Market Outlook

A monthly commentary on financial markets written on September 3rd, 2012

SUMMER RISE. AND NOW ?

Generalities (1-7)

1. Clearly, as we have done last month, the market - after some hesitation - ended up by considering important Mr. Draghi's speech, in which he declared that the ECB was ready to do whatever it takes to preserve the euro.

2. And while many expected a month of August similar to 2011 with falls of around 10 % for stocks, the month was effectively quite good with a generalized rise of equities : in Europe, +10.4 % for the Spanish indice, +8.4 % for the Italian one and +3.2 % for the DAX and in the US : +2.3 % for the S&P and +5 % for the Nasdaq.

3. The rising stock markets were also favorable to the euro, as the single currency recovered both versus the dollar at 1.2580 (+2.3 %) and the yen at 98.56 (+2.5 %).

4. The situation was more complex for sovereign bonds of the main developed countries, which fluctuated considerably during the month to finally end at a level almost unchanged; for example, the 10-year US government bond rose from 1.47 % to 1.83 % to end August at 1.55 %. A similar up and down move for its German equivalent, which closed at 1.33 % (against 1.28 % previously).

5. In the fixed income sector, the man influence of Mr. Draghi's speech was felt on the 2-year Spanish bond yield, down from 6.65 % to 3.5 % before ending the month at 3.65 %. The effect was more modest for the 10-year bond, which yield fell only from 7.6 % to 6.2 % to finish at 6.86 %.

6. Finally, the risk premium on corporate bonds continued to contract. In the US, for investment grade bonds, it moved from 47.75bp to 42.50bp and in Europe from 160bp to 149.2bp.

7. The negative consequence of this improved feeling and of rising geopolitical risks was a rise in the price of oil, which for Europeans in euros is now back to its peak. As a matter of fact, between September and March of this year, the barrel of Brent Oil moved up from EUR 75.- to EUR 93.-. Then it plunged to EUR 71.50 at the end of June, but it has now closed August at EUR 91.10 This increase is also reflected in the CRB/Reuters index in USD, which is now slightly positive for the year (+1.4 %).

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Equities (8-19)

8. Whether by chance or by a sense of timing, Mr. Draghi's speech could not have come at a better time. Indeed, during the weeks that preceded it investors had significantly sold equities to the point that in July for example, the redemption by US investors of equity funds was at its highest level in two years.

9. In addition, hedge funds were also positioned during this period for a bear market, and at the end of July they had accumulated large short positions, which were even higher than at the peak of their short positions in 2011.

10. Even stronger : the Bank of America measure of how Wall Street analysts view equities was at its lowest point in 15 years. So, they were even more pessimistic than during events such as the bursting of the tech bubble or the financial crisis.

11. Thus, by indicating that the ECB did not intend to commit hara-kiri, Mr. Draghi allowed for a stock market rebound. And as stop-losses on short positions were reached, a bull phase started, since each increase obliged short sellers to close positions by buying back the securities that they had previously sold.

12. Also in the US the possibility of a quantitative easing No. 3, coupled with acceptable economic data, helped the extension of the move.

13. However, it should also be noted that the recovery happened on low volume, indicating that most of the buying were closing of short positions and not investors increasing their exposure to the sector. But, no matter what, there has been a rise.

14. "And now" ? : this is the question that investors are pondering after their holidays, while facing a dilemma. The markets' good behavior is due to the expectation that the ECB, the FED and the Chinese authorities will, each one in its own way, vigorously act to support growth. But gradually as equities rise, the urgency for monetary authorities to intervene decreases, as markets seem to indicate that the situation is improving by itself.

15. In addition, indices are back to important technical levels. If these can be overcome, it will be interpreted by investors as a sign that the worst is behind us. But, if the rising wave fails at current levels, this would indicate that the upwards corrective move is complete and that a new bear move could be starting.

16. And this month, Louis Bacon, one of the best hedge fund managers, decided to reimburse 25 % of its main fund's holdings. His reasons are most interesting. He stated in a letter to investors that "the markets have been trickier and less liquid."

17. Then he notes that "Markets are increasingly distorted by central banks' attempts to squeeze drops of growth from an over-indebted private sector across much of the developed world, through such practices as bond purchases and super-low interest rates".

18. And if he has tough words for US politicians, his pen is harsher for the euro zone ones, which is "a potential disaster area of catastrophic proportions".

