Market Outlook

A monthly commentary on financial markets written on October 1st, 2013

JOBS, JOBS AND JOBS

Generalities (1-6)

1. As we enter the last quarter it appears that 2013 will be a good vintage for the stock market.

2. Indeed, in September, analysts have become more confident that growth around the world will resynchronize in 2014, since they consider that the worst of the economic slowdown in emerging countries is behind us, the Eurozone is out of recession, the Japanese economic policy will provide an important support to the global economy and US growth is going to accelerate.

3. Thus, a generalized rise of equity markets during the month, with the FTSE World Index in USD increasing by 5 %. In particular emerging markets, which have suffered so much in recent months, moved up strongly : +7.20 % for the MSCI Emerging Market Index in USD.

4. The other stock markets also performed quite well : +8 % for the Nikkei, +6.30 % for the Euro-Stoxx50, +3 % for the S&P +5.10 % for the Nasdaq.

5. However, this favorable wind did not reach the commodity market since the CRB index was down 1.90 %. Of its 29 components, only 10 rose (+9.40 % for cocoa and +3 % for copper), while the largest decreases were in the food sector (-11.30 % for corn, for example) or energy (-13.10 % for gasoline in particular).

6. Also, after their August increases, both gold (-7.40 %) and silver (-11.80 %) lost ground.

7. It was also a relatively volatile month for bonds as the yield on the US 10-year Treasury increased from 2.78 % to 2.99 % on September 5 before ending the month at 2.61 %. As for its German equivalent its yield was down from 1.86 % to 1.78 %.

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Generalities (8-10)

8. But the most interesting thing in this area is the fact that the yield on the 10-year Japanese government bond at 0.69 % has moved once again back to the level it was before the monetary easing measures decided by the Japanese government. This seems to indicate that the inflation generated by the fall of the yen will only be temporary.

9. And we can also notice that at 98.30, the parity USD/JPY has effectively stabilized just below 100 yens for one dollar in the last 6 months.

10. Finally, the hope of a better global growth has fostered a general weakening of the US dollar not only in relation to the currencies of developed countries (for example against the euro from 1.3220 to 1.3540) but also against emerging ones such as the Brazilian real (from 2.3850 to 2.2520).

Equities (11-19)

11. This year more than ever we are aware of this paradox of the financial world : the challenge for an investor is not only to try to understand what will happen, but he must also guess what hopes or fears other participants could have.

12. A few months ago we reduced our equity exposure, but the rise of the stock markets since then has shown that it was not a good idea. Yet the facts have well justified our caution.

13. In June, US corporate earnings in the second quarter were only up 3.6 % in relation to their level of 12 months ago. They were even down 1.3 % if one excludes the financials. And the expected increase in profits for next year is quite modest.

14. Globally, things where even worse. Excluding the US stock market, profits fell 6.5 % for the companies in the MSCI World Index.

15. And we have just learned that the average American family earns today in real terms less than in 1989. The stock market can break new records but average real income is down by 8.3 % in comparison to 2007. This is a significant data if one considers that consumers' spending represents 70 % of US GDP.

16. In addition, the fears that we had regarding emerging markets were confirmed with the fall this year of around 20 % of the Indian rupee, the Brazilian real and the South African rand in relation to the USD. This has brought back the bad memories of the defaults payments which followed the 1994 Mexican crisis and the 1997 Asian one.

17. Finally at 12.1 % the official unemployment in the euro-zone has reached a new record. It was only at 7.3 % in March 2008. And even if the economy of the area is not shrinking anymore, its growth in 2014 is expected to be low at around 1 %; a figure too weak to allow any reduction in unemployment.

18. All this should have led to less exuberant stock markets than what is currently the case. But a change in investor psychology has come to the rescue of equities.

19. Until recently, the market did not believe that the recovery of the U.S. economy could be sustainable. As a result, the rise of the U.S. stock market between 2009 and 2012 was quite difficult to the point that during this period profits increased faster than stocks rose. Thus, the price/earnings ratio declined during this period.

Equities (20-29)

20. However, 2013 marked a turning point since today not only investors' fears of a recession have disappeared but they are also now expecting an acceleration of growth. And as a result, they have agreed to pay more and more for equities. In other words, this year, the rise in stock prices is much higher than the increase of profits.

21. And the adjustment went even faster since, as yields began to rise, investors reduced their bond holdings - and given the fact that short-term interest rates remains at 0% - this liquidity did not have an alternative but to move into the stock market.

