

Market Outlook

A monthly commentary on financial markets written on February 2nd, 2015

DEFLATION, SWISS STYLE

Generalities (1-5)

1. It is customary to consider that January sets the tone for the year and if this should be the case, 2015 will accordingly be particularly volatile.

2. On equity markets, the first week was particularly bad, with declines of around 5 %, before the hope, followed by the confirmation of a quantitative easing (QE) program by the European Central Bank (ECB) that generated euphoria in Europe. Thus, for example, the Euro-Stoxx50 rose 6.5 %. From the lowest of the month - on January 6th - to the highest - on the 26th - the increase of this index reached 13.5 %.

3. However, the other stock markets did not follow the move : +1.3 % for the Nikkei and -1 % for the emerging markets index in USD. But the market which struggled the most was for once the US, with a drop of 3.1 % for the S&P 500 and 2.1 % for the Nasdaq. The US market suffered from the fact that in the current favorable environment - as pointed out by Barak Obama in his State of the Union address - it has become more difficult to have positive surprises from US economic indicators. And to this, one can add the acceleration of the dollar rise.

4. Indeed, from the end of June 2014 until now, the US Dollar index appreciated by almost 20 %, with a particularly sharp fall of the euro to 1.13 in January, its lowest level for more than a decade. The yen against the greenback remained relatively stable at 117.5. But of course the big news in this sector was the fact that the Swiss National Bank (SNB) gave up its peg of 1.20 CHF per

1 EUR on January 15th, which resulted, at the end of that day, on a 20 % decline of the euro, which reached parity with the Swiss franc.

5. The bond sector was also subject to a rather high volatility, with the 10-year US sovereign bond's yield falling to 1.64 % by the end of the month. It is now quite close to its historical low level of 1.40 %. But the most spectacular is of course the fact that the yield on the German equivalent (0.30 %) has now reached parity with the Japanese one (0.28 %) and that even those of Italy and Spain are close to 1.5 %. However, in this area, it was once again Switzerland which was on the spotlight, with a negative yield of 0.20 % per year for the next 10 years. Never before has a yield been negative for such a long maturity.

IN THIS ISSUE

P1	Generalities (1-5)
P2	Generalities (6) Currencies (7-12)
P3	Currencies (13-21)
P4	Currencies (22-23), Bonds
P5	Equities
P6	Commodities
P7	Conclusion

Generalities (6)

6. There was a renewed decline in January for the Bloomberg Commodity Index of 3.3 %, with, once again, a collapse of the price of oil of 9.4 %. The pleasant surprise came from an increase

of both silver (10.6 %) and gold (8 %). This move is even more interesting as it occurred with a stronger dollar, which means that the rise was even higher against other currencies.

Currencies (7-12)

7. So, the SNB gave in and stopped the Swiss franc peg against the euro. This decision was all the more surprising since economically there was no justification. The country was not booming, annual inflation was close to 0 % - i.e. well below the 2 % target - and larger down payment requirements had put a stop to a worrying rise in the real estate market.

like a horse that runs too well; one must add weight on its shoulders to create a handicap.

8. What frightened the SNB was the announcement of the European QE program. As this policy pushes the euro down, the SNB was afraid that it could be facing renewed pressures on the EUR/CHF exchange rate, which may have then required an excessive increase of its purchases of euros to protect the fixed exchange rate. It therefore considered that since it was already holding 80 % of the country's GDP in euros, a further expansion of its balance sheet could one day lead to a loss of control of its monetary policy.

10. By taking this decision, the SNB has chosen to fight an eventual and distant risk of rising inflation while pushing the country into deflation through the rise of the Swiss franc.