19. Farther on he writes that "Disaster economics, where assets are valued based on their ability to withstand a lurking disaster as opposed to what they may yield or earn, is now the prism through which investors are pricing markets."

Equities (20-31)

20. In the excerpts we have quoted one can see the constant tension which dominates the market since 2008. On the one hand in his letter, Mr. Bacon enumerates all the problems we are facing and all the damages that could arise from it by using strong words such as "disaster" and "catastrophe". But on the other hand, he complains that it is impossible to value assets at their fair value considering the possibility of this "end of the world" risk.

21. An image comes to our mind : that of a country in war. For days, weeks, there is a sense of false security and then, suddenly, a sniper, a bombing, makes war not only palpable but also potentially lethal to those who are in a battle area; an area which, furthermore, moves constantly. For the economy, the war is clearly between, from the one side, deflation, which is the natural slope that economies tend to follow because of the level of indebtedness, and from the other one, the aggressive monetary policy followed by central banks to avoid it.

22. In conclusion, from another angle, Louis Bacon illustrates what we have been mentioning for months : the current situation is a nightmare for investors, who have become hostages of the statements and actions of the political authorities.

23. After the summer rise, markets enter September in a wait and see mode, given the very busy political calendar in the three major areas : USA, Europe and China.

24. Faced with this high level of uncertainty, we maintain our advice not to look for an illusory absolute safety, but at the same time, to have an exposure to risk which, while painful, would still be bearable if the situation deteriorates.

25. And this is even more important as markets have become less liquid, including for equities.

26. "10 million a minute". This is how the article begins in the Herald Tribune dated August 3rd to illustrate the troubles of Knight Capital Group, who lost in a few hours USD 440'000'000.- because its high frequency electronic trading system has malfunctioned. This episode illustrates that, despite the flash crash of May 2010, too little has been done to make these systems safe for the markets.

27. One should remember that these electronic trading systems allow for the buying and reselling of a share faster than the time it takes for a human to blink. The speed by itself is dangerous as it exceeds human capacity, but it also gives the illusion that the market is liquid as it generates a significant amount of transactions, while in reality there are very few real investors.

28. But it is even worse : as soon as turbulences become too strong, these companies withdraw from the market in a few minutes, thus closing almost instantaneously some main roads used for the execution of buy and sell orders. This means that at the time where there is the greatest need for liquidity in the stock market, it mechanically becomes the most illiquid one, thus accelerating the decline.

29. In fact, high frequency trading has made the system more unstable, without providing any benefit to the investor.

30. In the old system, in which orders had to go through the trading floor, the brokers who were authorized to execute transactions were also required, in all circumstances, to continue to make a market by quoting a bid and ask price with a limited spread between them.

31. This situation is similar to the joke about the banker who lends you an umbrella when the sky is blue and takes it back when a storm threatens.

Bonds (32-45)

32. But this lack of liquidity does not affect only the stock market; the fixed income sector is also a victim. And this for another reason.

33. In his letter, Louis Bacon noted that "US banks have retreated from making markets in many securities because of the Dodd-Frank legislation, which limits them from trading for their own accounts". Dodd and Frank are two politicians who wrote a law adopted by Congress establishing new banking rules after the financial crisis.

34. Liquidity in this sector is therefore severely impaired and Louis Bacon writes : "I shudder to think of the stress that is going to occur during the new credit liquidation cycle, now that banks won't be there to make a market".

35. For the moment the opposite phenomenon is happening. The lack of liquidity, coupled with the vision that the price of an asset is determined by its "ability to withstand a lurking disaster" pushed yields significantly down, with the exception of course of sovereign bonds from countries under pressure in the euro area.

36. And this yield reduction was bigger and bigger as the quality of the debtor worsened.

37. Thus, there is a glorious contradiction here : if a disaster were to happen, stocks could then fall by 50 % for example, but at that point by some miracle, the ability of companies and governments to repay their debts would not be questioned ?

38. We maintain our view that volatility which was originally in the foreign exchange market and then gradually moved since 2000 to stocks will now migrate to the fixed income sector.

39. And maybe that little yo-yo movement observed in August on the 10-year US and German yields is the first sign of it.

40. Jamil Baz, chief investment officer of a company belonging to the asset management company Man, has noticed that for the eleven more developed economies, global debt (public and private) has presently risen to 417 % of GDP from 381 % in June 2007.

41. Thus, we believe that the mere fact that debt has become so massive implies that inevitably, sooner or later, its pricing will become increasingly unstable, upwards or downwards.

