Market Outlook

A monthly commentary on financial markets written on August 2nd, 2012

TOWARDS THE END OF THE EUROSCLEROSIS ?

Generalities (1-3)

1. Thanks to the intervention of the ECB President - Mr. Mario Draghi - at the end of the month, July ended well, in particular with a rise of the US stock markets : +0.2 % for the Nasdaq Composite and +1.3 % for the S&P. On the opposite, the Japanese stock market fell (- 3.4%) mainly due to the rising yen, while in Europe, performances were directly linked to the situation of each country regarding its sovereign debt : unchanged for Germany, +3.7 % for France, but -2.7 % for Italy and -5.1 % for Spain. And the divergence of performance since the beginning of the year is now significant with the DAX up 14.8 % while the Italian (-7.9 %) and Spanish (-21.3 %) stock exchanges have been hard hit by the effects of the crisis.

2. In relation to currencies, the faster decline of the euro than of the other currencies against the dollar - which began in late June - continued in July with a further decline of the single currency, which ended the month at 1.23 against the greenback, after coming close to the 1.20 level. But it is against the yen that its evolution is the most striking. From a parity of 130 at the creation of the euro on January 1st, 1999, the yen moved up to 90 in October 2000. Then came the phase of the euro superstar, with a yen decline to 170 (!) in July 2008 when the first tremors appeared around the Greek debt. And since then it reversed path and at the end of July it was trading at 96. Will the previous record of 90 be broken ?

3. The answer to the previous question obviously depends on the evolution of the debt crisis which, regarding fixed income, reproduced in July the now usual bond's behavior. To the worsening of the Spanish debt, whose 10-year yield remained around 7 % for most of the month, a level at which the debt becomes unmanageable for the country in the long run; so, this deterioration was matched by a further decline in US (1.47 %) and German (1.28 %) yields. In addition, a growing number of countries deemed to be safe were able to issue bonds at negative yields for shorter maturities. And this yield search also helped US investment grade bonds as their risk premium is now only 47.7bp. After having reached 300 bp at the height of the financial crisis in 2008, it is now back to its post-crisis levels. This is hardly the case with its European equivalent, which ended July at 160bp.

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Generalities (4)

4. Finally, commodities behaved in quite a divergent way as agricultural products have sharply risen since the beginning of the year because of the US drought (with for example wheat up 36.3% and soybeans up 38.9 %), while industrial commodities such as oil (-18.5 %) as well as nickel (-25.8 %) fell, reflecting a slower growth in China. And for the month, the CRB/Thompson/Reuters index was up 5.4 % thanks mainly to the agricultural products.

Equities (5-10)

5. The speech that Mr. Mario Draghi – the ECB president - gave at the Global Investment Conference in London on July 26th cheered up investors, since the major European stock exchanges rose by more than 4 % that day. And, as a matter of fact, it contained many key elements.

6. Mr. Draghi firstly mentions that at the national level significant progress has been made in controlling deficits and in introducing structural reforms. In relation to the supranational level, he notes that countries of the euro area have agreed to a larger financial and fiscal integration and he is convinced that concrete actions will be quickly taken.

7. He then recalls a truth that lies at the heart of the euro : "When people talk about the fragility of the euro and the increasing fragility of the euro, and perhaps the crisis of the euro, very often non-euro area member states or leaders, underestimate the amount of political capital that is being invested in the euro." And then he adds that the measures taken towards this financial and fiscal integration by the euro-zone countries in the area demonstrate that "the euro is irreversible."

8. If we have quoted Mr. Draghi's exact words it is because it contains two important elements. First, the fact that the euro was born from a political will and therefore it can only be destroyed by a political will. As long as there is a political will to stay together, or even to keep in the country most at risk - Greece -, solutions from an economic point of view will be found. But this sentence is also important for another reason : when Mr. Draghi noted the euro fragility, he has not linked this element to investors or to the market; no, the skepticism comes from "non-euro area member states or leaders countries or governments outside the euro area ".

