Market Outlook

A monthly commentary on financial markets
written on April 2nd, 2013

CONVERTIBLE INTO DUST

Generalities (1-6)

1. March confirmed what we already knew. In the United States the latest economic data shows that the situation is improving; Europe remains stuck in its crisis; Asian countries are beginning to suffer from the yen's decline and the emerging world is still lagging behind.

2. This is reflected in the stock market performances with an increase to a new record at 1'569.19 for the S & P, up 3.6 % for the month. The Nasdaq increased by 3.4 % while in Europe the DAX rose 0.69 % and the Euro Stoxx 50 moved down 0.36 %. In Asia, the Nikkei advanced 7.2 % while Korea fell 1.1 %. Among the emerging economies, the Brazilian stock market is down 6.2 % since the beginning of the year. Overall, the FTSE World Index in dollars rose 1.7 % in March and 6.2 % for the quarter.

3. If the yield on the 10-year US government bond remained virtually unchanged (1.85 %), the German equivalent benefited from Cyprus misfortunes as the yield fell from 1.45 % to 1.29 %. But it is worth mentioning that for the same maturity both the Italian yield (4.76 %) as well as the Spanish one (5.06 %) did not rise, a sign that there was no contamination from the events in Cyprus.

4. The risk premium on the European 10 year investment grade corporate bonds edged up from 116.3bp to 125.9bp while the US one was virtually unchanged.

5. In the foreign exchange market, the dollar index rose 1.2 % while on the contrary the euro index fell 1.7 %. And for once, both the yen (94.2) as the euro (1.2820) declined against the greenback.

6. Finally, following a down month, the CRB Index stabilized (1.2 %). But it must be noticed that once again in March copper (-3.4 %) and aluminum (-5 %) fell.

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Equities (7-14)

7. The management by the troika (ECB, EU, IMF) of the Cyprus crisis reminded us this quote from Karl Marx: "History always repeats itself twice: first as a tragedy and second as a farce."

8. Indeed, for at least one year it was clear that Cyprus would need help. And yet nothing, absolutely nothing, was thought in advance. Thus, this incredible mess.

9. And at the end of this month of March two interpretations can be made of the crisis. Optimists will consider that there was no contagion to other euro zone countries, suggesting that the bulk of the crisis is behind us and that this episode is just a coda, the quick passage that brings a piece of classical music to an end. But pessimists will say : careful, the coda may also just be the final passage of a movement, not of the symphony itself, and therefore the crisis is not over. For them the fact that the euro zone was ready to question without any qualms the guarantee on deposits up to EUR 100,000.- is likely to sooner or later create a bank run against a weakened bank of the Eurozone. And one should keep in mind that thanks to the modern means of communication, rumors can quickly take an unexpected magnitude.

10. The future will tell, but this episode shows once again the difficulty of managing a single currency without a political union. In the U.S. for example as soon as a bank is insolvent the FDIC is used to intervene, usually on a Friday evening, in order to take control of the bank. Part of his job is to guarantee all deposits up to US$ 100,000 as it acts as an insurer. And it also organizes for the transfer of its healthy parts to another entity so that on Monday morning everything works normally. Then it liquidates the rest of the failed bank and losses are covered first by the shareholders who lose everything, then by the bondholders - starting with the subordinate ones and afterwards the others - and finally, if necessary, those who hold deposits over USD 100'000.- will have to cover any eventual short-fall.

11. And this is what has finally happened in Cyprus but in the worst manner. Thus, it is easy to understand why all this has a bitter taste for the inhabitants of the island and is questionable whether the troika would have been so uncompromising with Italy or France. But since Jean de la Fontaine we know that : "Depending on whether you are powerful or miserable, The judgments of the court will make you white or black."

12. Incidentally, contrary to the declarations of the troika, the bankruptcy of the Cypriot banks was not due to an excessive size of the financial sector, but to a disastrous exposure to Greek government bonds. Indeed in 2010, while other banks were reducing their exposure to Greece, the two major banks of the island, Cyprus Popular Bank and Bank of Cyprus, increased their investments, so that by the end of 2010 they were holding EUR 5.8 billion of these bonds (one billion more than at the beginning of 2010).

13. And it must be remembered that in 2010 and again in 2011 both banks succeeded without any problems the two European Union's bank stress tests, because the tests did not consider the possibility of losses on sovereign bonds of euro zone participants. In fact, the two banks did end up losing 75% of the amount invested in these bonds. And on top of it, there were the significant losses incurred on loans made to Greek borrowers as the country fell into an economic depression.

14. The problem is that if Cyprus was an extreme case, it should be noted that, for example, Spanish and Italian banks are in the same position in relation to their national bonds. Therefore, any potential restructuring of these bonds will at the same time destroy the capital of these banks as well as the financial system of the country in question.

Equities (15-21)

15. While all this was going on, if markets were little affected by these events, it is thanks to the news coming from the United States which were good. Gradually indicators are turning green and it is likely we will see an increase in hiring by companies, now that the virtuous cycle has gained credibility and confidence that this recovery will be sustainable has increased.