42. In his comments accompanying these figures, Jamil Baz indicates that the deleveraging phase has not even started yet and that this will cause at least a 20 % decline in GDP. In other words, there would be a depression.

43. Jamil Baz is only one voice among many eminent ones defending such a theory. And effectively, this could happen.

44. But to quote the title of a Financial Times article dated August 9th : "Japanese bonds are defying the debt doomsters". Indeed, if there is one transaction that caused significant losses for hedge funds for years, it was trying to sell short Japanese government bonds. We have already mentioned it; but what is happening in Japan, where the 10-year yield is at less than 1 % and with a rising currency while public debt exceeds 220 % of GDP, should have been economically impossible. And yet this has been going on for more than a decade.

45. This example is here just to illustrate the fact that the evolution of such a massive debt is unpredictable.

Bonds (46-50)

46. Personally, we do not know how the plot will evolve; but what is inevitable is that the story can only end in tears for holders of fixed income.

47. What bothers us the most in the vision of Jamil Baz and the others, is that by applying only a pure economic reasoning, which leads for example Mr. Baz to predict fifteen very difficult years, they ignore the political consequences that will arise from such a situation. Rather than suffer for fifteen years, it is also possible for example, that countries will simply end up not paying totally of partially their debt. And Iceland, from this point of view, could become a reference.

48. A last word on structured products, which are so popular today. A journalist, Floyd Norris, told the misadventure which occurred on one of these products. He begins by indicating that the bank which created it has done well, that customers who have purchased it had a significant loss and that even those who were doing a market on it were not aware of the risk. Apparently, it was a simple product. It was issued at USD 25.- and should have been repaid 30 years later at USD 25.- , while during this time it would be paying, depending on the evolution of short-term rates, an interest between 3 % minimum and 8 % maximum.

49. The problem is that in the prospectus supplement, on page S-12, it was indicated that the product was linked to a 5.85 % fixed-rate bond issued by JP Morgan Chase with a maturity in 2035 and that the early redemption of said bond will also lead to the early repayment of the structured product with at that moment a possible loss on the capital. In the bond's prospectus, an early redemption was only possible in the event of a tax change. And this did happen; a tax change occurred, and since the coupon was high, JP Morgan Chase decided to immediately reimburse the bond. And surprisingly, JP Morgan's announcement did no impact the structured product's price, as traders themselves had not realized what was going to happen. And it was only on the redemption day of the structured product that the damage became visible, as of the USD 25.- invested only USD 14.6857 was recovered.

50. Therefore, before buying a structured product, investors should read the entire prospectus, assimilate it and study its potential risks. Unfortunately, in this area as with the computer programs that we download, who reads the terms of use ?

Currencies (51-58)

51. The hopes raised by Mr. Draghi's speech also helped the oversold euro, which moved up.

52. And as everything is connected, its evolution in the coming weeks, as it will also be the case for stocks and Euro zone sovereign bonds, will be related to the heavy political calendar of September. The most expected event is the decision of the German Constitutional Court regarding the legality, in relation to German law, of the European Stability Mechanism (ESM). This decision is expected on September 12th. The consensus is that the Court will approve the ESM, but with some limitations and it will be these limitations that the market will carefully study, as there will set the limits of intervention of the ESM. Of course, a clear and simple rejection of the ESM would trigger a storm which would be very difficult for the euro boat to face.

53. As the darkest scenarios have been extensively outlined in the press, let's look for once at a more positive scenario, assuming that the German Constitutional Court will allow the ESM to act effectively and that a new reprieve will be granted to Greece.

54. Then, one needs to imagine that during the month an agreement will be reached between the ECB, the ESM and the main countries of the euro area regarding the management of the sovereign debt.

55. In the last days of August, rumors began circulating that the ECB could intervene to prevent Spanish and Italian yields to rise above a certain level, or that it could set a maximum spread which would be tolerated between German rates and the others. This is the scenario that we mentioned 12 months ago as a solution for this problem.

56. However, we do not believe today that this is the path that will be followed by the ECB. It should refrain to set clear levels which will automatically trigger its intervention. By its acts and statements, it appears that the ECB wants to adopt a softer approach. Its goal would be to influence and manage only short-term rates (up to 2 years) to allow debt refinancing to happen at an acceptable rate level. That the 10-year yield on securities already issued be either 3, 6 or 10 % is of little importance if Spain and Italy may borrow up to 2 years at less than 3 %. And, as we previously indicated, their debt is easily manageable at 3 % but not at 6 %.

