Market Outlook

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

FLYING BLIND

Generalities (1-7)

1. The main event in April for the financial markets was the 15 % fall of gold on April 12 and 15, i.e. a total drop of 30 % from the September 5, 2011 peak of USD1'921.-/ounce. And not surprisingly, among commodities, silver had the worst performance of the month, down 14.7 % while at USD 1'477, gold ended April down 7.5 %.

2. But other commodities were also lower, such as nickel (-7 %), copper (-6.3 %) or cotton (-3.3 %). Thus, globally the CRB Index fell 2.8 % in April.

3. In terms of exchange rates, the yen continued to fall from 94.20 to 97.50 following the announcement by the Bank of Japan of asset purchases totaling 1.5 % of GDP per month, three times more than the current FED policy which amounts to "only" 0.5 % of US GDP. On the opposite, euro was up against usd to 1.3170.

4. Another element which attracted the attention of investors is the fact that the 10-year Italian sovereign bond yield dropped to 3.94 %, its lowest level since last year's crisis. And it was the same pattern for the Spanish equivalent which ended the month at 4.1 %

5. And the yield of other similar sovereign bonds also moved down, such as the US one, from 1.85 % to 1.67 % or from 1.29 % to 1.22 % for the German. And so, it is also not surprising that risk premiums on investment grade corporate bonds dropped from 90bp to .66.75bp for the US index of 5 years maturities and from 126bp to 100bp for the European one.

6. As for the stock market, after some turbulence in the middle of the month, it came back nicely and so the Nikkei was up 11.8 % in yen and 8 % in USD terms. The Euro Stoxx50 rose 3.3 %, thus significantly better than the DAX 1.5 %. In America the S&P increased by 1.8 % and the Nasdaq by 1.9 %.

7. And once again emerging stock markets where the laggards with a rise of 1.2 % of its index.

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Currencies (8-19)

8. Normally our comments on gold are made in the commodities section, but exceptionally this month we will do it under the heading currencies to remind that gold is also an instrument of payment.

9. Since the dawn of time, an ounce of gold allows a human being, anywhere in the world, to obtain the three items which are the most basic to him : housing, food and clothing. No other means of payment holds such longevity

10. This is something that we would like to emphasize at a moment when analysts have become quite negative on the yellow metal.

11. The explanation for this move is to be found for starters in the fact that the gold's increase from the USD 834 level. at the end of 2007 was mainly driven by those who feared a collapse of the financial system. However, the measures taken by the central banks willing to lend, in an almost unlimited way, to banks have greatly reduced this risk.

12. And as time went by, holding gold as insurance for this type of investor appeared to be less and less necessary. And this became even more obvious when the Cyprus crisis had no impact within the euro area.

13. The other major investor category consists of those who wish to protect themselves from inflation and from negative real yields on fixed income. It was them who led the first move up from the level of USD 272/ounce at the end of 2000 and they are not sellers toda

14. But presently they are not buyers either since - so far - the quantitative easing policy did not generate higher inflation. And therefore there were no new purchases of gold after the FED announced that its monetary easing policy will continue aggressively, without a time limit, and this until unemployment has dropped significantly. This was also, once again, the case after the Bank of Japan announced its own easing program which, as we have already mentioned, is proportionally three times larger than the American one.

15. Gold therefore became vulnerable and it is likely that hedge funds joined forces to initiate the move, which then self-powered itself thanks to the standing sell orders which are to be executed once the price drops below a certain level.

16. But beyond all these reasons, the only really surprising element of this decline is that it took so long to happen. Since 2009 we are indicating that it was time for gold to have a negative year. How many assets have moved up for 12 consecutive years as gold did between 2001 and 2012 ? And yet, we are taking a risk by making this announcement since 2013 has not even arrived to its midterm.

17. But the risk is rather limited as investor psychology has now changed: upward moves have become selling opportunities.

18. However, we are not yet ready to declare that the long-term bull market is over. As long as real returns on fixed income for major currencies remain negative and central banks keep flooding the market with liquidity, gold as an instrument of payment could still end up being the winner.

19. The other major move in the currency market in recent months is the 25 % drop of the yen against the dollar and of 30 % against the euro. However, figures which have just been published are showing some quite surprising facts.

Currencies (20-25)

20. What did the Japanese do after the government declared it would start a quantitative easing policy ? What was their reaction when they learned that the measures that will be taken will be even stronger than the American ones ?

21. Exactly the opposite of what should have been expected: they sold stocks and foreign bonds for an amount of USD 82 billion and they brought the funds back to Japan in yen.