9. The SNB also considered that, since the peg has been in place for already three years, Swiss companies had had enough time to adjust to the 20 % rise of the franc against the euro in 2011 (from 1.50 to 1.20) and were thus better prepared to withstand a new 20 % increase, especially taking into consideration that economic growth is good and that the country is in full employment. In a sense, Switzerland is

11. No one knows, not even the FED that initiated them, if QE policies will one day have harmful consequences. So far, it has been a pleasant surprise as it appears that QE policies by themselves, and contrary to the expectations, do not generate inflation. If, at that time, Mr. Bernanke decided to move into uncharted waters and initiated this program, it was because he considered that deflation was the worst that could happen to a central bank, since once deflation has taken root, a central bank has no means to fight it and its monetary policy becomes powerless.

12. With an inflation rate of -0.3 % in 2014, Switzerland was already on the edge of the deflation precipice and thanks to the SNB it made a big step forward. Therefore, Switzerland has become a guinea-pig that will enable us to see if deflation is really that bad. It will also be interesting to observe if, as Mr. Bernanke fears, by allowing deflation to appear, the SNB has, in fact, already lost control of its monetary policy.

Currencies (13-21)

13. By the way, one can also challenge the idea that the European QE would have exercised an unbearable pressure on the Swiss franc. During 6 months, the euro weakened against the dollar and the Swiss franc followed the move thanks to the support of investors who sold the franc against the euro and the dollar, considering that the SNB was a credible institution when it said it wanted to keep the peg. Certainly the SNB had to buy euros recently, but this was due to a mechanical reason. Significant currency moves of the dollar happen first against major currencies, deutsche mark yesterday and euro today. Thus, for example, when the dollar weakens, its fall is faster against the euro than against the franc, which automatically pushes the franc down against the euro.

14. Currently, the opposite move is going on and thus the euro tried to fall faster than the franc. This is why the peg was under pressure. Had the SNB announced some dollar purchases against Swiss franc to signal its intention and, given its credibility, it would have been enough for the market itself to accelerate its franc's sales, immediately reducing the pressure on the fixed parity. And one could even have imagined that some European investors would then also start to buy dollars with some of the francs they had previously bought.

15. The European QE program could not have led to massive purchases of francs because, given the credibility of the SNB, investors would have considered that there was nothing to gain by exchanging euros to francs.

16. Moreover, the SNB abandoned its policy at a time when the market had already anticipated the ECB QE move and was thus already heavily short euro which implied that - mechanically - the franc was also heavily oversold against the dollar. And since much of the fall had already occurred, the euro did not go down sharply after the announcement.

17. Thus by acting on January 15th the SNB's timing was quite bad since the market was already strongly bearish on the franc, i.e. in the direction desired by the SNB. The market was working with the central bank and not against it. This is one of the reasons why the exchange rate moved violently as the SNB destroyed its own allies.

18. It will be interesting to see whether the foreign exchange market will focus on the franc or not in the next weeks and months : investors may be tempted to push further up the franc since the SNB has shown it did not have the guts to fight. And the franc is particularly attractive as, because of deflation, its real return is positive, which is not the case for the currencies of other major countries.

19. Indeed, since the Swiss interest rate is at 0 % and Swiss deflation is at -2 %, then the real return rate is : $0 \% - (-2 \%) = +2 \%$, whereas if the ECB or the Fed are successful and inflation moves to their target of 2 %, their real return rate will be of $0 \% - 2 \% = -2 \%$. Should this happen, the +4 % spread between the franc and the euro and/ or the dollar will make the Swiss currency quite attractive despite its overvaluation.

20. There is therefore a significant risk that the SNB will be ultimately forced to buy foreign currency in a much more significant way than if it had kept the peg.

21. Presently there is also a clear danger that Switzerland could fall into a deflationary cycle with deflation pushing the currency up, which will then increase again deflationary pressures, thus keeping at a high level the real rate of interest, pushing again the franc up. And this spiral would stop only after substantial and lasting damages have been inflicted to the economy.