9. Therefore, three years of debt crisis have finally created doubts about the survivability of the euro all the way up to the top of non-member countries. And this is something that can be seen on the foreign exchange market : for a long time during the crisis, any drop in the euro was an opportunity for foreign central banks to buy the single currency as they looked to reduce their dollar exposure. This meant, as we often said, that if the euro fell against the greenback, its fall was not faster than what was happening with the other currencies. In short, it wasn't the euro which was falling, but the dollar which was rising in view of the global economic uncertainties. This is no longer true today. For several weeks, it is indeed the euro which is going down, as the distrust regarding the euro has, by contagion, also reached the governments and central banks outside the euro area.

10. The only good news is that the ECB is well aware of the situation. And since it must share its views with the euro-zone countries, and particularly with Germany, this should lead to the introduction of new measures, which will need to be effective as, obviously, it will take more than words to regain confidence. Anyway, the stakes for the euro area have gone even further up.

Equities (11-19)

11. And Mr. Draghi is aware of that, because he then pronounces very strong words : "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

12. He then notes that the interbank system is broken and that under the pressure of the national regulator each bank is hard-pressed to move back inside its national borders, which de facto results in a "financial fragmentation" of the European banking system. He asks that this situation be corrected, even if he acknowledges that if a bank has a funding problem, no technical measure will be sufficient. Implicitly, he indicates that capital for these banks will have to be raised, one way or another.

13. And he then reaches the final theme of his speech and here too it is important to quote him verbatim : "Then there's another dimension to this that has to do with the premia that are being charged on sovereign states borrowings. These premia have to do, as I said, with default, with liquidity, but they also have to do more and more with convertibility, with the risk of convertibility. Now to the extent that these premia do not have to do with factors inherent to my counterparty - they come into our mandate. They come within our remit".

14. Let's quickly note that for the third time in this short speech, through this convertibility risk, he once again recognizes that there is an uncertainty regarding the ability of some countries to remain in the euro.

15. And he ends with this sentence which has so pleased the markets : "To the extent that the size of these sovereign premia hampers the functioning of the monetary policy transmission channel, they come within our mandate".

16. Here again, several comments are essential. For the first time, the ECB notes that the sovereign risk of some countries, implicitly Italy and Spain, is no longer linked to their economic situation, or to their budgetary and fiscal policies. And therefore he considers that this provides him with the motive for a stronger intervention.

17. Mr. Draghi's presentation is very clever. We are not sure that presently the risk that Spain and/or Italy abandon the euro is a main fear for investors. But by presenting the problem in this way, he approaches from another angle what is lacking the most for investors : a buyer of last resort equivalent to the Bank of England or the FED.

18. And thus, we have reached what is at the heart of the euro area debt crisis: how to intervene effectively when the risk premium on sovereign debt becomes excessive, while maintaining the pressure on the most lax countries in order for them to manage their finances in a healthy way.

19. Luckily a consensus solution is beginning to appear. The basics are actually quite simple. First, the European Stability Mechanism (ESM) - which should soon start operating - should be given a banking license. This will give the institution access to the ECB funds, thus correcting its present main disadvantage : the resources at its disposal - i.e. EUR 500 billion - are considered insufficient by the market. With a bank status, there would be no longer any doubt about its ability to intervene effectively and in whatever situation, since the ECB could make available to the ESM almost unlimited means. Some even go further and imagine that it is the ESM which could borrow directly from investors, then lending itself to the euro-zone countries, in order to create a market as liquid as the one for US Treasury bonds.

Equities (20-28)

20. But, in return for its intervention, countries should strictly observe the criteria of sound fiscal management to which they would have previously committed themselves. Otherwise, the ESM will refrain from acting on their behalf. In a certain way, the ESM would become the countries' policeman.

21. Furthermore, the ESM could also have a role similar to that of the FDIC in the US, by creating a bank insurance fund that would allow it to intervene when a bank is undercapitalized in order to close it and transfer its assets to another entity, while guaranteeing the savers' deposits. This would eliminate a big chunk of the present interbank counterparty risk.