22. Certainly importers have accelerated their yen sales to protect themselves from the devaluation, but in return foreign investors during the same period purchased for USD 80 billion of Japanese equities and it is unlikely that all has been covered for the foreign exchange risk.

23. And therefore, once we have eliminated all other possibilities, it can only remain one: it is the hedge funds (and those who act like them as automated trading) which have been so far the main drivers of this falling yen. Their problem now is to convince local actors to replace them. However, with the decline that has already occurred, it is unlikely that the Japanese are willing to do so aggressively and even more so that if Japanese growth improves, their equity market will remain one of the best performing in the world.

24. We will see in coming months if they will be successful or not. But these startling figures indicate that the continuation of the yen's downtrend, with no significant reversals, is not as inevitable as it looks.

25. In any case, the behavior of hedge funds in relation to gold and the yen indicates a change of their strategy. As a matter of fact, they found out that some of them have problems with the law because of charges of insider trading and also that they really perform well only when there are major moves in which they are the main actors. So it seems that their new strategy is to create alliances among themselves in order to trigger avalanches in areas which have become unstable.

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Commodities (26-34)

26. At the end of 1998 a barrel of oil was trading at USD 13.-. And it is easy to understand why oil companies were quite skeptical when the price per barrel moved up to USD 70.- five years later. For them it was unsustainable and USD 40.- was their maximum favorable forecast in the long-term. And this is why they were so slow to react to rising prices and to increase supply.

27. But this is now over: technological breakthroughs plus massive investments in recent years are now producing their effects and this is true for the entire commodities sector, not just oil. We can therefore consider that the structural bull market - which lasted a decade - is finished.

28. If this is the case, then it would be a continuation of the long-term cycle that began after World War II. Commodities prices first peaked in the late 1950s, then for 20 years they did nothing before an increase of above 3x in the seventies, followed by another 20 years of stagnation, before the rise during the first 10 years of this century which was also greater than 3x.

29. In such a scenario life will now become more difficult for the major commodity producer countries.

30. And it is also important in this case to correctly interpret the downward trend in this sector relatively to equities.

31. When we are in a bull market, as in the 2000’s the evolution of commodity prices and of the global economy is correlated. A slowdown in the first necessarily implies a decline in the other and therefore stock markets move as commodities do.

32. But from the moment the cycle becomes bearish, the correlation breaks, and commodities can fall without this being necessarily a negative signal for the economy and therefore for shares.

33. In addition, in the long run, this is the best possible news for consumer countries because instead of paying the equivalent of a higher and higher tax to the producing countries, it will now be declines in real terms of this "tax” that they will be receiving in the coming years.

34. And we are already beginning to see the positive effects of this new situation, for example with U.S. companies creating new production facilities in their country following the fall of energy prices.

Bonds (35-46)

35. It is when we have to write about this subject that comes to our mind this market's saying: "Things always take longer to happen than one expects, but when they happen they move much faster than one can imagine".

36. It is remarkable that, four years after stock markets reached a bottom, the world economy is still in the same situation as then, with this natural tendency to deflation being fought with the reflationary policies of central banks.

37. In our minds the world economy is like this plane which has just taken off and is in this dangerous phase where it can still crash but where it would normally be able to pick up speed and altitude to be out of danger.

38. It is in this sense that we believe bonds to be dangerous: either the plane crashes (deflation) or reaches its cruising altitude (reflation), but they will suffer in both cases.

39. And in this context it is interesting to mention the following declaration from Professor Eswar Prasad of the Brookings Institute: "Tiger (Tracking Indexes for the Global Economic Recovery) showed the global economy unable to achieve lift-off and facing the risk of stalling".

40. So we are in the same kind of uncertainty as in 2009. And it is this neither too hot nor too cold situation which allows bonds to continue to perform well and even more so that since a rise leads to another rise, investors are increasing more and more their exposure and their risk taking in this sector.

41. And this happens even in the US, the country that has made the most progress since 2009. US domestic equity funds suffered significant withdrawals and despite the fact that the stock market now regularly breaks its records, the move continues, even if it is at a more moderate pace. In contrast, investments in bond funds have been twice as large in volume than equity redemptions and, here too, this continues.

42. Furthermore investors are strongly positioned on bonds of emerging markets debtors, either in foreign or local currency. And certainly there is a risk that unsound investments were made thanks to the easiness of obtaining credit and now that the party is over for commodities, the wake-up could be difficult.

