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# Market Outlook

A monthly commentary on financial markets by Gabriel V. Safdié
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## A GOOD AMERICAN SURPRISE ?

**Generalities (1-5)**

1. The beginning of the year rally continued in February, with a rise across the board. And for once, the best performance was done by Japan, with an increase, probably linked to a weaker yen, of 10.5 % of the Nikkei. But the other markets also made good progress : +6.1 % for the DAX, +5.4 % for the Nasdaq, +4.7 % for the CAC40 and +4.1 % for the S&P.

2. So, the yen effectively weakened after the Bank of Japan decided on a moderate monetary easing. Thus, it was down 6.4 % (at 81.15) against the dollar and 8.4 % (at 108.10) against the euro. Finally, the adoption by the countries of the euro zone of a new plan for Greece allowed for a small rise of the single currency in relation to the greenback from 1.3080 to 1.3325.

3. Commodities also performed well, since the CRB/Reuters index moved up 3.2 %, led by soybean (+9.5 %), crude oil (+8.7 %) and sugar (+8.5 %).

4. Regarding fixed income, the decline in investors' fears was very favorable to the sovereign bonds which were under pressure in the euro zone, notably Italy where the yield on the 10-year government bond declined from 7 % at the beginning of the year to 5.20 %. Regarding its German and US counterparts, they moved in a fairly narrow trading range to finish the month respectively at 1.82 % and 1.97 %.

5. This was also the case for risk premiums on corporate bonds, virtually unchanged : 85.5 in dollar and 129 in euro.

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**Equities (6-16)**

6. As we have already mentioned, the fact that we are in an unprecedented economic situation - in which central banks have to implement a monetary policy that can be described as revolutionary - has made most of the leading indicators, which were implemented by investors during the second half of the twentieth century, irrelevant.

7. In a sense, we are back to the starting point, where the only really credible leading indicator in relation to the future evolution of the economy is, once again, the stock market.

8. But investors are currently hesitating between two states of mind. On the one hand, they have become more optimistic regarding the economy in view of the rising markets, but, on the other, they are suspicious of this move, as it reminds them of the beginning of last year.

9. Indeed, on the first two months of 2011, the S&P was up 7.7 %, against 8.6 % currently.

10. But there is a significant difference compared to last year : in 2011, most emerging countries were tightening their monetary policy and this was then reflected in a 3.9 % decrease of the emerging market countries index in January and February, while this year it is up by 16.8 %. This difference is obviously linked to the fact that since the last quarter of 2011 these countries have also started to ease their monetary policy.

11. Moreover, in Europe, investors have "got used" to the debt crisis in the euro zone and they don't get scared as easily as before.

12. Finally, in the United States - which was the third source of concern last year - the evolution has been such, that the question now is whether or not we are going to finally have a takeoff - certainly a delayed one, but nevertheless stills a takeoff - of the US economy. In short, are we going to have a good US surprise in relation to growth ?

13. It has been four years since the FED began its monetary easing campaign. Usually, after one year or two, the economy responds favorably to this easy monetary policy. Therefore, the current lag is unprecedented, which is a good illustration of the strength of the 2008 financial crisis. Furthermore, for the bears, it is a sign that this strategy has finally found its limits and they believe that for the first time since 1945 it will not work, given the high level of indebtedness in the economy.

14. Nevertheless, today some indicators suggest the possibility that, in spite of everything, it will end up by bringing a favorable response from the US economy.

15. From jobs creation to the economic activity, positive signs are multiplying and it has led to a rise in February of the US consumer confidence index above its April 2008 level; thus moving above the level which is usually associated to a recession.

16. Therefore, we could be at the beginning of a virtuous cycle where better economic results lead to a further improvement of the economy and so on. And one may even witness a surprising acceleration of US growth if the real estate sector picks up again in the United States.

**Equities (17-29)**

17. If the inventory of homes for sale remains at a high level, it is because, on the one side, buyers are cautious as they fear that they may lose their job in view of a too weak growth and, on the other, buyers have found difficult to secure mortgages.

18. But, if a growing number of Americans become convinced that this recovery is here to stay and since the necessary adjustments of the balance sheets of the US banks is almost completed, this sector could experience a surprisingly quick turnaround.

19. Indeed, not only are interest rates at historically low levels, but the 40 % drop since the bubble burst has made real estate prices rarely as affordable as today for the American population.

20. Some experts expressed concerns about the fact that the rise and subsequent burst of the US housing bubble has been following an identical pattern to the Japanese one of the 1990s. Therefore, if this should happen, prices could continue to contract as was the case in the country of the rising sun for another decade. But it would be missing a significant difference : the Japanese population was practically not growing, while the US population should rise by 27 million between 2010 and 2020 and by 90 million between 2010 and 2050. In addition, during this crisis, many adults had to move back under one roof and they would like, at the first opportunity, to regain their independence, while the younger ones have delayed their departure from their family homes. Thus, the number of households created in 2011 was only 700'000 against a peak of 2'000'000 in 2006.

