Market Outlook

A monthly commentary on financial markets written on January 3rd, 2013

2013: AND THE WAR GOES ON…

Generalities (1-5)

1. With the exception of the bears, 2012 was quite satisfactory to all other investors.

2. At the equity level, using the dollar as a base in order to make easier comparisons, the FTSE World Index rose 13.7%. Among developed countries it was the DAX (+29.1%) which had the best performance, while in the US the S&P (+13.4%) and the Nasdaq (+15.9%) moved in quite a similar way. Finally, Japan was the laggard with an increase of the Nikkei of 9.9%.

3. For emerging countries, the MSCI Emerging Markets Index increased by 15.1% despite the fact that two of its main components, China (+4.1%) and Brazil (-2.0%) had mediocre performances.

4. The year was also good for the bond market, as the yield on the 10-year German government bond declined from 1.83% to 1.32%, while its US counterpart fell more lightly from 1.88% to 1.76%

5. But the strongest increase in this sector was in the high yield area as the iBoxx USD Liquid High Yield Index went up 11.7%. In euro, the move was even stronger as its equivalent index rose 23.1%, thanks in particular to the reduction of risk premiums on banks of Mediterranean countries in difficulty.

6. Once again, the year was relatively quiet on the foreign exchange market with a very slight advance of the euro against the dollar from 1.2960 to 1.32, while the yen depreciated from 77 to 86.7 in the last quarter of the year. Globally the dollar index was virtually unchanged with a drop of 0.6% at 79.8.

7. Finally, the CRB/Thompson/Reuters commodities index declined 3.3%. Wheat (19.2%) and soybeans (18.4%) posted the largest increases, while coffee (-36.5%) and orange juice (-31.2%) suffered the largest losses.

IN THIS ISSUE

Equities (8-17)

8. The main surprise of 2012 has been the lack of volatility, which resulted in a loss of almost 50% on products linked to it.

9. This quietness can be illustrated by the fact that for the S&P, over the last 12 months, a daily movement higher than 2% occurred only 7 days (4 up and 3 down) and there was none exceeding 3%.

10. Even if the exposure was cautious, we did maintain throughout the year a positive attitude on this sector, taking into consideration the easy monetary policy followed by central banks.

11. Furthermore, we even raised our exposure during the fourth quarter as almost all central banks further increased their efforts in order to promote stronger growth. We were also encouraged by the fact that there have been several signs indicating that the economic situation is globally improving.

12. And there is a symbol that illustrates it. In 2008, James Paulson was the star of the year with his bear positioning in the sub-prime market. But in 2012, the spotlight was on a bullish investor, Dan Loeb, whose Third Point fund made USD 500 million by investing in Greek debt.

13. With hindsight, the perfect time to buy these bonds was just at the end of May, when we titled our June report : "A Greek tragedy". As a matter of fact, at that moment despite an initial debt restructuring, the new bonds were yielding 30%, after having been issued at 20% in March. Today, the yield has fallen to 12%. For Dan Loeb, it means that he was able to buy these bonds during the third quarter at an average price of 17 cents and sell them at the end of the year, when Greece made a debt buyback, at 34 cents. And he even kept some of them, since he believes that they could rise a further 40 % if the government sticks to its course.

14. The losers in this transaction were European banks that sold these bonds to him. Once again, banks confirmed what we have known since 2008 : they are very bad hedge funds.

15. From its recent declarations, it appears that for Dan Loeb two elements were essential to his investment. First, during his visits to Greece, no one mentioned the possibility of an exit from the euro zone. And then he had, like other hedge funds and potential investors, an unprecedented access to Antonis Samaras' government, who gave them a red carpet reception. This allowed the Greek Prime Minister to become credible and thus by extension also his economic plan.

16. Of course, without the support of Mr. Mario Draghi and of the ECB, Mr. Samaras' efforts would have been insufficient. But the Greek prime minister had the intelligence not to demonize hedge funds, turning them into allies, even to the point of fixing the buyback price of the bonds in consultation with them.

