Market Outlook

A monthly commentary on financial markets written on July 2nd, 2012

THE BOND TRAP

Generalities (1-4)

1. After the May fall, June was a month where investors alternated between hope and fear, thus leading to up and down moves for the stock markets. And at the end, thanks to a new agreement in the euro-zone, the S&P was up 4 % for the month, the Nasdaq 3.8 %, the DAX 2.42 %, the Euro-Stoxx 50 6.9 %.and the Nikkei 5.4 %. Finally, the emerging markets index in dollars rose 3.8 %.

2. And after a strong performance last month, the bond market gave back some of its gains as the yield on the 10-year US Treasury bond moved back to 1.65 % and to 1.58 % for its German equivalent. However, the risk premium on US investment grade corporate bonds continued to move down to69.5bp and the reduction has been quite significant since the beginning of the year (133bp in January). But this has not been the case for the equivalent European index, which at 165.8bp is virtually unchanged (173.50bp then); this divergence is obviously due to the crisis in the euro zone.

3. Crisis which continues to bring an orderly decline of the euro to 1.2660 and which has lost almost 15 % of its value over the past 12 months against the US dollar. And as a matter of fact this corresponds to the size of the move of the greenback in relation to the major world currencies if one refers to the dollar index. For now, the rise of the dollar appears to be due to the fact that the U.S. economy is in relatively better shape than the others, rather than a mere flight from the euro.

4. Finally, despite a rise in June of the Reuters CRB Index (+4.1 %), the fall for the semester reached 6.9 %. A special mention needs to be made to the significant decline in the price of oil to USD 85.-/barrel (-14 %), which represents, as usual, the equivalent of a tax reduction for consumers and is therefore particularly welcomed right now. And one should also notice that gold, despite the deflationary pressures, continued to perform well since it is practically unchanged (USD 1'597.-/oz) over the last 6 months. But this was not the case for gold mine shares with the Blackrock World Gold Fund for example down 13.2 % in the same period.

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Bonds (5-15)

5. For the first time in June, a long article in the Financial Times raised the possibility that the English and American central banks may not require the repayment of all the sovereign bonds that they have massively bought since the financial crisis. This possibility, which we mentioned several months ago, will not happen any time soon, but the debate has just begun. It is tempting indeed to do so, since at current levels this forgiveness would result in a 20 % decline in the debt to GDP ratio for the United Kingdom and of 12 % for the US, while at the same time reducing proportionally the interest rate costs. And since anyway these amounts are already in the financial system without inflationary consequences why be shy ?

6. This situation vividly illustrates how a central bank balance sheet is like no other, since it alone has the ability to create money in an unlimited way. It therefore has no balance sheet constraints. Its only real limitation is the inflation that may be generated by its actions.

7. What the 2008 financial crisis has powerfully shown is that inflation is not only related to the amount of money available in the financial system, but also to its velocity of circulation. With the banking crisis this velocity collapsed because the credit mechanisms broke down. And since then banks have been very restrictive in their lending.

8. And as uncertainties continue to remain high, those with ample liquidity, such as corporations, prefer to hoard them rather than invest.

9. All this lessens bond investors' vigilance as they have the impression that no matter what central banks do, inflation will not return. This is exactly the inverse reasoning which was popular in the 1980s when it seemed that central banks will always be unable to significantly reduce inflation, thus justifying the need for real returns (after deducting inflation) of around 10 %.

10. And what a contrast with the current situation where not only real yields are negative by about 2 to 3 %, but furthermore the U.S. futures interest rates market currently expects this situation to continue until 2020 !

11. Let us suppose that debt forgiveness will eventually occur. Even if in the short-term this does not seem to have inflationary consequences, the reality is that once the velocity of money increases this will happen on an expanded monetary base thus creating an important leverage effect.

12. Therefore this increase of the base will lead to a disproportionately stronger inflation which will then require that interest rates are pushed up to a higher level in order to keep the situation under control.

13. Furthermore as central banks will continue to inject liquidity at the slightest threat to economic growth, the velocity of circulation may increase at a time when the monetary base will be at record level.

14. Thus, the return of inflation is linked to an acceleration of the velocity of money. But the difficulty is that it is virtually impossible to predict, not only when it will happen, but also the amplitude of said acceleration. Furthermore, it can only be noticed after it has occurred.

