Market Outlook

A monthly commentary on financial markets written on October 1st, 2015

CENTRAL BANKS ARE FAILING

Generalities (1-6)

1. September was a volatile month with stock markets behaving as if they were on a roller coaster. Concerns persist in particular with respect to the evolution of Chinese growth and the impact on countries that supply raw materials to China.

2. This stress has been less evident on the MSCI Emerging Market in USD, which is down 3.1 % in the month, than on the bond market where the yield of the Bloomberg USD High Yield Corporate Index rose for the fourth consecutive month from 7.7 % to 8.4 %. And in a country at the heart of the crisis as Brazil, long term bond yields of the oil company Petrobras in USD are now closer to 15 % than 10 %. Twelve months ago the yield was still around 4.50 %.

3. In this context the search for security enabled the German sovereign 10-year bond yield to fall from 0.80 % to 0.59 %, while its US counterpart moved from 2.22 % to 2.04 %.

4. This situation also led to a heavy fall of equities, particularly European: -5.8 % for the DAX and -5.2 % for the Euro-Stoxx 50. In Japan the Nikkei dropped 7.9 % while in the US the S&P 500 Index fell 2.6 % and the Nasdaq 3.3 %.

5. Obviously the plight of emerging countries also continued to have a negative impact on commodities with the Thompson Reuters Commodity Index down by 4.1 % in September with only a few agricultural commodities rising such as sugar (+13.8 %) or corn (+6.6 %).

6. Finally, in relation to currencies, after having traded in a rather narrow band, the euro was almost unchanged in the month against the USD at 1.12, as was the yen at 120. But what caught most of the attention was the fall of the Brazilian currency which dropped to a new historic low level below 4 reais for 1 dollar. Since the beginning of the year the decline now exceeds 50 %.

IN THIS ISSUE

P1	Generalities
P2	Equities (7-18)
P3	Equities (19-28)
P4	Equities (29-38)
P5	Equities (39-42), Bonds
P6	Commodities
P7	Conclusion

Equities (7-18)

7. A few months ago when the European Central Bank (ECB) decided to engage in a policy of quantitative easing we expressed the view that deflation would not win since all central banks had become aware of the risk and were therefore acting accordingly.

8. Presently it seems that this statement was premature. Even in the most active country in this field, the United States, its central bank, the FED, just lowered its inflation expectations with a forecast of an increase of 0.4 % this year and 1.7 % in 2016, down from its June figures of 0.7 % and 1.8 % respectively.

9. Even more significant is the fact that the market now expects that in five years' time, the average inflation rate for the following five years will only stand at 1.79 % against 2.26 % in June. Professionals consider that the FED attaches great importance to this figure because it expresses the inflationary expectations of investors. Moreover, when this indicator moved for the first time below 2 %, it was one of the reasons that pushed the FED to sharply increase its quantitative easing policy in 2010 and 2011.

10. And so today with the rate again below 2 %, if we add the fact that growth in developed countries remains weak and that the growth in company sales has strongly decreased for three consecutive quarters, it would have been rather more logical to expect, despite falling unemployment, new monetary stimulus measures rather than a rate hike !

11. What is happening then ? Given the fact that the last increase in the US prime rate happened more than 10 years ago, that this rate has stood at 0 % for seven years and that the Fed has been very aggressive in its monetary policy, why does inflation remains at such an uncomfortably low level ?

12. To understand the reason, certain facts must first be remembered. At the end of World War II Western countries were concerned that the mechanical reduction of their military spending would lead to a severe recession as had been the case after the First World War.

13. But the depression of the 1930s and the economist John Maynard Keynes had changed the situation. Thus after 1945 governments used the new taxes they had created before and during the war to invest massively, allowing their economies to develop rapidly.

14. And so during the next thirty years, whenever economic activity weakened, the government took stimulus measures. This continual stimulus policy eventually led in the early 1970s to an economic overheating with large budget deficits and inflation less and less under control.

15. One of the first signs that the system had become sick was in 1971 when US President Richard Nixon terminated the fixed parity of USD 35 for 1 ounce of gold in force since 1944.

16. For Richard Nixon, as indeed all the politicians of his time, recession was the mortal enemy that had to be fought at all costs. Inflation was then considered as merely an unpleasant side effect.

17. And so it was that during his tenure Richard Nixon pressured the then Fed Chairman Arthur Burns not only for him not to take any restrictive measures, but to do exactly the opposite and this despite the fact that inflation had already reached 5 %.

18. The result was a loss of control of inflation which reached its peak in 1979 at 13.3 %.

Equities (19-28)

19. This situation led Congress to act by establishing in 1977 what is still the dual mandate of the FED : price stability and the pursuit of the highest possible level of employment.

