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Market Outlook

A monthly commentary on financial markets by Gabriel V. Safdié
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TO FOLLOW OR TO PREEMPT ?

Generalities (1-6)

1. Is it the rays of hope we identified in our previous report ? Or simply the January effect where, mechanically, investors position themselves at the beginning of the year ? Anyway, markets started 2012 in a rather good mood, as illustrated by the good equity performances during the month : +4.11 % for the Nikkei, +4.36 % for the S&P, +4.39 % for the CAC40, +8.01 % for the Nasdaq and +9.50 % for the Dax.

2. And one should note that contrary to January 2011 - when emerging stock markets were the only ones to fall - they also benefited this year from the move, as illustrated, for example, by Brazil, which, after a 27 % decline in USD in 2011 was up 18.40 % in January. Globally, the emerging markets index in dollars rose by 11 %.

3. This situation was also favorable to investment grade corporate bonds as the risk premium fell from 173 to 144 for the European index and from 133 to 89.50 for the US one.

4. Government bonds' yields slightly fall, with the German 10-year moving from 1.83 % to 1.79 % and its US equivalent from 1.88 % to 1.80 % .

5. The improved mood was also favorable to commodities, with an increase in January of 3.5 % for the CRB/Reuters index, led by orange juice (+24.3 %), silver (+19 %) and gold (+10.7 %).

6. Finally, currencies were quite stable, with the euro (1.3080) and the yen (76.30) virtually unchanged against the usd.

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Bonds (7-19)

7. One of the major decisions that an investor needs to take is to decide whether to follow a move or, on the contrary, preempt its reversal.

8. In the first case, one follows the saying that "the trend is your friend" and in the second, the goal is to follow the adage that "trees don't grow to the sky."

9. Financial markets tend to amplify human emotions, making investors act in an often irrational way, both on the upside and on the downside in relation to asset prices.

10. The bubble on the tech sector in the late 1990s coincided with a period of euphoria, where the end of history was proclaimed since democracy was inevitably going to spread around the world and where therefore bad things could no longer occur.

11. Today, the feeling would quite be the opposite : everything that can go wrong will go wrong.

12. To this phenomenon one needs to add the tendency of extrapolating the continuation of an existing move. Thus, today investors are positioning themselves for a rise on the price of a bottle of Bordeaux or of a painting, reassured by the positive trend of recent years, while at the same time they neglect equities which have not performed for over ten years.

13. And this situation is also compounded by the fact that investors have become increasingly impatient regarding results. Therefore, they tend to concentrate only on the quarterly performance, with little interest in the strategy and the risks taken. Thus, managers prefer to blindly follow the herd and to look for safety in the crowd.

14. A good example of this situation is currently the bond market. It has been in a bull market for almost thirty years and investors are therefore reassured by its past performances. We are far away from the inflationary period of the 1970s, when a bond was considered to be a "certificate of confiscation".

15. And last year was not an exception, with a further decline in bond yields in the United States, in the UK and in Germany.

16. In Japan, despite a debt that is over 200 % of GDP, the government continues to finance itself for 10 years at an interest rate below 1 %.

17. James Grant, one of the best analysts in the bond market, recently noticed that in 2001 the total number of US government bonds issued was "only" USD 3.3 trillion, with an average interest rate paid of 6.1 %. Today, on a USD 11 trillion debt, the Treasury pays on average only slightly over 2 %. Ironically, he quotes Lenin : "The worse the better".

18. In the 1980's, Paul Volcker in the US pushed short-term interest rates up to 20 % in order to combat inflation which was then running above 10 % per year. For a long time investors did not believe it, based on their experience of previous years. They were very much convinced that neither the United States, nor the other countries, would be able to lower in a meaningful way their inflation rate.

19. Similarly, they are today convinced that central banks can inject billions of euros, dollars or pounds in the financial system without creating inflation. Perhaps.

Bonds (20-26)

20. Anyway, in 2011, investors clearly followed their "historical" experience of ever lower bond yields and they were further motivated by the massive bond purchases done by the FED. And with no doubt, most of them believe to be smart enough to be able to get out of those positions in time.

21. However, the increasing indebtedness of the developed world makes an investment in this sector much more dangerous than previously. Taking into account all the liabilities of the federal government, US debt has reached at the end of 2011 100 % of GDP. And this situation is not bound to improve, as the US budget deficit, which in 2011 was almost at 9 % of GDP, is expected to be around 6 % this year.

22. And if one wants to refer to history it is not useless to mention that during the 1990 decade the average inflation in the United States was 2.3 % per year, while the 10-year bond yield was on average 6 % during that period.

23. For the time being, governments have been able to convince investors that it is a good deal to take the risk of holding a long maturity bond in order to receive an interest well below inflation.

24. Personally, we prefer to anticipate what seems to us an inevitable evolution, by refraining from investing in this sector. It is impossible to predict how long this situation will continue, but it can only end badly.