15. Finally, we must keep in mind that since central banks will act in a very cautious way in order to avoid the risk of disrupting the economic recovery, it is likely that they will be late when it comes to withdrawing the liquidity that was injected during the crisis.

Bonds (16-24)

16. The Anglo-Saxon strategy is thus quite clear since it aims to boost the economy at all costs through an aggressive reflationary policy. Meanwhile, in contrast, the Eurozone is trying a different policy under the leadership of Germany of first reducing the deficit and afterwards the debt through a tight fiscal policy.

17. In an ideal world this policy should be implemented by 2/3 of budget cuts and 1/3 of tax increases with a focus on reducing the number of state employees and improving the productivity of the state activities. But in fact currently the adjustment is primarily being made by raising taxes and without taking drastic measures in the public sector. Hence our scepticism about the effectiveness of the current austerity policies. They are inadequate and poorly structured and could even do more harm than good.

18. For those who are in favor of this policy, the short-term suffering which is caused by the increased unemployment and the resulting recession will be more than offset by the long-term gains for the economy; just like the obese which by a strict diet loses weight and knows that this short-term effort will bring improvements to his health over time.

19. Normally, a tight fiscal policy should be simultaneously accompanied by a lax monetary policy. But the drama in the euro area is that there are no collective adjustment mechanisms and the result, for Spain for example, is that despite having dutifully swallowed the bitter medicine of austerity, its interest rates did not decline, on the contrary they rose, due to the lack of a buyer of last resort. And this makes de facto impossible the payment of the debt. At 3 % the debt can be honoured, but not at 7 %.

20. The other problem is that the recession created by the necessary fiscal adjustment leads to a further increase of the debt. Latvia, where a similar policy was applied successfully a few years ago saw its debt rise from 40 to 80 % of GDP. But what to do when the departure point is already a very high level of indebtedness ?

21. The danger of the current economic policy in the euro area is that it may lead the continent into a deflationary spiral where the fall of tax revenue in relation to an unchanged debt burden would make it impossible to service the debt.

22. So bonds are not just vulnerable to inflation and negative real returns but also to deflation and the partial or total repudiation of debt.

23. Admittedly there is a virtuous path that would allow the payment of the debt in a non-devalued currency. But it is a difficult one. Indeed, the BIS estimates that, globally, developed countries should maintain a budget surplus of 2 % for 20 years in order to return debt to its 2007 level. Politically this is practically infeasible as the populations do not feel responsible for this situation, which they consider to be the banks' fault, and thus refuses to bear the consequences.

24. All this leads us to clearly advise not to be invested in bonds issued in the currencies of developed countries, except for those with a short maturity or a floating interest rate.

Equities (25-33)

25. US debt has increased 3-fold over the past decade to USD 15 trillion of which USD 5 trillion just since President Obama is at the White House. Critics of this policy note that despite this massive indebtedness growth has been very weak, indicating that monetary policy no longer works. And for them, it has just delayed the necessary adjustment but at the cost of a recession that will be much more severe.

26. They go even further and estimate that by preventing the small natural recessions to occur in the last 20 years, central banks have merely accentuated the imbalances in the economy and since the adjustment will now have to be done in one stroke, the ensuing recession will be devastating. It is a bit like in forests where the policy for a long time was to prevent at all cost fires from spreading and which ended up creating a gigantic fire with all the accumulated dead wood. Today foresters prefer to simply control small fires rather than extinguishing them.

27. We have much sympathy for this theory and this is why we wish to maintain not only an important cash allocation but also to diversify it as much as possible in different currencies as it would be the only defence in such a scenario against what will be an implosion of all assets without exception.

28. But historically it is not the most likely hypothesis. As soon as the situation becomes difficult economically, political pressure will increase until governments and central banks do what voters expect of them, which is to print money in an attempt to keep alive for a while longer the existing system.

29. And the market itself contributes to this situation. Demonstrations in democratic countries are the most visible way for a population to send a message to his elected officials. They can ignore it for a while but then protests only grow until the government gives in and acts in the direction desired by the protesters. How the market "protests" is by falling and it does so in a stronger and stronger way until it is heard. And what it always asks for are reflationary measures to revive the economy and increase the value of assets.

30. This is why we continue to hold a reasonable equity allocation. And even more so as a fairly good predictive model, the one from GMO, indicated in late May that for the next 7 years the annual real return on equities stood at 6 %.

31. Unfortunately, if the end objective seems to be achievable, we do not know the many peaks and deeps that the road will take in order to get there as there remain quite a lot of uncertainties.