20. It is worth mentioning that the mandate does not mention unemployment but employment instead. And currently if the US unemployment figure is effectively quite low, it masks the fact that the number of people working remains lower than before the financial crisis of 2008. This indicates that the number of potential workers is still high and explains why wages are not rising substantially. And it is one reason for the reluctance of the FED to raise its interest rates.

21. And with the notion of the dual mandate also appeared the FED's independence in order to prevent other politicians to act like Richard Nixon. And so Paul Volcker, appointed chairman of the FED in August 1979, did not hesitate to raise the prime interest rate to 20 % in 1980 in order to curb inflation.

22. Following this success, all other modern countries followed, also guaranteeing the independence of their central bank.

23. What is therefore important to understand is that the system currently in place was designed to fight against inflation and uses the central bank as a policeman in relation to governments. If for example the fiscal policy is too irresponsible and generates large budgets deficits, the expected role of the central bank is then to raise interest rates to prevent economic overheating and thus restore a healthy balance. In contrast a government behaving well would be rewarded with a lower level of interest rate from its central bank.

24. However, to everyone's surprise, very quickly in the 1990s inflation became fully under control to the point that the average US inflation rate during that decade was only of 2.9 %. Even better, in 1997 and 1998, when the speculative equity bubble began, inflation had even fallen significantly below the level of 2 % per year.

25. The world had entered the deflationary era that continues until now because of the cumulative effect of the technological advances and the entrance of millions of workers in the global economic world, especially in China.

26. In the past decade many criticisms were addressed to Mr. Alan Greenspan, the FED chairman at the time, for not having raised interest rates to prevent the two bubbles - in equities and then in real estate - from forming. But in view of the level of inflation during that period, it would have been a clear breach of the mandate given by Congress.

27. In relation to the stock market bubble, what Mr. Greenspan should have done, and he had the legal means to act, was to increase more and more the margins required for the purchase of shares on credit. However, whether under pressure from Wall Street or not, he never did it. One should remember that without debt no bubble can appear.

28. Similarly, during the real estate bubble of the 2000s it was not the interest rate that should have had to rise but the minimum requirement of capital for a purchase. However, the US government did exactly the opposite, requiring for example in 2000 that at least 50 % of the mortgage loans granted by two large state agencies - Fannie Mae and Freddie Mac - be directed to borrowers with incomes below the mean of the area where they were living. This rate was previously at 42 % and it reached the peak of 56 % in 2008.

Equities (29-38)

29. What these two bubbles illustrate is that countries fell asleep as they considered that the independence granted to the central bank was enough to prevent all economic excesses.

30. With the bursting of the housing bubble and the 2008 financial crisis the US prime interest rate fell to 0 % creating a constraint that nobody could have imagined in the late 1980s.

31. Given this limitation, very quickly the FED embarked on its first quantitative easing program by purchasing - and this has been forgotten - USD 600 billion of mortgage-backed securities with the aim to lower mortgage interest rates in order to stabilize the housing market and prevent the emergence of a very dangerous spiral of falling prices which could become self-feeding.

32. The program was successful, leading the FED to sharply increase its size in order to boost the economic recovery. No one knew then what would be the consequences, but when the ECB committed itself in the same way in January 2015 it was clear that this policy had little usefulness because long-term interest rates were then already at a very low level in Europe. It was by the way the observation made in 2014 by Mr. Mario Draghi, the ECB president. And when he had to explain his change of course in 2015 he simply said that the market expected it.

33. Thus, if despite all that has been done, inflation remains at such a low level, it is clear that central banks are failing. And this failure is because the constraint of a zero % interest rate prevents central banks to effectively counteract the negative effects of the overly restrictive budgetary and fiscal policies followed by governments since 2008.

34. We are in fact at the opposite of the 1970s; governments have learned to be "responsible". Austerity needs to be applied and even the more so as indebtedness is high. However, such a policy when the central bank is unable to bring relief to the economy, has disastrous effects, especially on the morale of citizens. And since they are angry, voters naturally look to the extremes and this even in the Anglo-Saxon countries with for example Mr. Jeremy Corbyn in the UK or Mr. Donald Trump in the US.

35. A complete change of mindset is needed because, as with cholesterol, there is good and bad debt.

36. In an ideal world the ECB for example should agree with the European states to lend them sums, at zero % with a repayment in 20 or 30 years, to be used for very specific goals : investments, reduction of taxes etc. It is only by having a lax budgetary and fiscal policy conducive to investment and growth that the problem can be solved.