22. Moreover, even foreign central banks participated in this move. For example, the Swiss National Bank (SNB) currently holds around USD 25 billion of US equities.

23. However, this year’s move is now coming to an end in the US given the current level of the price/earnings ratio and therefore any further sustainable increase of stocks will depend primarily of the expectations regarding future profits.

24. And a debate regarding whether the U.S. stock market is expensive or not is in full swing. In particular, it revolves around a specific figure developed by Professor Robert Schiller : CAPE (Cyclical Adjusted Price Earnings) or the price/earnings ratio adjusted for the economic cycle. The figure now stands at 22 and if it were to return to its historical average, it will imply that the stock market is presently overvalued by more than 60 %.

25. Remarkably, another important indicator confirms this figure. It is q, a ratio developed by Professor James Tobin which calculates the relationship between the market value of a company and the replacement cost of the assets of this company. The current figure also indicates an overvaluation of the US equity market by around 60 %.

26. These numbers are not new and there is a whole literature to explain why some economists believe they do not correspond to reality. Furthermore, it is dangerous for an investor to rely too much on them. CAPE for example shows that, apart from a brief moment in March 2008, the stock market is overvalued since 1991.

27. It is not our goal to enter this debate, but historically it appears that when CAPE is around 10, stocks double in 10 years (an average of 14 % per year), when it is at 15 they rise only by 50 % (an average of 7 % per year) and at around 25 there is no increase in the next ten years (an average of 0 % return per year).

28. And indeed, it can be noted that theoretically it is quite conceivable that - even if economic growth is good - the US stock market could be at the same level of today in ten years’ time. For this to happen, it will be sufficient that the level of interest rates normalize and that profit margins, which are now at a historically high level, contract.

29. But what seems the most useful information for an investor today is the fact that if Cape is at 22 in the US, it is only at 12 in the Eurozone because of the crisis around the single currency.

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Equities (30-32)

30. Thus, irrespective of the validity or not of this indicator, a convergence between these two Capes must occur in coming years, which implies that the stock markets of the euro zone should greatly outperform the American ones.

31. And it should also be noted that if convergence is to happen by an increase of European equities, a return to normality in the euro zone is required. And in this case, the German stock market will underperform those from countries which have suffered the most during the crisis, such as Italy, Spain and even France.

32. In conclusion, any increase in the equity allocation should focus on the euro area in relation to the US.

Bonds (33-41)

33. Many were surprised by the fact that the Fed has at the end decided not to reduce its bond purchases in September. But this was not our case.

34. It is well known that the answer to the question “which are the three most important factors in real estate?” is : location, location and location.

35. Similarly, to the question "What are the three most important factors for the FED today ?", our answer is : jobs, jobs and jobs.

36. And from this point of view, far from having shown an improvement in the labor market, the August data pointed rather to deterioration in this sector. While superficially the unemployment rate fell from 7.4 % to 7.3 %, this was not due to jobs' creation, but to a reduction in the number of those seeking work. In a normal situation the unemployment rate would be close to 8 %. It would even be around 12 % if we take into account all those who might have a job if growth was as strong as in the late 1990s.

37. Another data illustrates this weakness. In January 2000, 67.3 % of the US population was employed. Then this figure fell to 66 % in 2003 with the recession of 2000. It then stabilized at this level until 2008. However, it is now been falling for 6 consecutive years to reach 63.2 % in August 2013, the lowest level since 1980.

38. And since the FED's favorite measure of inflation - the US price deflator - rose by only 1.5 % in the last 12 months - well below its target of 2 % - the US central bank was in no hurry whatsoever to act.

39. Most probably it should nevertheless decide to act since the recent stock market rise indicates that growth will be good over the next few months. And it is quite likely that it will be in December that the FED will begin to reduce those purchases.

40. But the fact that the FED refrained from acting in September only confirms what we have been indicating for months : the priority is now to reduce unemployment. And on this subject we are now witnessing an evolution in the FED's thinking as it now considers that the unemployment figure is not the best indicator. Today, what the FED wants is an increase in the number of individuals employed.

41. And to achieve this objective, it will be willing to tolerate poor inflation figures, as does currently the Bank of England. Indeed, UK inflation in the last three years has been on average at 3.5 %, but the British base rate has remained unchanged at 0.5 %.

Bonds (42-44)

42. This situation will continue to make bonds quite volatile and especially since it is difficult to predict how investors and banks will react when the FED, which has been the buyer in recent years of 90 % of net new bond issuances, will withdraw from the market.