16. As a matter a fact, we expect that a good surprise will happen in this area and that jobs' creation in coming months will be stronger than what is currently expected by the market. Thus, a real growth of 3 % for 2013 has become more likely.

17. A recent Bloomberg article studied Wal-Mart problems and in particular the fact that the shelves of many of its shops were empty because the company lacked sufficient staff just to restock the shelves with the merchandise which was in storage in the stores themselves. And the article adds that if in the past 5 years the company opened 455 new stores - a 13 % increase - the total number of employees decreased during the same period by 1.4 % and the number of hours worked per employee declined also sharply.

18. Incidentally, it is thanks to measures as aggressive as this one on personnel. which enabled firms to have historically high margins, thus allowing profits to rise despite the recession. But it is clear that this has now gone too far and that some companies like Wal-Mart are trapped in a dangerous spiral: too few employees causes operational problems, which results in a low level of sales and then leads mechanically to a reduced labor budget

19. Articles such as the Bloomberg one lead to awareness that excesses have been committed in this field, and with a favorable economy, the pressure on companies to change their attitude will increase, thus allowing for the employment pendulum to strongly move in the opposite direction.

20. Fortunately there is the United States because elsewhere it is not that great. Europe seems to want to follow the Japanese example of a negative cycle that auto-feeds itself, Asia is not progressing in terms of equity prices and emerging markets continue to underperform with a drop of 3.6 % in the MSCI Emerging Markets Index in dollars since the beginning of the year.

21. In conclusion, nothing really significant happened in this sector since our last report and therefore we continue to hold our equity positions and this as long as signs of weakness do not appear in the US.

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Currencies (22-27)

22. With an accelerating US economy and a new crisis in the euro zone, one might have expected the euro to suffer much more than the slight decline of the end of the month.

23. This resilience of the single currency confirms that for the time being there was also no contagion in this sector. Furthermore, it looks increasingly likely that at around 1.30 in the euro/dollar parity we are in the middle of a trading range between 1.20 and 1.40.

24. The future evolution of the exchange rate will depend on which priority investors will give to different elements of the economic situation.

25. On the one hand the euro could behave more and more like the yen, which rose endlessly despite a poor economic situation, thanks to the surplus of its balance of payments. Indeed for the euro zone, the surplus of this balance has reached a record EUR 120 billion annualized, while at the same time the US had a deficit of USD 530 billion.

26. But on the other, the euro is already overvalued against the greenback, according to the purchasing power parity by about 15 % (25 % in the case of the Swiss franc), the attractiveness of the U.S. economy may eventually attract investors and of course the crisis in the euro area could at some point finally scare investors.

27. A word about the yen. We know that the decline of the Japanese currency is due to expectations by hedge funds that the Bank of Japan will launch a quantitative easing program at least as large as the US one. This has yet to happen and with investors already heavily positioned on the short side, the yen has room to move up.

Commodities (28-31)

28. Dr. Copper, as it is known by investors, is not happy. In the last 2 years its price has dropped by 30 %, reserves continues to pile up and just the inventory in the London Metals Exchange has reached 514'000 tons.

29. And since copper has the eputation of being the bellwether of economic growth, its current weakness should be a bad sign and even more so that this poor performance is confirmed by the other industrial metals. Moreover, the CRB Commodities Index is below the 200 days average, which technically is considered to be negative for an asset.

30. Currently, we believe that one should not give too much importance to this. Indeed, the past decade has been very supportive for this sector and the continuous rise in prices eventually led, on the one hand, to an increase in supply, and on the other, to the massive use of new technology to reduce consumption and therefore demand.

31. Furthermore, in this cycle the US is clearly in the lead and the size of its economy is such that it can "pull up" global growth as China did after 2008.

Commodities (32-36)

32. And we must finally consider that a price moderation in this area is quite favorable to growth. This is the case for example with a barrel of oil below USD 100.-.

33. By the way, in this area Japan has announced that it had developed, for the first time, a method for extracting, off its coast, the frozen undersea methane gas deposits. For the moment the cost of extracting it is not yet economically viable, but this was also the case 10 years ago with shale gas. Given the fact that this would give the island a measure of energy independence, it is likely that the Japanese will use all their ingenuity to quickly put these reserves to work.

34. Anecdotally, we would like to mention that one of the founders of Greenpeace, Mr. Patrick Moore, recently declared : "Think of all the benefits that nuclear energy can bring to bear on a growing civilization". It appears that a growing number of environmentalists are starting to advocate the use of nuclear energy to combat global warming.

35. Clearly we should expect quite a number of surprises in the energy area in the next years.

36. From an investment point of view, it is unlikely that this sector will attract attention in a good or a bad way in coming months. Indeed, global growth is strong enough to support prices, but insufficient to lead to a boom.

Bonds (37-41)

37. When the autopsy of the current secular bull market will be made - because everything has an end, even this bull market - it is probable that the bonds recently issued by banks will become a symbol of the excesses happening at the end of this cycle.