22. However, if the solution can easily be presented, one can also imagine that from a political point of view it is quite a different matter. First for Germany, for which the quantitative easing measures, as currently practiced by the US and the UK, are anathema, even a heresy. And we can imagine that before giving the green light to such a solidarity mechanism, it will want to ensure that a really effective corset is in place around the states' fiscal policies. Or, to use another image : it would want to ensure that the countries wear at the same time a belt and suspenders.

23. But this will not be easy either for the other European countries. One must remember that the first parliaments were set up primarily to legislate on revenue and expenditure. The budget is therefore at the heart of the parliament's DNA and one can imagine the difficulties that an elected body will have in accepting to limit its powers in this area.

24. In both cases, it is therefore a matter of breaking taboos. But is this not what crisis are all about ? To challenge oneself ? To metamorphose, as butterflies do ?

25. In order for the euro to continue to exist, this, or a mechanism close to it, is essential. This is the progress which was achieved during the last meeting of the euro-zone countries, whose final communiqué indicated that they are committed to "a specific and time-bound roadmap for the achievement of a genuine economic and monetary union". The key word is obviously "genuine". By using this word, the zone leaders recognize that their current monetary union is not "genuine" and, in a rather ironic way as they wanted to reassure the financial world, implicitly, by using this word, they recognize this convertibility risk to which Mr. Draghi referred.

26. And since the acceptance to mutualize the sovereign risk under certain conditions by Germany is the only way to eliminate this convertibility risk, and given the fact that the euro is politically and economically very favorable to the country, it should eventually accept it.

27. The difficulty is that in a certain way Mrs Merkel was the big loser of the Greek double election. The results of the first Greek election accelerated the evolution of the crisis, as it provided the fuel needed to attack Spain. And this destroyed Mrs Merkel's hope to keep the European crisis under control, without additional measures, until the German federal election, scheduled for the fall of 2013.

28. And from the euro point of view, the best would now be that this election be held as soon as possible. It is not so much the result that counts, since both major parties have fairly similar views on Europe. But in a democracy, it is the election which provides legitimacy to a government and gives it the power to act. This power is at its peak just after the election and it then diminishes to become almost non-existent just before the next election.

Equities (29-41)

29. Currently, Mrs Merkel does not have the necessary legitimacy to make the country and Parliament accept to mutualize in some way the debt, an action which is needed to definitively settle the euro-zone crisis. Only a government issued from the next elections will be able do so.

30. Regarding the other end of the chain, i.e. the abandonment of a portion of budgetary sovereignty in favor of a supranational entity, it may be not that difficult to obtain it from the other European countries and this for several reasons.

31. Firstly, the only thing that parliaments would give up is their ability to fix the level of deficit. This limited loss of sovereignty seems acceptable, since in case of excessive deficit it will still be the national parliament who will continue to decide whether to raise taxes, cut spending or do a mixture of both. From this perspective, one can even imagine that a significant proportion of the population would be quite favorable to this.

32. Furthermore, in reality, is it not already the case today ? Even without acting in an irresponsible way, Spain and Italy are penalized by investors, so imagining a country which could allow its deficit to increase with impunity...

33. As one can see, it is just a matter of formalizing what is already a reality, even if the importance of the symbol should not be underestimated.

34. The last reason why the acceptance of this loss of sovereignty could be easier to achieve than what we can imagine today is simply linked to the toughness of the crisis itself : a majority of the European political community wants to settle once and for all this problem in order to be able to go back to a normal environment.

35. In conclusion, with the decisions of the June euro-zone summit and Mr. Draghi's speech, the disease the euro suffers from has finally been clearly identified, as well as the treatment needed to cure the patient.

36. It only remains to convince the patient to follow the treatment. And for the time being it is not yet ready.

37. This is why we continue to recommend caution to investors. The gap between the rhetoric and the political reality remains too wide for the moment.

38. Soon we will see how the European leaders will act facing the problem of the level of interest rates of the Spanish and Italian debt. But this will only allow the euro-area to gain time; time which is essential for the political transformations that need to occur.

39. In 2008-2009, with on the one side the financial crisis and on the other the growing importance of China, the press has often mentioned that in Mandarin the word crisis is composed of two ideograms : "Wei" (danger) and "Ji" (opportunity).