Currencies (22-23)

22. The franc could therefore remain unusually volatile in coming months, but this should also be the case for other currencies. Indeed, both the Japanese and the European QE programs have pushed investors to build quite large long positions in dollars against yen and euro. But the current dollar rise has already proportionally reached a level which normally happens only when the interest rate differential had moved to 3 % in favor of the dollar. So, the market has currently already anticipated several rises of the US prime interest rate.

23. And if there rises of the US prime interest rate do happen when expected, a violent downward correction of the dollar would become possible, and even more so as the Japanese QE program does not seem to have fulfilled the hopes that had been placed on it, since neither inflation nor growth have yet appeared in a sustainable way in Japan.

Bonds (24-30)

24. The idea that the FED could delay its monetary tightening is not a farfetched hypothesis. Indeed, the US bond market is currently positioned as if not a single interest rate rise will take place in 2015. A few months ago, its skepticism was based on the fact that the priority of the FED is not just to reach full employment. It also wants wages to increase in real terms as this is necessary to make growth self-sustaining. And until now, despite the fall in unemployment, wages have not risen.

25. And the bond market's conviction was reinforced since then with the oil price decline and the strong dollar which further reduce inflationary pressures.

26. Finally, there is the fact that the US economy has not yet accelerated as expected.

27. Presently the pricing in the bond market is at odds with the expectations of

the FED's members, who put the prime interest rate at 1.13 % (by calculating the average forecast) in December 2015.

28. At present, it seems likely that the bond market will be proved right. The FED does not want to jeopardize growth in any way and will likely delay its first rate hike, expected by economists to happen in the middle of the year. Instead, the FED could begin to reduce its balance sheet by not replacing all the bonds coming due.

29. The most interesting question is whether this delay in lifting rates will help reduce the yield of junk bonds, which, according to the Bloomberg High Yield Index, is currently at 7 %.

30. There could be an opportunity here, despite the dangers of the sector. However, the potential of equities is even better and with a lower risk.

Equities (31-43)

31. The economist John Kenneth Galbraith had already noticed that : "The only function of economic forecasting is to make astrology look respectable."

32. And thus, after having stated in our last report that "in 2015, we will not become Japanese" - i.e. that deflation would not appear anywhere else besides Japan - just 15 days into the new year were sufficient for a spectacular refutation of our forecast, as the SNB, voluntarily, pushed Switzerland in deflation.

33. Fortunately, one week later, the ECB president, by announcing a larger than anticipated European QE program, brought an equally dramatic confirmation that almost everyone will not become Japanese.

34. We can only pay tribute to Mr. Draghi. The way he bypassed the German obstacle is remarkable. He accepted the fact that only 20 % of the QE program will be mutualized and that therefore it will be each national central bank which will be instructed to buy its own sovereign bonds for the remaining 80 %. But in exchange, he obtained that the size of the program (over one trillion euros) more than met the market's expectations, thus demonstrating on this occasion that the ECB is in command of the situation and that it is not powerless.

35. As we mentioned last month, the QE program itself will not help the economy a lot, but the psychological impact is very important. The contrast with the SNB is all the more striking. On the one hand, we have a central bank which has destroyed its credibility and trust and on the other, we have an institution which is becoming more and more respected and which is able to deliver as needed.

36. This QE also comes at a time when the Eurozone is showing more and more signs of recovery : retail sales are up in the last 12 months, the velocity of circulation of money is accelerating, bank

loans are increasing and fiscal austerity is over. And all these factors have been reinforced by lower oil prices.

37. In short, European growth in 2015 and 2016 will be significantly better than expected. And since this has not yet been discounted by the stock market, European equities have quite a lot of space to rise.

38. Unfortunately, we do not live in a perfect world and at the same time the sky has cleared over Europe, a storm is possible in the USA.

39. Indeed, the behavior of the US market in recent weeks indicates that a downwards move has become more likely. Like summer thunderstorms, corrections are unpredictable. The weather is fair, suddenly the rain comes, but it does not last, and then the blue sky returns.