21. One should also note that the number of newly constructed houses in 2011 (160'000) is at its lowest level since the 1950s.

22. Finally, it is time to start analyzing again the figures regarding the inventory of unsold homes region by region and not just nationally, since a disproportionate number of vacant housing is in areas in decline, while the population being highly mobile quickly moves to the growing areas.

23. In conclusion, while until now the real estate sector was in recession and weighed negatively on GDP, its contribution is becoming gradually positive and it could even be the source of a nice surprise.

24. Similarly, this increased confidence could be favorable to the resumption of all cyclical spending, such as car's sales which are still quite low as the number of new car' sales since 2007 has been below the number of cars sent to scrap.

25. Despite this improved situation in the United States, we are not increasing for the time being the risk allocation in the portfolios. Just the size of this beginning of the year increase shows that volatility remains present in this sector.

26. But this rise also illustrates our position to remain invested in the market in a reasonable way.

27. As we have already mentioned, moves have become much too violent and random to try to anticipate them.

28. Also this present increase happened with a limited number of participants, many having withdrawn themselves from the market during the last months of 2011; they have been therefore wrong-footed. And even more so because at the beginning of the year analysts were hesitating between two scenarios : bad markets or very bad markets. So, the surprise would be that the year ends with a surprisingly good performance.

29. But let's wait for a real test of this bull move, which will come from the market's reaction to bad news. A good behavior at that time would increase investor confidence.

**Commodities (30-36)**

30. And one must also be aware that the favorable scenario outlined above, essentially implies that oil price behaves well, which has not been unfortunately the case in February, with an increase of more than 10 % for the price of a barrel of Brent oil.

31. One should remember that the weak US economy in the middle of last year was directly linked to both, higher energy and food prices which occurred at the beginning of 2011. The purchasing power of US households is still too fragile to sustain such a shock. Fortunately, for the time being, food prices are sharply down compared to their levels of 12 months ago.

32. The increase in the price of oil is directly linked to the renewed tensions with Iran, which has resulted in a rise of the risk premium. Regardless of the real evolution, the highest the fears, the highest the risk premium, which can represent up to 50 % of the price of a barrel, as it was the case in 1974 and 1979.

33. Another source of concern in relation to commodities is the fact that the shares of the major mining companies have been stagnating for a month, despite their low valuation.

34. This could therefore be a warning sign of a coming sharp fall in Chinese demand, which would then ultimately also result in a fall of the industrial commodities.

35. If it is too early to draw definitive conclusions, what is certain is that this situation should be monitored.

36. Finally, it should be noted that it is silver which has the largest rise since the beginning of the year : 24 %, a sign that precious metals are still attracting investors.

**Currencies (37-39)**

37. And this in itself is not surprising, since if gold is a commodity, it is also a currency and its upside potential remains intact as long as monetary policies will remain so lax in all developed countries with negative real yields.

38. All countries are trying to devalue their currencies and since they cannot do it all at the same time, gold becomes a major beneficiary.

39. And it is also the fact that they are all trying to follow the same policy which explains why volatility has disappeared from the currency market : the JPMorgan G7 Volatility Index is at its lowest level since 2008. All G7 countries being sick, none of these currencies has a major advantage over the others.

## Bonds (40-44)

40. Here also, volatility has disappeared, as central bank interventions prevent investors to actively operate in this sector.

41. We do not expect large moves in coming months. But investors should be aware that this market is sitting on a time bomb. In the same way that it would be surprising if all this easy monetary policy does not result in an economic recovery, it would be strange that, in case of success, inflation does not start to rise and this even more so as central banks will react very late, because their main concern will be to ensure that nothing prevents growth to strengthen.

42. This being said, one must also remember that the battle between deflation and inflation, which started in 2007, is still not over. Deflationary pressures on the world economic system are significant, which can be mortal given the current level of debt.

43. And even if central banks aggressively intervene to neutralize each deflationary shock, the patient's health remains fragile and a new recession linked to an exogenous event (for example oil) could allow deflation to win at the last minute.

44. If such a scenario should occur, the repayment capacity of the G7 countries as a whole would be put into question. And Greece bankruptcy - not only a total loss for investors of more than 70 % of their capital, but also an indebtedness that will still remain even after the default at an extravagant level - this bankruptcy would look then just as an appetizer.

## Conclusion (45-46)

45. Even if our last reports were more optimistic, we did not increase yet the risk in the portfolios, in the same way that we did not decrease it during periods when the markets performance was poor.

46. We remain aware of the fragility of the situation and we are waiting to see how markets will react to bad news.





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