40. What we hope is that the European crisis will be an opportunity to banish the Eurosclerosis which has taken hold of the economies of the Eurozone in the last decade and which has long been hidden by the budget deficits.

41. The whole continent is now aware that the only real long-term solution is growth and that changes, not only structural but also in mentality, can no longer be deferred.

Equities (42-50)

42. Well, the entire continent ? No ! Since a small village of indomitable Gauls continues to resist now and always against the invaders. In fact, the policy of the new French government presently looks like Asterix. Far from taking measures that will promote growth, which is the only way to create jobs, the government has locked itself into populist measures that will solve nothing. But for the French left, these are of great symbolic value, as were the banks' nationalization when Mr. Mitterrand came to power. However, one knows that the facts are more stubborn than ideology and this explains why it was under Mr. Mitterrand's presidency - but only after a few years - that privatizations were the most numerous. And one can estimate that this will also happen with Mr. Hollande, but who will have far less time than Mr. Mitterrand to begin his ideological turnaround.

43. In short, France will get there too, but it needs more time. All this reinforces our belief that the patient's recovery will be slow and that therefore a sustained bull market in Europe will also take some more time.

44. But as we write this, we are nervous. No one is positioned for a market's rise, since the only discussion happening is whether the situation will be bad or very bad. And the market has this nasty habit of not doing what is expected from it.

45. Our problem is that currently we cannot establish what will be the importance of the current recession, which has already reached 85 % of the euro area. Indeed, as the weeks go by, it gets worse because of the messy economic policy of the area's countries. It is necessary to intervene with quite a lot of sensitivity in this fragile situation and this has not been the case until now. Let's hope that the decisions that have to come very soon will allow us to be more positive.

46. Therefore, taking in consideration what is happening not only in Europe, but also in China and the US, we decided to slightly reduce our equity exposure this month.

47. But one should also be aware that never in the last 40 years European stock markets have been so cheap as today relatively to US equities and that a once in a generation opportunity should appear in the next 12 months on stocks and bonds which are now oversold.

48. And this conviction is also based on the revolution that will happen in the European economies in the coming years. Very often, for convenience, we divide society into two blocks : left and right. Furthermore, our democratic systems are built so that either it is a party or a coalition of the center-left or of the center-right which obtains a majority. But this view is incomplete.

49. Indeed, more than being from the left or the right, it is often generational interests that transcend partisan interests. And today the baby-boomers – who just by their numbers effectively control the agenda in our societies - are going into retirement and therefore their priority, whether they are from the left or from the right, will be to make sure that the state will be able to fulfill their two basic needs.

50. First, anything that is related to their health. This will be an area where the state, whether in left leaning Europe or right leaning America, will continue to spend and spend.

Equities (51-56)

51. And secondly, they will be willing to take any measures which will enable them to continue to receive the same pension with the same purchasing power they currently enjoy. Therefore, they have a direct interest in putting to work all these young people who are now unemployed in order for them to finance their retirement. And this means, for example, that the timid measures taken by Spain and Italy for more flexible employment contracts are just appetizers.

52. The more baby-boomers are retired and the easier it will become to gain acceptance from the society of the need for a reduction in employment protection for those who are still working, for increased productivity and for a longer working period, either by an increase in the weekly hours worked or by an increase of the retirement age. The important thing is that workers are able to generate enough income to pay the pensions of the old.

53. And this will be even easier to implement as the youth themselves will be asking for it. After years of hardship, they will be ready to accept conditions that their eldest would have refused.

54. Hence our questioning concerning the return of sustained bull market. Obviously, the end of the Eurosclerosis will be long, but as noted in a recent article in the Financial Times, during the 1970's, in an environment that was as bad as today, the market reached its lowest level two years before the UK required the IMF assistance and six years before the level of job seekers reached its peak. Certainly, at that time, the high inflation was an effective help to support the nominal level of the market. But this example illustrates that what makes the markets move is not the economic situation as such, but, whether compared to what is already incorporated into current prices, the situation is improving or deteriorating further.