40. However, there are warning signs of a possible storm. Technically, the market is showing signs of tiredness : the number of shares going up compared to the ones moving down is decreasing, defensive stocks are outperforming cyclicals. And one needs to add the fact that global growth is slowing and that the American growth may not meet expectations. Finally there is the significant rise of the dollar.

41. This means that in the coming weeks, a worse than expected economic indicator could become the trigger for this potential correction.

42. Despite this risk, there is no need to strategically reduce equity exposure, since any weakness would only be temporary and would represent a buying opportunity for those looking to increase their exposure.

43. In any case it appears that 2015 will finally be the year when European equities will outperform US ones.

Commodities (44-51)

44. The recent rise in gold indicates that despite Switzerland, not only deflationary pressures are not increasing, but they are even beginning to recede. It is therefore important that this bull trend continues.

45. Regarding oil, it is interesting to mention that, just a few years ago, several experts predicted that "oil peak" - i.e. the moment when world oil production would have reached its ceiling before starting to decline due to the depletion of exploitable oil reserves - had already been reached and that, therefore, the price of the black gold could only go up inexorably. Today, on the contrary, Prince Alwaleed has predicts that the price of oil will never reach again USD 100.- per barrel.

46. Once again, Galbraith's words mentioned in paragraph 31 come to mind.

47. It is striking to notice how investors tend to underestimate the fact that a slight imbalance between supply and demand can have a disproportionate effect on the price of a commodity.

48. Consider the case of the recent decline of the oil price. Thanks to the major producing countries' cartel, the price of the black gold was kept at a higher level than if the market had been

left to fluctuated freely. The emergence of gas and shale oil in the US changed this equilibrium and when Saudi Arabia refused to cut its production - as it had always done until now - producers became then naturally keen to increase their sales with each fall in price, in order to partially regain in volume what they had lost in value. So, the imbalance between supply and demand persists and, in such a situation, the return to equilibrium will only be achieved when the oil price will have fallen to a level below the cost of extraction of a sufficient number of production units which will be forced to stop their activity.

49. And if one adds the fact that consumers anticipate their purchases when prices are rising and delay them when the move is down, it is easy to understand why the oil price is so volatile.

50. The current price of oil is now low enough to significantly reduce investments in this sector and in a few years the lack of new production units, combined with greater global demand, will bring the opposite effect and there will then be nothing to prevent the oil price from rising above USD 100.-.

51. It is the curse of the commodities sector to live solely between boom and depression phases.

Conclusion (54-60)

52. It is unusual to have been both right and wrong in just a few days. But thanks to the ECB and the SNB, this was possible.

53. In any event, the path remains clear for equities, since competition with bonds has become increasingly non-existent. Who could have imagined that, despite the explosion of debt in developed countries, a significant number of investors would agree to lend at negative interest rates, thus being guaranteed of losing money ?

54. This situation is unique in history and the bond analyst James Grant recently mentioned that in 1931, at the peak of the depression, no US long-term sovereign bond traded below a yield of 3.13 %.

55. At the current level of the Dax index the dividend yield is at 2.5 % and this dividend is likely to increase in the near future thanks to the higher expected earnings. And even if it stays unchanged, an investor will be able to obtain over a period of 10 years, a return of 25 % on the invested capital, and this just through the dividend, against a maximum total return of 3 % with the purchase of a German sovereign bond.

56. Everything really needs to go spectacularly wrong around the world in order for bonds to outperform equities in such a period. Fortunately, this does not seem to be the case at present and equities thus continues to remain the investment which should be favored.

Marketoutlook

Important Information

The value of an investment may fall as well as rise and an investor may not get back the amount invested. Exchange rate movements may also cause the value of your investments to fluctuate. Past performance does not guarantee future returns. This document is for information only and does not by itself constitute an offering. Information used herein has been obtained from sources believed to be reliable.