37. More likely, one day a government will decide to become "irresponsible" and it will be rewarded by the market and the voters.

38. Unfortunately, we are still far from it. And in the US the resignation of Mr. John Boehner, the Speaker of the House of Representatives and one of the few adults among US Republican congressmen is bad news. It should be noted that the economic policy proposed by the extremist Republicans would be as bad for the country as if Mr. Corbyn came to power in the UK. The refusal of the US Republican Congress to vote a substantial program to improve the country's very poor infrastructure is the best illustration.

Equities (39-42)

39. We are therefore sentenced to this slow growth which periodically anguishes investors and is a source of volatility. Moreover the safety margin to any unexpected negative event is low.

40. The difficulty of this situation is that the glass is half empty or half full depending on the state of mind with which we observe it. There are indeed sufficient disturbing elements or on the contrary enough positive ones to justify being pessimistic or optimistic.

41. Currently we are in a phase where the glass is seen as rather half empty. But in the long run what is important is that any economic weakness be fought vigorously and one can only hope that the weapons which will then be used will be more effective.

42. This is why we consider that the best strategy in the long term remains to have a reasonable equity allocation in order to withstand volatility, with the balance of the capital invested in the most secure possible way.

Bonds (43-48)

43. Presently the main danger comes from the lower rated corporate bonds as yields are climbing because of the weakness of emerging countries' economies and lower commodity prices.

44. This increase is dangerous in a context of sluggish growth and was sufficient to justify the non-increase in the FED's key rate in September.

45. The problem is that, as we foresaw it, the market took it badly considering it as a sign of weakness of the US economy. Moreover, the FED has been so much criticized after this decision that there is a risk that, just to reduce the pressure, it ends up increasing its key rate before the end of the year.

46. Anyway, increasing the key rate or not by 0.25 % is not the most important consideration. If yields of low rated corporate bonds continue to move up this could lead to a greater exodus of investors from bond funds, thus creating a self-feeding spiral.

47. Such a situation would then push the FED to intervene in a surprising way, probably this time by purchasing low rated corporate bonds.

48. In the meantime, we refrain from taking large positions in this sector given the low yield levels of good quality debtors.

Commodities (49-54)

49. The research firm BCA recently published an interesting study showing that since 1688, which is the date since when the Bank of England has reliable data, commodity prices in real terms have remained unchanged.

50. Thus, based on their current level and if inflation is at 0 %, commodity prices need to fall a further 40 % to move back in real terms to their 17th century level.

51. The reason commodity prices have rarely deviated from this equilibrium is that in the long run any increase in demand, in particular due to the improvement of real incomes, is eventually offset by innovation which allows supply to meet this increased level of demand.

52. For oil for example, if the rule is still valid, for the current price to reach the real level of the beginning of the 20th century when its reign started, it will need to come down to USD 30 per barrel against USD 45 presently.

53. Obviously the equilibrium price will rise with inflation and it is encouraging that, despite deflationary fears, gold is down in dollar terms in the past twelve months by only xx % despite an increase of more than 10 % of the US Dollar index.

54. Unlike many worried analysts, the fairly reliable barometer of future inflation that is gold does not indicate that deflationary pressures will increase significantly over the next twelve months. Similarly inflation risks also appear to be negligible.

Conclusion (55-62)

55. The current low level of interest rates as well as of inflation shows that the idea that there is a magical fixed number beyond which the level for a country's debt in relation to GDP becomes harmful is completely wrong.

56. Not only does this Debt/GDP ratio vary by country depending on its savings rate, its productivity and the confidence of its citizens in its institutions but also it changes according to economic circumstances.

57. It now appears that developed countries are making a big mistake by not listening to the market which is offering to lend them for example for 30 years at around 3 %, since their budgetary and fiscal policy remains too restrictive in view of the 0 % interest rate constraint faced by central banks.

58. And since this insufficient growth has been going on for too long, after trying alternately center-left and center-right governments, citizens are now turning to the extremes with all the dangers that it entails.

59. Most probably without a substantial worsening of the economic situation it is unlikely that the extremists could reach power, but the safety margin has become quite low.

60. Anyway, the most likely scenario remains that the current sluggish growth in developed countries will gain strength, even if it will be a slow process because of the weakness of emerging countries.

61. And one can hope that the youth of emerging countries will allow them to recover quickly and without too much trouble from their recent fall. Ideally the bottom should be reached for them in the next six months, which means that worrying signs from China need to decrease.

62. In conclusion, the situation should continue to improve in the long term but volatility will still be high in coming weeks. A reasonable market exposure remains therefore desirable.