43. However, all is not the same compared to 2009. Today the U.S. is the leader whereas previously, global growth was driven by China which is now facing many questions regarding its economic health, including towards bonds.

44. For example, on the front page of the Financial Times of April 17 there was an article entitled "Warning on out-of-control China debt". In this article a top Chinese auditor declared that local government debt is out of control, that their ability to service it was questionable and that this could lead to a bigger financial crisis than the one which followed the collapse of the US housing bubble.

45. The statement is not innocent because it comes at a time when the new government wants to bring order in the credit sector, especially with the explosion of credit outside the banking sector, the so-called "shadow banking".

46. Another symbol of the excesses will probably be the fact that, on average, sovereign bonds of emerging countries, with the exception of Venezuela and Argentina, are currently yielding in local currency 3.9 %, a record low.

Equities (47-59)

47. And this situation also raises the question of whether this inevitable lending slowdown in China, at the same time when its economy is less exuberant than before, is likely to be the trigger of a new deflationary wave.

48. It is interesting to note for example, that for the last two years there has been a contraction - and which is now accelerating - of Chinese demand for commodities, industrial products and luxury goods.

49. It is also worrying that the bond yield on the 10-year U.S. government, which rose from 1.4 % to 2 % from August 2012 to March 2013 has moved down to 1.67 %. And the Japanese equivalent, despite the aggressive new policy, remains at 0.6 %.

50. And since the U.S. is the main engine of growth, the decline in bond yields could be a sign that the market has become too optimistic in relation to the growth potential for the coming months.

51. As for Europe, even if the maximum phase of fiscal tightening is behind us, the monetary policy of the ECB is less expansionary than the one followed by the FED and now by the Bank of Japan.

52. Also the gold decline can also be interpreted as a sign that the quantitative easing policy has reached its limits because if there is a lot of liquidity at the banking level there has been no multiplier effect in the real economy.

53. And it should be mentioned here that in Japan it is not the policy of quantitative easing which is currently favorable to growth, since it has just started, but the sharp decline of the yen.

54. This has led us for tactical reasons to reduce in early April our equity exposure by a quarter.

55. In making this decision we run the risk that not only the deflationary pressure will be insufficient to worry the market, but also that the expected great rotation from bonds to equities eventually starts to happen.

56. In addition, at the end of this month a new fact has emerged. It seems that central banks, now that they have brought bond yields close to zero, have decided to buy shares. This was particularly noted in a Bloomberg article dated April 25 entitled: "Central banks load up on equities as low rates kill bond yields”. The article mentioned the fact that the Bank of Japan plans to buy USD 35 billion of shares by the end of the year and that the Swiss National Bank currently holds USD 46 billion in equities, representing 10 % of its reserves.

57. Somehow this evolution is logical. In the U.S. for example, lower yields on mortgages favored the real estate recovery, thus allowing the stabilization of individuals’ finances. But it has been insufficient to create the necessary momentum that would allow capital expenditure by companies to increase enough for unemployment to move down.

58. And in this context it is natural that after real estate, central banks try, in a more or less discreet way, to push equity prices up as this improves investors’ morale and increases the resources available to businesses.

59. In short, central banks are ready to embark in a new experiment and one must expect that any eventual equity fall will be fought with strong measures in order to push prices up again.

Equities (60-61)

60. Hence our strategic vision that, until the end of the decade, equities, and especially those from the G7 countries, will bring the greatest rewards.

61. However, one should be aware that the degree of uncertainty remains as high as in 2009. Lorenzo Bini Smaghi a respected former member of the ECB recently said: "We don’t fully understand what is happening in advanced economies”. This we translate as: central banks are flying blind.

Conclusion (62-68)

62. Investors are also hoping that the Japanese will sell in large quantities their currency at current prices to come and invest their money in Europe. But this seems unlikely for now.

63. Finally industrial Europe - and therefore firstly Germany - has not yet suffered the shock of the weaker yen which makes Japan very competitive.

64. As was the case before with the yen and gold, equities have become more vulnerable but they continue to be actively supported by central banks. And it will be therefore investors’ actions in May which should dictate the direction of stocks for the coming months.

65. Will stock markets experience an air pocket ?

66. This is not impossible if China and the United States disappoint and the mood changes in relation to Europe.

67. Indeed, investors are quite strange animals. At the end of April, European bourses made a good recovering since the market decided that the bad news coming from the old continent should actually be considered as good news because it will force the ECB to aggressively act.

68. But they may be disappointed with both equities and bonds performing well and being a few months away of the German elections.