55. In conclusion, we maintain and have even slightly strengthened our defensive position. However, recent developments in the euro area feed our hope that sometime in the next twelve months, an historic opportunity will present itself to achieve in a short period a performance which will offset all the bad times that we have been living since 2008.

56. But in the meantime, patience.

Currencies (57)

57. Without being fundamentally negative on the euro - whose balance of payments is globally in equilibrium - we have been diversifying towards currencies of countries with a healthier economic situation than the major industrialized countries. And this explains why we hold only a small tactical position in dollars for euro based portfolios.

Currencies (58-61)

58. And, as we have already mentioned, until about a month ago this diversification did not bring much benefit. But since then, things have changed. And this is not only due to the new wait and see attitude from the other central banks towards the euro; this decline is also the consequence of the almost automatic mechanisms of monetary self-stabilization that have kicked in to counterbalance the effects of the recession in the euro zone and the inherent deflationary risks that go with it. These risks are linked to the fact that in normal circumstances, the tightening of fiscal policy should have been offset by an easing of monetary policy whereas, because of the prevailing situation, the opposite occurred for many countries in the euro zone.

59. This means that it will be difficult for the euro to move up as long as a definitive solution has not been implemented for the debt management in the zone.

60. In addition, the 25 % decline of the single currency from its 2008 peak is a welcome break for the weakest countries in the area. Moreover, a return to parity between the dollar and the euro would match the 40 % devaluation that some deemed necessary a few months ago for the new currency that Greece would have to establish if it left the euro.

61. The conclusion here as for equities, is that a trend reversal is linked to the implementation of credible measures to solve the European crisis.

Commodities (62-67)

62. As long as oil continues to decline, this can only be good news for consumers. One should remember that earlier this year, a continuation of the rise was the main factor that could have disrupted the US recovery.

63. In relation to the other commodities, we are in a classic pattern where prices in the agricultural sector and for industrial commodities reflect quite accurately on the one side the drought in the US and on the other side the Chinese slowdown.

64. However concerning gold, we expect that it will be a very important leading indicator of the progress of the ones and the others in their fight against deflation. The fact that it has stabilized in recent months is a positive sign, since it indicates that the global economic situation is not, in a global manner, deteriorating.

65. But we now need to see it moving up, in order to indicate that there are finally enough reflationary measures in the system. We will use it as a leading indicator of the evolution of the world's economy.

66. Without gold rising, it will be difficult to be more aggressive in our investments.

Bonds (67)

67. Last month we mentioned our distrust towards bonds at current levels, but we stopped short of calling it a bubble. This month, with the extension of the number of issues with negative yields - you invest 100 and at maturity you only get back 99.5 - we are ready to ask ourselves if there is not a bubble on so called safe assets.

Bonds (68-69)

68. Anyway, the largest profit potential will come from being positioned to benefit from higher yields. In other words, it means being short duration.

69. But, here as elsewhere, to the risk of repeating ourselves, we fear one still needs patience before implementing such a strategy.

Conclusion (70-75)

70. If the recent statements, from the European leaders as well as from the ECB, allows us finally to envision a solution to the crisis in the euro area, we believe, unfortunately, that given the need of breaking taboos - taboos which are indeed more serious than the political blockages themselves - it is probable that markets will have to put more pressure on European political leaders to force them to adopt the common sense measures which are needed.

71. Thus, uncertainty should remain for some more time and we know that the market hates uncertainty.

72. Moreover, this uncertainty has even increased recently with the risk that a too restrictive fiscal policy in 2013 should compromise US growth (this is the fiscal cliff we mentioned in our previous report), while in China the authorities seem to be behind the curve in relation to the current economic slowdown of the country. This is what led us to slightly reduce once again our risk in July.

73. The storm which began in 2007 has obliged every money manager to be positioned more and more defensively. But we consider that any eventual further market's fall would be like bungee jumping : the moment the rope becomes stretched, the move up could be explosive.

74. However, what would allow the rope to become stretched are good political decisions in the major countries of the world. We believe that this will eventually happen, but the timing remains uncertain.

75. In conclusion, if we continue to maintain our defensive positioning, we are impatiently waiting for acts which will allow us to be bolder.