38. Barclays Bank, for example, issued a USD 3 billion bond with a coupon of 7.625 % and a maturity in 2022. At first glance it is one of the many bonds issued by banks and subordinated to about everything. Except that this one is much worse. Indeed, the issuer has the right not to pay - and thus to do a complete write down - if the bank's "core Tier 1" falls below 7 %. And this is what we call being convertible into dust.

39. In a very simplified way, there will be a total loss for the investor if the capital plus the reserves of the bank falls below 7 % compared to its total risk-weighted assets. The problem is that the notion of "risk-weighted assets" is anything but scientific as the stress tests done on the Cypriot banks have shown. In addition it is the banks themselves that have to establish this figure and they benefit from a significant leeway to do so.

40. Therefore, depending on the circumstances, the banks themselves may have an interest in being pessimistic in their interpretation of their risk-weighted assets in order to push the ratio below 7 %, which would then mechanically increase - at no cost - their capital and in Barclays' case for an amount of USD 3 billion.

41. Thus, the banks invented a new risk category which is worse than shares. If unlike stocks, the gain is limited to 7.625 %, it can also lead, as is the case with equities, to a total loss of capital. But in this case, the big difference is that if for the shareholder the total loss implies the complete bankruptcy of the company, the total loss for the bondholder will instead strengthen the company's ability to survive.

Bonds (42-50)

42. Another symbol of the excesses will probably be the fact that, on average, sovereign bonds of emerging countries, with the exception of Venezuela and Argentina, are currently yielding in local currency 3.9 %, a record low.

43. And we are having again the issuing of bonds where the debtor does not have to pay interest until the maturity of the loan.

44. In short, to quote Bill Gross, who holds the crown of best bond manager in the world : "Corporate credit and high-yield bonds are exuberantly and somewhat irrationally priced. Spreads are tight, corporate profit margins are at record peaks with room to fall, and the economy is still fragile."

45. All this is the will of the Fed which by massively buying US treasuries is obliging investors to take on more risks.

46. And it is now the moment to mention that if many were surprised by the losses inflicted on the deposit holders of Cypriot banks, they are in fact not that shocking. Indeed, the banks were paying more than 4% interest per year on customer deposits in euros and in dollars. It was therefore a high-yield investment with all the risks that it entails. Also, from a legal point of view there is no difference between a bond and a bank deposit. The only difference is that the buyer of the bond makes a loan to the bank for a longer period than the depositor who can quickly ask for his money back.

47. As long as the market expects the Fed to continue to buy bonds it is unlikely that investors will be frightened.

48. But, as we get closer to the end of these purchases, most professional investors will try to anticipate the move because they are aware of the lack of market liquidity. In November 2007, according to Citigroup, dealers held USD 232 billion of corporate bonds against USD 459 billion held by funds. Presently dealers hold just USD 57 billion while bond funds have now USD 795 billion invested. This huge reduction in the capacity of dealers to hold bonds, because of the new rules regarding the size of balance sheets, is worrisome.

49. Indeed, the big problem is that bond funds are exactly in the same situation of a bank which is borrowing short-term - since an investor may at any time request the redemption of its units - and lending long-term, with the purchases of bonds in our case. These maturities mismatches will be very difficult to manage. When the redemptions requests on a bond fund will be larger than subscriptions, managers will be obliged to create the necessary liquidity for the repayments by selling bonds. To whom ? And at what price ?

50. Our prediction: At the peak of the crisis, just as it happened with hedge funds during the events of 2008, bond funds will eventually be obliged to apply the force majeure clause and put on hold redemptions.

Conclusion (51-58)

51. At the time these lines are written the President of Cyprus has just declared that “Cyprus had no intention of leaving the euro”, which means that this hypothesis has now become credible because if it wasn’t the case he would not have felt the need to make this statement.

52. We will see, but should this happen, summer may not be as quiet as Mrs. Merkel would like prior to the German elections in September.

53. Also, the Cyprus events once again raise the question of whether the debt crises of the euro zone’s Mediterranean countries is not just the beginning of a move that will end up by reaching the large developed countries as well.

54. In 1933 in the US, the total public and private debt, as a % of GDP, peaked at 299%. Then it fell sharply to 125% in the 1950’s before moving up again and reaching in the second quarter of 2009 a record of 386 %. And, at the end of 2012, this figure still stands at 355 %.

55. This is why some are forecasting that the last phase of the crisis which began in 2008 will be, as was the case in Cyprus, a massive reduction of debt in the OECD countries one way or another.

56. Without using brute force as in Cyprus, one can for example create inflation. From this point of view, there are a growing number of economists who believe that it is in the U.S. interest to let inflation rise between 3 and 5% to help the recovery.

57. This does not seem unlikely given the fact that the Fed will be very cautious when the time comes to take restrictive measures, because it will be afraid of harming growth. Its priority has now become the fight against unemployment and therefore a moderate rise of inflation will be acceptable, and this even more so because the Fed will consider it to be temporary.

58. In conclusion, we continue to avoid bond exposure in favor of equities. But our exposure in this sector is increasingly dependent on the good behavior of the U.S. stock market.

Important Information
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