17. And one of the few predictions that we are willing to make at the beginning of this year is that 2013 will be a better year for Greece, or at least less bad than what is expected today. This is a major change, since from the beginning of the crisis it was the opposite, the economy was always much weaker than expected. This can also be seen in the Greek stock market index, which after having fallen 35% in 2010 and by another 50% in 2011, was up 33.4% in 2012. Nevertheless, the total fall from the 2007 top exceeded 90 %.

Equities (18-26)

18. One could even be more optimistic and consider that if global growth does not collapse, Greek growth may pleasantly surprise, since fundamentals have finally been restored. Indeed, the deficit of the balance of payments appears to have been erased and now that Greece is not going to pay more than 3% interest on its debt, it has become manageable. This last assertion may seem surprising since the press is full of articles claiming the opposite. The problem is that their analysis is based on a single figure : the level of debt in relation to GDP, which de facto remains quite high at around 150%.

19. But this figure taken by itself does not mean much. Certainly, it indicates that the size of the debt is still uncomfortable and that the financial situation remains fragile; but it cannot alone indicate whether the debt may be serviced or not. For that, it is necessary to estimate the cost of the interest payments in terms of GDP. And it appears that it is now only at 5.5% per year and this on the current depressed level of GDP. As a comparison, the rate was 7% in 2001, as the average interest rate paid then was higher than today. It had therefore a greater impact on GDP even if the debt level was lower.

20. A second prediction we are ready to make is that in 2013 Ireland and Portugal will also obtain the right to pay a 3% rate on the loans received from the Europeans and the IMF.

21. And we will stop making predictions here since, as we regularly point out, the zero interest rate policy coupled with a massive injection of liquidity is so unique that it is futile to try to draw conclusions, as there are too many unpredictable factors.

22. Will this policy finally enable global growth to accelerate ? Or rather will it eventually anesthetize the real economy by putting pressure on banks, insurance companies and pension funds - which cannot function properly in a 0% environment - to the point of adversely affecting the real growth rate of the economy ?

23. No one knows it. For the time being, we believe that the patient is showing signs of recovery and this justifies our favorable view towards equities. But the allocation in this sector will continue to move up or down depending on the events, as it is necessary to remember once again at the beginning of this year that the 2008 crisis is not over.

24. Indeed, this will only be the case once short-term interest rates are normalized, i.e. when they will be around 2% above the prevailing inflation of the moment.

25. This does not mean that nothing good can happen before, on the contrary. It is the improvement of the economy, with its positive effects on the stock markets, which will allow for the zero interest policy to come to an end.

26. But it is also likely that the road to recovery will be very tortuous and that new battlefronts could still appear.

Bonds (27-37)

27. And one of these should be in the bond market.

28. We have been questioned by some regarding the fact of how is it possible to be relatively positive on equities, while being absolutely negative on bonds, insofar as higher yields would heavily weigh on the stock market.

29. In fact, the answer to this question must be nuanced. If yields rise due to a clear improvement in the economic situation, equities may continue to rise, as it would only be a normalization of interest rates.

30. On the other hand, if for example yields climb because the debt weight has begun to frighten investors - and this while the economy is still weak - then one should not overstay his visit to the stock market.

31. Moreover, will yields rise in 2013 ? We believe that the monetary policy currently followed is so revolutionary that it is virtually impossible to establish when and why this will happen. This leads us not to be invested and rather seek opportunities to position ourselves towards higher rates, because there is much more to be gained in that direction.

32. Moreover, by whichever way we look at it, the bond sector is a potential nightmare.

33. Here is another example of a potential danger, similar to others that we have been mentioning in recent months. This one was presented by Bill Gross, the manager of the world's largest bond fund Pimco. In the US, UK or the Euro area the search by investors of yield at any cost, currently allows to sustain a credit offer of 10 to 15 times the amount of liquidity that is provided by central banks. In other words, in the US for example, the FED makes currently available around USD 4 trillion of liquidity. And it is on these USD 4 trillion that USD 54 trillion of public and private credits are currently being supported.

