an interesting rebound in commodity prices.

Currencies (45-48)

45. How far away seems to be the time when the FED expected four interest rate hikes in 2016. Yet, it was in early December 2015 at the time when it had moved up the interest rate by 0.25 %. But presently, interest rates futures indicate that the probability of even just a single rise in 2016 is close to zero.

46. Without surprise, this development stops the rise of the dollar which had strengthened in 2015 in the hope of multiple interest rate hikes.

47. As for the immediate future of the euro/dollar exchange rate, it is now linked to what the ECB will do or will not do at its March 10th meeting.

48. The fact is that its room for maneuver is reduced. It is politically impossible for the ECB to be the first to suggest debt monetization. Yields on sovereign bonds are already microscopic and it is unclear how additional liquidity injections - which would enable, for example, a fall of the 10-year German sovereign bond's yield from 0.10% to 0 % - would be a help to the European economy.

Currencies (49-52)

49. Furthermore, as we have already mentioned, the current low yields are putting European banks under pressure as these greatly reduce their profitability. To continue in this direction could even have the opposite effect since 80 % of credit in the Eurozone is granted by banks, while in the US this figure is only 30 %.

50. The ECB is also aware that the situation in Europe is not deteriorating, on the contrary. For example, surveys of consumer confidence are on a positive trend and nothing seems to indicate that a deflationist mentality is developing, as the willingness of households to make in the near future a significant acquisition is rising.

Conclusion (53-58)

53. While markets agitate themselves, until now, developed countries' economies continue to move forward even if in a leisurely way. In fact, US and European growth should be better in 2016 than in 2015 even if profits could be under pressure.

54. Therefore, additional stimulus measures do not appear necessary. So, the immediate danger is not of an economic nature. Also, a spontaneous return to recession seems unlikely.

55. But at the political level risks have increased significantly as this stunted growth which has been going on for years is feeding the frustrations of citizens to the point that it could push them to do something stupid.

51. But there is also the need for the ECB to avoid the risk of a quickly rising euro if it fails to act forcefully. The ECB must be satisfied with the current exchange rate against the dollar of around 1.10, as most of the benefits brought by a weaker euro have already been achieved at this level. Thus, it would be quite unhappy if the EUR/USD moved back to 1.20.

52. In short, after having disappointed investors at its last meeting, the ECB is facing a difficult communication exercise. How to act with the little at its disposal, while giving the impression that it is a lot ?

56. Indeed, warning signs are multiple today : Brexit risk in UK, Trump-style populism in the US, rising of far right protectionist parties in Europe. The more this type of ideas spread, the greater the danger of witnessing the implementation of economic policies that could cause significant and lasting damage to the economies of developed countries.

57. This is why central banks should strengthen their efforts to reinforce growth and do the "unthinkable" since the only effective weapon left to them is monetizing the debt.

58. Unfortunately, the only central bank that could have the courage to do so - the FED - is facing an economy that does not need it today.

Conclusion (59-62)

59. Actually it is even the opposite as the FED still considers that, even if it is ready to move more slower than previously announced, interest rate hikes are needed since the economy is close to full employment and wages are starting to rise.

60. Thus, it is giving little weight to current investors' concerns and it is likely that this will be the case as long as the financial market turmoil does not bring concrete negative effects on the behavior of economic participants.

61. Time will tell whether, at a time when economic growth remains uncomfortably low, this is a correct view as the inflationary threat seems to be quite weak.

62. Nevertheless, as long as economic growth holds, even at the present low level, an investor needs to maintain a reasonable exposure towards quality equities and accept the volatility linked to it. Taking in consideration the current bond yields on high rated debtors, the opportunity cost is nonexistent and thus time works in favor of equities.

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