32. Firstly, the European crisis drags on and investors remains hostage to political decisions. The costs of a failure of the euro would be such, for all participating countries, that last-minute agreements such as it happened at the end of this month of June are inevitable. But this leads to significant market volatility.

33. The situation is also getting more complicated in the U.S. with what is now called the tax cliff. Following a process put in place at the time of the "drama" of the authorization by Congress to increase the debt ceiling last year, a law was passed which will be applied automatically on January 1st, 2013 and consisting of significant budget cuts. Economists believe that doing so will impact GDP by 4%, thereby resulting in a new US recession.

Equitites (34-42)

34. If no one believes that there is a political will to maintain the law as it stands and that adjustments should soften its impact, the political calendar is not favorable.

35. Ideally, Congress should delay its implementation this summer by 6 months or a year to have time to negotiate and also to avoid that corporations start already cutting their investments during the second half of the year to reflect the economic impact brought by the law.

36. But we are in an election period and this is unlikely. Nothing should happen before the election and then, if Mr. Obama is re-elected in November, he will have less than a month to reach an agreement with a Congress that will be at least partly hostile to him. And if Mr. Romney wins, he would only assume power in January and much of the damage would already be done and this even if the law is quickly changed.

37. And to this complicated situation one must also remember that in December Congress needs to authorize a further increase of the debt ceiling.

38. Finally in China, concentrated in the political transition phase, authorities are behind the curve regarding the economic slowdown, which is thus likely to increase.

39. All this creates a high level of uncertainty and the market hates uncertainty. But before becoming too negative it should be remembered that all these risks are already, at least in part, incorporated into the existing prices. What will move markets is that the situation worsens or improves compared to what is feared today. For example it is enough that the situation is less bad than what has been already discounted to push prices up.

40. And this is what characterizes a bear market : the price level incorporates fears, while in a bullish phase, it adds hopes.

41. It is therefore possible that the market will need to "protest" again to get what it wants. But, if it is heard, the risk exists that the subsequent rise will be at least as powerful as the decline had been.

42. In short, all this leads us to maintain a conservative equity allocation.

Commodities (43-45)

43. There is no indication so far that the decline phase in this sector is coming to an end since the chinese economic slowdown will continue to weight on the prices and also because the investments done in the last years in the sector will lead to a supply increase

44. Regarding gold in particular, as the uncertainties mentioned above increase the deflationary pressures, it is possible that given the fact that the rise earlier this year to USD 1'785.- could not be sustained that a test of the important support level of around USD 1'500.- will happen; and if it gave way, this will cause a larger drop of the yellow metal.

45. But such an eventuality will then bring a new buying opportunity given the debt problem.

Currencies (46-48)

46. This sector continues to be amazingly stable probably due to the fact that all major developed countries have a similar debt problem.

47. For the time being, trades in this sector only amplify market moves. For example when the Brazilian stock market declines, the national currency - the real - also moves down against the USD, thus increasing the loss for a foreign investor. The reverse naturally occurs during an equity rise.

48. We are presently not very active in this sector but we maintain our diversification out of the euro towards currencies of countries with good economic fundamentals.

Conclusion (49-54)

49. At USD 15 trillion, the US debt to GDP ratio has currently reached 70 % against 40 % in 2008. And this amount does not include commitments to both organizations, Fannie Mae and Freddie Mac who finance the bulk of US mortgages and which were nationalized after the bursting of the housing bubble. The total commitments of both organizations is USD 5 trillion and the losses that the government may suffer in this area are directly related to the evolution of the economic situation.

50. Finally, one should not forget that future US commitments in favor of its social security system, and which are currently not funded, represents an amount of USD 45 trillion at present value.

51. And if the country known to be the least committed socially has a hole of such a magnitude, one can imagine the extent of the problem for the other major developed countries, including Germany.

52. We do not know if this will end in deflation or inflation, but the debt burden is such that it can only end badly for its holders.

53. Furthermore, if one takes into account the negative real return on these bonds, there is no reason to hold them, with the exception of speculative short-term trades.

54. Thus, we prefer to stay highly liquid, while maintaining an equity allocation; however it should be of a size that makes the current volatility bearable. This position reflects the fact that central banks will continue to react strongly against any deflationary pressures. Eventually, unlike what's been happening in Japan, they will win this war but in the meantime the moves up and down will continue to be significant.

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