34. The leverage is therefore considerable. What will happen once the FED begins to reduce liquidity and that at the same time - because it is always then that this happens - the multiplier decreases ? A simple reduction of 12.5% in liquidity with a decrease of the multiplier from the current 13.5 to 12.5 in the US will imply a reduction in the demand of credit by investors of nearly 20% and one can then imagine the pressure this will put on rates.

35. Another example: the current consensus is that the weakness of the economy is such that nothing could bring a change in the FED's policy before two or three years. This includes a belief that wages cannot increase, due to the high level of unemployment.

36. But history does not support this belief. Since the 1980s it is true that wages take a lot of time to resume their rise after a recession. But until now they have always did so, on average 3 years after the end of a recession, and this even with a high unemployment level. As we will be entering the fourth year of the recovery it will be interesting to see if this could start happening in 2013.

37. Where this to occur, the FED's room for maneuver will mechanically be greatly reduced, thus creating uncertainty in the fixed income sector. And since markets hate uncertainty an upward move on yields could start just for this reason.

Bonds (38-44)

38. And then one should remember that US junk bond ETFs have grown from USD 300 million in 2007 to USD 32 billion today. Globally more than USD 250 billion are currently being invested in this area of the bond market, currently been called high yield. Thus, what will happen once the tide reverses ?

39. Yet another potential danger could come from an opposite reason: the current consensus does not anticipate a recession either. But expecting this to happen is not unreasonable and should it occur, the globally inadequate returns on the existing debt will then become apparent and taking into consideration the present level of leverage the consequences could also be quite important.

40. Another possibility would be that the debt crisis, currently contained in the peripheral countries, moves to major developed countries. Atca, a foundation which studies economic issues, made an interesting analysis. To make it more understandable the problem of the US debt, it withdrew eight zeros from figures linked to it, in order to imagine that this is the budget of an indebted family at the end of 2012. Here they are :

- Annual income of the family : USD 24'410.-
- Spending : USD 35'450.-
- New debit on credit card : USD 11'040.
- Total amount due on the credit card : USD 163'660.- (compared to the maximum debt ceiling of USD 163'940.-)
- Interest paid on this debt : USD 2'383.-
- The debt on the credit card grew by 50% over the last 4 years.

If the fiscal cliff measures were fully implemented, this would lead to an increase in revenue (i.e. higher taxes) of USD 5'360.- and to a lower spending of USD 1'200.-. This means that the amount that would be added to the credit card in 2013 would be of USD 4'480.- instead of the USD 11'040.- of 2012.

41. The exercise stops here, since obviously the income of a country is much more volatile - both upwards and downwards - than a family's one. Economists fear that if the jump from the fiscal cliff where to occur - which is considered, or even desired by some politicians - a recession would result with the risk that the government revenues will decrease by a larger amount than what was obtained through the taxes increases. This is why it will not happen.

42. The interest of this exercise is to clearly show that in order to keep debt under control, it has become vital for countries to increase revenue - ideally by growth, but also even by inflation - while preventing that the interest paid on it increases too much.

43. In short, the situation is much more delicate than what is reflected by current yields. And should the sovereign debt situation deteriorate, it is illusory to believe that credit linked to companies will not suffer as much.

44. We believe that too many investors underestimate the true risks in this sector, since they have become anesthetized by the continued yields' decline of the last 30 years. Thus, the awakening will likely be painful.

Currencies (45-51)

45. With hindsight, our biggest mistake has probably been not to have benefited from the rise of the euro in the second half of the year, after Mr. Draghi's commitment to do everything to preserve the euro. And, as a matter of fact, we did study in detail his statements in our August report in order to highlight its importance.

46. However, caution required waiting and seeing which acts will be associated with these words. But the surprise was that actions were not necessary, as the market considered Mr. Draghi's strong words to be sufficient.

47. Nevertheless, this nearly 5 % increase of the euro in the last 6 months should come to an end. The euro index is at 95.2 and there is a very strong resistance at 96. As we previously mentioned, the situation in the euro zone does not allow a significant rise of the single currency.