25. And it is here where the main difference between having a bullish position or instead a bearish one lies. To be positioned on the upside means to hold an asset which has an interesting capital appreciation potential; thus, one just needs patience in order to collect its fruits, while receiving an income meanwhile. In the opposite case, not only you do not have an income, but you often have to pay a premium to keep the position. For example, being short a 10-year bond costs annually the difference between the short and the long-term interest rate; in the United States, the cost is currently 2 % per year.

26. Therefore, the timing in this strategy is essential, since as already noted by John Maynard Keynes : "Markets can remain irrational a lot longer than you and I can remain solvent".

Equities (27-29)

27. If it is therefore quite difficult to go short on bonds, it is at the moment easier to hold shares. They are unloved, with an interesting capital gain potential. And the investor is paid for his waiting as he receives an income - i.e. the dividend - which is well above the interest rate on bonds.

28. For bears, the main argument against equities is that they consider that whatever the central banks will do, the deflationary pressures are such that a recession, or even a depression, is inevitable. In such a scenario, only cash would protect, as not only stocks, but also bonds, real estate, wine, etc… would lose a significant portion of their value.

29. We consider this risk to be low, since Ben Bernanke, for example - who has extensively studied the 1930s depression - is convinced that this event was only possible because monetary policy was then too restrictive. He therefore plans to use all the means at its disposal, which are unlimited since he is the one which issues the currency, to avoid such a scenario.

Equities (30-35)

30. To put everything in cash today is therefore a bet against the FED and the other central banks. And this strategy has a cost, since the FED clearly indicated this month that real interest rates would remain very negative at least until 2014. Even the European Central Bank has started to act. Its balance sheet rose by 37 % in 2011, notably thanks to its unlimited 3-year loans to the banks. And this will continue, since a new 3-year loan offer will happen in late February.

31. Indeed, equities will remain volatile and this is why the exposure should be reasonable. But it is necessary to remember that equities are interesting because fear is running high. The better the news, the more expensive they become. In the present situation, it would be sufficient if things would be less bad than expected for shares to rise.

32. Finally, the events of recent months have demonstrated that it is futile to expect to be able to preempt a move - up or down - in this sector.

33. Deflationary pressures on the economy and the reflationnist answers of central banks have impaired the existing correlations between the macroeconomic processes and equity prices. The intensity of the problems, as well as their complexity and interaction, has destroyed any ability to predict the influence of one on the other.

34. This is the reason why we continue to advise investors to position themselves conservatively in this sector and to accept the existing volatility, without trying to time the market. The position must be strategic.

35. And in conclusion, the real surprise today would be for global growth to be better than expected. We gave in our previous comment some elements which could lead to such an outcome.

Commodities (36-40)

36. Most mining shares fell sharply in recent months, given the fears of a Chinese hard landing.

37. Just as with the other equities, these securities could rebound - and with it the associated commodities - if news will be less bad than expected.

38. Regarding gold, its main enemy is interests with a positive real return. The previous bubble in the 1980s only burst when the FED increased its interest rates well above inflation. With the FED stating that its interest rates will remain close to zero until 2014 this danger is not in sight.

39. Moreover, it is likely that in its current state of mind, the US central bank will increase its interest rates only with some delay in relation to economic developments, since it would want to make sure that any eventual improvement is durable.

40. Finally, it should be noted that since most major countries are following the same policy, gold will continue to attract more and more investors, as it is a way of preserving one's purchasing power.

41. Therefore, we continue to maintain our goal of USD 2'500.- per ounce for 2012.

Currencies (42-43)

42. Nothing new in this sector, despite all the problems of the euro zone. All developed countries are in a difficult economic situation and there is little reason to prefer one currency to another.

43. And, as we have often noted, the United States needs to run just in order to stand still, because of the large deficit in its balance of payments. This is why we remain cautious about the possibility of a sharp decline of the euro against the dollar. The dollar could even begin to depreciate against the currencies of countries with good economic fundamentals, such as Canada, for example.

Conclusion (44-48)

44. For the moment, investors remain skeptical regarding this beginning of the year increase as they consider it to be just a temporary relief rally.

45. However, it is interesting to note that the US manager GMO - whose chief executive Jeremy Grantham is one of the most respected men in the asset management industry - started early this year to buy equities in Europe ex-UK and in Japan.

46. With these purchases, they are following their credo which is to consider that markets always return to their average; the average being what they see as the fair value.

47. And they did shock investors when they announced in late 1990 that their models showed a negative real return for equities in the early years of the 21st century. It is therefore interesting to mention that as per 12.31.2011, they expect for the next seven years a positive real return of between 5 and 7 % for equities depending on the different categories, while bonds are at -1.5 to -2.5 %.

48. And when they announce these purchases, GMO commented : "What we need from our clients is patience."

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