Market Outlook

A monthly commentary on financial markets written on May 1st, 2012

FROM CURRENCY RISK TO DEFAULT RISK

Generalities (1-6)

1. The calmness that the European Central Bank was able to obtain through its 1% interest rate loans to the banks lasted finally much less than expected as the fever has, once again, increased in the euro area.

2. And the best illustration is given by the evolution of the CDS on sovereign debt. This market, which is animated only by professionals, has been since the beginning of the crisis a fairly reliable thermometer of the developments in this sector. It is therefore worrying to note that the risk premium to insure against a default of Spanish sovereign bonds is at a record level of 450bp. As a matter of fact, even more than the new cut in the country's credit rating or the return to 6 % of the yield on the 10-year bond, it is this insurance cost which testifies of the increasing distrust of investors towards Spain

3. In this context and without surprise, German government bonds again distinguished themselves, with a reduction of the yield on the 10-year bond from 1.79 % to 1.66 %, i.e. a new historical low level. US bonds moved in the same direction, with the yield decreasing from 2.21% to 1.91 %. And even Japan has seen a reduction in its bond yield from 1 % to 0.90 %.

4. The euro zone equity markets suffered from this : -12.4 % in Spain and -6.2 % in France. However - and this is an interesting element to observe - both the UK (-0.5 %) and Switzerland (-2.2 %), which are outside the euro zone, have experienced much lower declines and in line with what happened in the USA (S&P -0.7 % & Nasdaq -1.5 %).

5. And in a way which remains incomprehensible to North American investors, despite all the problems, the euro was almost unchanged against the dollar (1.3240). Against the yen it moved up by 3.7 % to 79.8.

6. Finally, commodities dropped slightly 0.8 %, with virtually all components down, with the exception in particular of soybean.

IN THIS ISSUE

Bonds (7-17)

7. Europe and the United States are used to clash regarding the organization and values of their respective societies. It is therefore not surprising that at the monetary policy level we also find an important ideological difference.

8. The dream of the founders of the euro was to create a currency that could compete with the dollar, and, in a sense they have succeeded, as the euro has a far larger share of the world monetary reserves than the deutsche mark previously did.

9. But this came with a high cost.

10. During the first decade of the euro, it was party time for the countries of the Mediterranean area, thanks to cheap credit since the interest rate that the ECB had set, taking into consideration the situation in the whole area, was far too low for these countries, often even lower than inflation. This logically pushed investors to borrow as much as they could.

11. And this credit orgy was much facilitated by the disappearance of the risk of currency devaluation since it pushed the banks of the most important countries of the area to massively lend in the Mediterranean countries.

12. But what banks, as well as investors, discovered with horror since the beginning of the Greek crisis two years ago is that in fact they had exchanged the currency devaluation risk for a default risk, since Europe is not a country.

13. Everyone is now trying to reduce its exposure to these countries at the same time, resulting in a significant flight of capital from the periphery to the heart, i.e. essentially Germany. This weakens even more so the "Club Med" countries as they have a large deficit in their current account balance of payments, which requires regular transfers from the surplus areas.

14. And insofar as the private sector is no longer willing to do so, then the task falls naturally to the ECB. We mentioned previously the European payment system "Target 2", which does the compensation within the euro zone. The Bundesbank, as well as the other central banks with a surplus, deposit their excess of liquidity with the ECB, who recycles them to the other central banks, mainly in the periphery. Thus, in March, the surplus deposited by the Bundesbank reached EUR 615.6 billion. In comparison, the amount was on average less than EUR 10 billion before the crisis.

15. From our point of view, this means that it is quite likely that the sum that will be lost by Germany if the euro disappeared would be considerable. Germany is today in the situation of a man who made a woman pregnant. If we were in the nineteenth century we could expect the culprit to do the right thing and marry the woman. This would be the equivalent of the creation of a budgetary union in one form or another.

16. But in the twenty-first century there is also the possibility of a large indemnity, corresponding to the loss inflicted to the Bundesbank in the event of a breakout of the euro zone. Finally, there is the possibility of a monthly payment to the mother and child, which represents the current situation where in one way or another, financial assistance is given to the weakest.

17. We could also remember the old joke which says that if a modest customer owes USD 100'000.- to his bank he has a problem, but if he owes USD 10'000'000.- it is the bank that has the problem.

Bonds (18-26)

18. Germany as the "banker" of Europe needs therefore to properly manage this crisis in order to limit its own financial exposure. Furthermore, it has an interest in maintaining the union, which has been in other aspects quite beneficial to its economy.