48. In our previous comment, we mentioned that “the FED’s aggressive easy monetary policy is forcing the other countries to follow the same road. And as the number of countries going in this direction increases, pressure on the remaining one intensifies. Indeed, staying inactive means accepting an overvaluation of its currency, thereby excessively penalizing its own economy”. The proof this month came from Japan since, following in particular the pressures done by the new Prime Minister M. Shinzo Abe, the Bank of Japan announced Yen 25 trillion of additional easing measures, i.e. the equivalent of what the Fed should do in 2013. The Japanese have also indicated that additional easing measures could come during the year. All this lead immediately to a further weakening of the yen.

49. We will be also looking with interest what M. Abe will do, because he had such a large victory that he can without the support of another party introduce major structural reforms. In particular, he has promised to take any necessary measure to bring the country out of deflation and back into growth. Japan is clearly the country which needs to be followed at the beginning of this year.

50. In relation to the foreign exchange markets, we are basically in a stalemate situation as no major country wants to see its currency strengthen and each one is thus ready to take measures equivalent to the ones taken by their competitors in order to avoid such an outcome.

51. In conclusion, the choice of one currency in relation to another is therefore tactical rather than strategic and it will not be surprising if in 2013 currencies fluctuate in a trading range equivalent to the 2012 one, with relatively low volatility.

Commodities (52-59)

52. For the twelfth consecutive year gold rose with an increase of 7%. But for the first time, it is showing signs of weakness to the extent that some technical analysts believe that the level of USD 1'900.-/oz. reached in May 2011 was the peak of the move which started at the beginning of the century.

53. Actually, if the yellow metal has been such a superstar, is it because it benefited from the purchases of two groups with opposite motives. For some, gold is the ultimate protection against the inevitable inflation which will appear because of the very lax monetary policy conducted by the central banks. For others, gold is the safe heaven against the deflation threat since, if it were to happen, it would lead to massive debt defaults, thus threatening to destroy the Western financial system.

54. This means that if investors become more convinced that the world economy is not about to fall in a black hole and that therefore the fear of banks' bankruptcies - which continues to worry many investors still traumatized by the events of 2008 - decreases, an acceleration of the gold's decline may happen, which could bring it to around USD 1'300.-/oz., i.e. a total correction of more than a third from its peak.

55. This could then be a good entry level if real yields continue to be as negative as they are today.

56. But in such a scenario, the increase of volatility would be a sign that we have entered the final phase of the bull move. The rise will continue but in a more hesitant way, as the end of the crisis will imply that central banks start to withdraw liquidity from the market and there will be a lot of uncertainty on how fast they will do so.

57. Regarding the other commodities, we expect that 2013 will provide answers to a debate that has developed in recent months.

58. On one side, we have those who believe that the bull move is over, since recent technological advances are sufficient to allow from now on commodity prices, as it has been the case throughout the 20th century, to rise at a slower pace than inflation, and this even if global growth improves. And their conviction comes from the fact that in the past century, only oil was able to maintain its real price at the same level where it was 1900, while all others commodities are much cheaper.

59. On the other, we find those who believe that the situation has changed and that it has become so difficult to extract minerals or to obtain adequate harvests that this will result in price increases above inflation, to the point that growth will suffer. Some go even further and say that this situation combined with the aging of the population could bring in fifteen years globally the world to a growth close to zero.

Conclusion (60-65)

60. We would have loved to be able to declare at the beginning of this year that the crisis is over.

61. But the war continues. And the question now is to find out where the battlefront will be. Currently, the two camps - deflation and inflation – have found an unstable equilibrium, as none was able to take a decisive advantage. 2011 was a rather favorable year to deflationists and 2012 to inflationists.

62. Thus we start 2013 on the momentum of 2012, with a portfolio leaning towards the success of the reflationist policies wanted by the central banks. We remain however quite flexible, in order to adapt our strategy to events.

63. Nevertheless, one needs also to notice that the present bull move, which started over a year ago, has obtained no respect from investors, who rather tend to view it as an eccentricity considering the world's problems.

64. However, this usually indicates that the present trend should not only continue, but that it could even accelerate in a rather surprising manner; thus implying an improved world growth.

65. And it is on this optimistic note that we take this opportunity to wish our readers a Happy New Year in good health.