57. The agreement that must be reached between the European institutions should be along the following lines : the ESM should be able to subscribe to new short-term debt issued by countries having difficulties refinancing themselves, and then the ESM needs to be able to refinance itself by borrowing from the ECB using these securities as collateral. Through this mechanism, the intervention capacity of the ESM would potentially be unlimited, therefore give him credibility with the market.

58. And the paradox is that if the market is convinced that the ESM has the means to intervene in a credible way, investors will then be quite willing to buy themselves these short-term bonds in order to benefit from the yield and thus the need of intervention by the ESM will be much reduced.

Currencies (59-64)

59. This type of solution would be acceptable by all since, on the one side, it is the one that leads to the lowest level of buying from the ESM and the ECB, while ensuring an acceptable refinancing level. And on the other side, it would oblige the countries under pressure to continue their efforts to improve their public finances. If a country decided at some point to no longer meet the agreed objectives, a few words of displeasure from the ESM would be enough to push yields higher and indicate to the country in question that the ESM support is not unconditional and can be withdrawn in case of misconduct.

60. This solution also has the advantage of letting the 10-year rate move freely, thus providing a reliable indicator of the market perception regarding the debt management of these countries. And the day when they will be able to easily issue long-term bonds at “normal” rates, the crisis will then be completely over.

61. Thus, a window of opportunity exists in the next two months to solve in an appropriate manner the management of sovereign debt in the euro zone. If this opportunity is taken, the euro, as well as all the assets of the region will be the main beneficiaries and one should then be positioned to benefit from it.

62. But the scenario also shows that there is still quite a difficult road to reach the goal.

63. A final word regarding currencies : since the introduction of the floating rates system in 1973, 2011 was the year with the lowest volatility ever. Once again, this clearly illustrates our views that volatility moved from currencies to equities and that it should now migrate towards bonds.

64. Therefore, regarding foreign exchange, we do not expect an imminent return of volatility, because of the generalized super-low interest rates.

Commodities (65-66)

65. The stabilization of the price of gold in the last 12 months is a good sign that global monetary conditions have not deteriorated. The way gold will exit the present range, either up or down, will be a powerful leading indicator regarding the evolution of the economic situation, thus allowing for the investment policy to be adjusted accordingly.

66. Regarding oil, the new rise is bad news and one must hope that it will not continue, in order to avoid doing too much damage to the economy.

Conclusion (67-73)

67. Rarely a rise like the one of recent weeks has been received with so much skepticism, since not only it was done on low volume, indicating a small level of participation, but furthermore in the US the sale of equities by private investors has continued, since in mid-August, for the previous six weeks, they had withdrawn USD 16.3 billion from equity funds and invested USD 32.2 billion in bonds one.

68. This bull move could therefore continue to surprise. We had already mentioned last month that it is enough that things be just a little better than what was expected by the market for the stock market to rise; and the reverse also applies of course.

69. It is possible that everything will go badly in Europe in September, but for the first time in months, there is a real opportunity for the euro zone countries to regain control of the situation. The challenge is difficult, but not impossible.

70. US economic figures were encouraging in August. And this should continue without an exogenous shock. James Grant, for example, one of the best American analysts, issued a favorable opinion on General Motors. In his study he mentioned that in 2007, Americans had bought 16 million cars. Sales then collapsed to 10.4 million in 2009 and they were 12.8 in 2011. In 2012 the figure should be between 14 and 14.5 million. Then he notices that just by the population increase at a rate of slightly less than 1 % per year, the level of 16 million should naturally be reached by 2015. But to this growth potential, one must add the fact that because of the crisis, the average age of the fleet currently in circulation is of eleven years, the highest level in history and this at a time when the affordability for the consumer to finance and purchase a vehicle has rarely been as high as today.

71. Therefore, one can consider that a simple decline of consumer fears in relation to a new recession would be sufficient to release a significant portion of the current suppressed demand, which should maintain growth at a level that allows unemployment to go down, even if it is at a slow rate, thus creating a virtuous self-feeding circle.

72. But also in America, the market is dependent on the willingness of political authorities and their ability to find a compromise in order to avoid the "fiscal cliff", this strong fiscal contraction which is currently mandatory because of an existing law, and which, if it were to be applied in 2013, would inevitably push the country into recession.

73. By its stakes, September will likely be an unusually important month for markets and we will carefully monitor events in order to decide in which direction risk in portfolios should be adjusted.