19. Yet it should be noted that under its leadership the provided answer is insufficient, as it only tries to strengthen the budgetary corset around the countries.

20. Let's take the case of Spain and Ireland. Until the crisis appeared, both countries largely met the Maastricht criteria. They were even such good budgetary students that they could have easily then followed the just adopted new tougher rules. In fact, throughout this period, the problem was not an excessive indebtedness of the public sector but of the private sector.

21. As in the United States, Ireland and Spain have seen the development of a speculative real estate bubble due to lax credit policies coupled with a too low level of interest rates which acted as an accelerant.

22. And once the bubble bursts, the government has to intervene in order to prevent the banking system to quickly become insolvent. But, if the hole is too large, by taking over the banks' liabilities - as was the case of Ireland - it is then the country debt which becomes unsustainable. And this is the main risk which is currently hanging over Spain.

23. Therefore, one should be aware that the famous "golden rule" that Germany wishes to be followed by every country in the area would not have prevented the current crisis. Thus, the answer is insufficient because it is incomplete.

24. When a country has a deficit in the current account of its balance of payments, its currency has a natural tendency to weaken in order to rebalance the terms of trade. This is the currency risk that we mentioned earlier. However, in the euro area the situation is more complicated. Globally, this element of the balance of payments is in equilibrium, which means that for example, in view of the structural deficit of this balance in the US, the euro tends naturally to move higher against the dollar under normal conditions.

25. But inside the euro zone the situation is different because there are large imbalances between countries. And since there cannot be internal currency devaluations, the deficit of the current account of the balance of payments of a country becomes painless as it remains hidden. And it is even more difficult to correct it since the currency cannot contribute to the adjustment through devaluation.

26. Instead of focusing exclusively on the sole budget deficit, the problems arising from this deficit should also be dealt with. Japan succeeds easily in financing a public debt representing 200 % of GDP, since for the moment revenue generated by Japanese investments abroad allow this balance to remain positive. In other words, the public deficit is balanced by a surplus in the private sector.

Bonds (27-35)

27. And it is in this context that the medication that is given to the sick countries of the euro area does not help much. Let's take again the case of Spain. The bursting of the real estate bubble causes a massive destruction of jobs in this sector, with the usual negative multiplier effects in the economy. Then, lower asset values and rising unemployment lead to an increasing number of delinquent mortgages, with at the end the loss of their homes for many families. The state suffers a collapse of the income generated by the real estate sector at the same time when the economy goes into recession, thus creating a huge budget deficit. Faced with this situation, the government raises taxes and limits its spending in order to try to reduce its deficit. Logically these two measures not only reduce consumption but also lead to a further decline in housing prices, thus creating a negative feedback loop.

28. All this is quite normal. A severe recession, the equivalent of a hangover, is inevitable to purge all the excesses. The problem is that this self-sustaining loop is lethal for an over indebted country as it is almost impossible to reduce the budget deficit sufficiently to lower the debt/GDP ratio since the indebtedness exerts a negative leverage effect.

29. Thus, Spain is in a difficult position with a debt default risk which increases the probability that contagion could spread to other countries through the banking system, as a significant number of financial institutions have important commitments in the periphery.

30. One must also bear in mind that sooner or later the population will start to rebel, which could lead to dangerous political measures.

31. Facing this situation, the ECB - which is aware of the dangers - tries to react every time that the situation deteriorates. But it does not have the means to solve by itself the crisis once and for all.

32. One solution could be the forced recapitalization of all banks of the euro zone area through the stabilization fund. While this would lead to a massive dilution of existing shareholders, or even to the nationalization of some institutions, this would allow the banking sector to start working again satisfactorily and to properly finance the economy. It would also mechanically reduce the pressure on countries, since the risk of an Irish like scenario would disappear.

33. And if this action was coupled with the use of the structural funds that the EU has for investments in the countries in difficulty, then the pain coming from the essential economic restructuring measures could be bearable.

34. In conclusion, the current policy in the euro zone is potentially lethal for the sovereign bonds of all the participating countries, including Germany which will also be affected if the situation worsens. This is an area which should fundamentally be avoided with just short-term trading positions.

35. And it is also by the way, the same conclusion that we reach for US government bonds, but for different reasons since the monetary policy followed in the United States is the opposite of the European one.

Bonds (36-40)

36. In order to offset the negative effects of the bursting of the real estate bubble in the economy, the US government - with the active support of the FED - has agreed to substantially increase its deficit. The current Spanish situation is identical to what happened and still continues to occur in states like California or Florida, where the bubble was among the biggest. Without the economic support of the central government they would also be in an economic depression.