43. Anyway, we remain negative on this sector. If market's expectations are accurate and therefore US growth increases by 1 % in 2014 to reach 2.9 % and if inflation moves back to the FED's target of 2 %, this implies that - in a normal situation - the yield of the 10-year bond should move up from the present 2.61 % level to around 5 % in 12 months.

44. Whether the economy can bear it...

Currencies (45-53)

45. It is always difficult to establish what impact a particular player may have, but it is certain that the current monetary policy of the SNB influences the currency market.

46. Two years ago, at the height of the Eurozone crisis, the SNB in order to protect the Swiss economy from an excessive overvaluation of the CHF against the EUR, set a minimum exchange rate between these two currencies at 1.20. In other words, since that time, the central bank is ready to buy unlimited amounts of euros at this exchange rate.

47. The effect of this decision can be measured as follows: if in 2000, its foreign exchange reserves were only at CHF 50 billion, they are now at CHF 430 billion, i.e. the fifth largest foreign exchange reserves in the world after China, Japan, Saudi Arabia and Russia.

48. By itself this amount is already a problem given the country's size. But even beyond this figure, the difficulty for the SNB was that euro represented over 70 % of these reserves in late 2011.

49. And the SNB's strategy in the last two years has been to reduce this exposure. Thus, when the EUR against the USD is relatively strong - as is the case today at around 1.35 - the SNB sells EUR against USD and other currencies.

50. This logically leads to a USD rise. And then, once the exchange rate EUR/USD has moved under 1.30, the SNB tries to sell USD against CHF in order to reduce its balance sheet.

51. And this is how the euro exposure decreased today to below 50 % of its balance sheet. However, the size of the balance sheet itself has not decreased significantly, in particularly because Switzerland has a large surplus in its balance of payments of more than 12 % of GDP per year.

52. The question now is whether the SNB will continue to reduce the euro exposure and/or it considers that there is an opportunity to reduce its balance sheet more aggressively.

53. Alternatively, it could decide that now that its holdings have gone below 50 %, it can let the single currency rise against other currencies, as this will mechanically also push the Swiss franc up. The SNB could be favorable to such a move as it would slow Swiss growth and delay therefore the moment when the SNB will have to choose between the exchange floor and the control of inflation.

Currencies (54-55)

54. In summary, if the SNB continues its policy, the euro is at the top of its trading range and it should move down. However if the central bank has changed its view, then the probability that the single currency moves out of the range to the upside strongly increases.

55. Nevertheless, we remain skeptical about the ability of the Eurozone to support a much stronger currency and the ECB is expected to begin to act if the EUR/USD parity moves above 1.40.

Currencies (56-61)

56. The agreement regarding Syria only brought a relative decrease for oil since its rise since the beginning of the rest is still of 9 %.

57. And if indeed the worst is behind us for the emerging markets, its price and that of other industrial commodities should continue to move upwards.

58. And such a scenario would be quite favorable to countries such as Australia and Brazil who have suffered from China's slowdown.

59. Regarding gold, given the expectations of improved global growth in 2014 and in the absence of inflationary pressures, there is little hope to see it move back up in the near future.

60. So it would not be surprising that it moves down once again towards the lowest level of the year, i.e. USD 1'200.-/oz. And it is only if this level holds that a more sustained rise could happen, in particular if investors at a certain point start to believe that central banks are behind the curve in relation to the rise of interest rates.

61. Finally, it should be noted that USD 1'200.-/oz is the current cost price for many gold mines. Thus, any extended drop below this level would end up by bringing a significant reduction in production.

Conclusion (62-66)

62. Nothing seems to worry anymore US investors, as nor the significant slowdown in the growth of corporate profits, or the absence of a significant decline in unemployment or a reduction in the purchasing power of the population, and abroad, nor the sharp slowdown in emerging economies, nor the sharp declines in some currencies, have had a negative influence on equities.

63. This indicates that as long as there is growth - even a small one - shares have become the default investment choice. And this should be the case until bonds offer an attractive yield.

64. But now that U.S. stocks are fully valued, other markets, Europe in particular, should outperform.

65. However, it would be desirable to have evidence of this assumption. And this would be the case if other stock markets are effectively able to go down less than US ones during a market correction.

66. Maybe the fight which has just begun in Congress on the 2014 budget, to which will be soon added the one regarding the increase of the debt ceiling, will provide such an opportunity.

Important Information
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