37. Moreover, the USA has a federal insurance banking fund to which all banks must contribute and which has effective tools to close and transfer in a weekend the assets of a troubled bank to a healthier institution. And it is this insurance which then absorbs the losses of the failed bank. Losses which currently are coming in a disproportionate way from banks of these particular states.

38. US authorities are betting that the unique nature of the present crisis justifies an exception to the usual economic rules which are those that Germany wishes its partners to follow by encouraging them to reduce their deficit at all cost. It will be too long to explain it here but the theory is that the support given to the economy by a bigger deficit will be "self-financing" thanks to an increase of fiscal revenue much larger than in normal circumstances.

39. The risk for bonds is that if this policy works, at best interest rates will be normalized and at worst inflation could take hold. On the contrary, if it fails, the debt level will quickly become unmanageable.

40. In conclusion, US policy is quite clear. Any eventual economic slowdown will be automatically counter-balanced by a new phase of monetary easing. One should keep in mind that in 2011, 60% of the bonds issued by the government were bought by the FED, leading to an artificial low level of interest rates. Only a dollar collapse (but against which currency ?) or a flamboyant inflation could undermine this policy.

Equities (41-44)

41. As we mentioned in our last monthly comment, a virtuous cycle seems to have started in the US.

42. However, the situation in Europe is much more unstable, as the current policy is not satisfactory. It seems that it is only market pressures which push the leaders of the euro zone to act and not always in the right direction.

43. This situation makes the evolution of stock markets particularly unpredictable in the short-term. In a way, the volatility which long existed in the foreign exchange market has transferred itself to the equity market. Thus, one should be exposed to the sector but in a reasonable manner, with a medium-term strategy.

44. And recently a new fashion has appeared which consists of trying to benefit from the increased volatility. This is typically management through the rearview mirror. Since 2007, markets have been on a roller-coaster, one could have gained or lost much by trying to anticipate the evolution of this volatility.

Equities (45)

45. But it is not obvious that this phenomenon will continue to occur. It could also disappear for a more or less long period before returning. In addition, one must be aware that it is impossible to hold volatility as such, since volatility is only the theoretical premium integrated in the prices of the buying and selling options of the S&P shares in order to reflect the potential volatility itself of said shares. Thus, the exposure must be done through futures contracts which are already anticipating an increase in volatility relatively to the current level equities as investors are currently pessimistic; this requires quite a large move for the trade to be profitable. Finally, the only real market for this product is linked to the US stock market which is currently the one with the best visibility, making it less volatile than the others. In conclusion, we advise great caution regarding investments in this sector.

Commodities (46-48)

46. In a way, gold is the inverted image of US and European government bonds. Management through the rearview mirror makes investors comfortable with bonds - and why should they not, since for thirty years they saw for example the yield on the 10-year US bond fall from 16 % to less than 2 %. But it is now that it has become really just an accident waiting to happen.

47. If sovereign bonds are less and less attractive in view of the deflationary policy in Europe or the inflationary one in the US, the attraction of gold as an instrument to protect the capital increase. Certainly, it is a volatile protection, but it is nevertheless a good protection.

48. Currently, one of the most interesting opportunities for investors is to be found in the gold mines sector. While equity prices in this area have fallen back to the 2006 level, physical gold since that date is 140% higher and profits are up 540 %, bringing the price/earnings ratio to 7, against 14 presently for the S&P. As we do not see reasons which could justify the end of gold's long-term bull market, this anomaly will end up by being corrected.

Currencies (49-51)

49. Should we rather sell the dollar because of the FED's monetary policy, or, conversely, the euro given the imbalances inside the single currency zone ?

50. For the moment, they cancel each other. However, it is not impossible for a dollar bull market to start, if growth continues to strengthen in the US this year. Stay tuned, but in the meantime we see no reason to favor one of these two currencies.

51. Our preference continues to go towards currencies of countries with good economic fundamentals.

Conclusion (52-54)

52. The most interesting lesson of the month was the decoupling of the European and American stock markets performance. Clearly, as the recovery strengthens in the US and because of the importance of the internal market for the American GDP, the European crisis, at its present magnitude level, can only slow, but not derail the US economic machine.

53. But it would not be so in the event of a collapse of the euro or of a new systemic banking crisis in the euro zone.

54. For the time being, we prefer to maintain our risk level unchanged, since sooner or later a new chapter in the crisis of the euro area will need to be written. This generates uncertainty and as we have often mentioned markets hate uncertainty.