Market Outlook

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

SALVATION OR DAMNATION ?

Generalities (1-5)

1. Do US investors watch too much Fox News, the pro-Republican news channel? Because on election night it seemed that Fox News and its viewers were the only ones surprised by the reelection of President Obama. Indeed, if the national vote was tight enough, a state by state analysis indicated that the Democrat victory was probable. And even the market expected it, since the Intrade platform, which allows making predictions through the purchase and sale of securities, had always displayed during the year a 60 % minimum probability of an Obama winning.

2. Thus, the over 5 % fall of US indexes after the November 6th elections looked as an ill-humored reaction and in fact the move down was quickly erased since by the end of the month the S&P was almost unchanged and the Nasdaq rose by 1.1 %. In Europe, the Euro-Stoxx50 increased by 2.3 % and the CAC40 by 2.8 %. The MSCI Emerging Markets grew by 1.1 % in dollars. But the month's star was the Nikkei, up 5.8 %.

3. The Japanese move is directly linked to a decrease in 2 months of more than 5 % of the yen against the dollar to 82.50 after positive statements for growth by Mr. Shinzo Abe, the favorite of the upcoming elections. And the yen decline was even more dramatic against the euro, since it reached 12 % in 4 months. It is also worth mentioning that in November the euro/dollar was virtually unchanged at 1.30.

4. Regarding bonds, the FED's continuous purchases are still influencing positively the sector and yields remain low : 1.60 % for the US government 10-year bond and 1.39 % for its German equivalent. A small reduction of the risk premium for European investment grade corporate bonds index at 122.9bp, while it American equivalent closed the month at 99.4bp.

5. Finally, a slight increase for the month (1 %) of the CRB/Reuters commodity index.

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Equities (6-14)

6. So, Mr. Shinzo Abe should win the December 16th election in Japan and an important element of his campaign was his confrontation with the Governor of the Bank of Japan, Mr. Masaaki Shirakawa. Without going into the details of their argument, what is important to know is that Mr. Abe is requesting the equivalent of an unlimited quantitative easing in Japan; and this until inflation is back to 3 %. However, this is unacceptable for the current governor of the Bank of Japan. And the stand-off has gotten bad enough to the point that Mr. Abe declared that he was ready to call into question the central bank's independence.

7. However, one should keep in mind that it would not be the first time that a Japanese politician made encouraging declarations before refusing ultimately to take concrete action once in power, since the country tends naturally to look for harmony rather than dispute. However, investors are beginning to hope that this time events could be different, since this is what the people also want.

8. 20 years of deflation have increased inequality, compressed income and forced the Japanese to continue working far beyond the official retirement age. And of course it has impacted the country's debt, which is over 200 % of GDP. It is therefore possible to hope that the new governor, who should be appointed by parliament after the elections, will at least follow a more easy and aggressive monetary policy than its predecessors.

9. Such a scenario would then be the salvation for the Japanese economy and, by extension, a valuable aid for global growth.

10. And it would be very, very favorable to equities. The Japanese market is probably the least expensive in the world, since it is valued with a discount of 6 % to book value. Therefore, there is no premium and for its value to return to the world average, equities must double.

11. But the risk of damnation also exists. One can easily imagine that after the elections the will for change of Mr. Abe could be diluted, as it is usually the case until now, in parliamentary discussions between the various factions and political groups, to the point that the new Bank of Japan governor will be a supporter of the status quo. This would then quickly push the yen up, the stock market would become again the Sleeping Beauty and there would be no positive impact for the world economy.

12. In Europe, the scenario of damnation is well known : under the leadership of Germany a restrictive budgetary policy is implemented, which leads to severe recessions in many countries of the euro-zone, with the risk of default for some states and the implosion of the area.

13. This situation is reflected by stocks since, if the S&P is only at 10 % from its historic high, the Stoxx Europe 600 has to move up 50 % to find itself in the same situation.

14. Nevertheless, there is salvation too. We could have kissed the cover of The Economist magazine devoted to France if we had then the print edition in hand, because on a tablet it is not very hygienic ! The reason for our joy is paradoxical given the cover on where bread baguettes are held together by a blue-white-red ribbon forming the equivalent of a stick of dynamite with a lit fuse coming out of one of these baguettes. And the page title reflects this image : "The time bomb in the heart of Europe". In fact - and without even reading the article - this cover is positive, as it means that the potential risks that we previously expressed concerning France are now in the public domain. As a matter of fact, the greatest danger for investors is the submerged icebergs, which have the ability to sink a financial market. Once they become emerged, there can be more easily bypassed. For example, the recent measures taken by the French government to reduce the public deficit indicates that they are quite aware of the fragility of its situation.

Equities (15-24)

15. Time will tell whether it will be able to go far enough in its structural reforms to avoid all the pitfalls, but the probability that the debt crisis will infect the country in 2013 has become much lower.

16. In addition, in Europe too, the fiscal tightening phase is coming to an end. This is illustrated by the fact that not only the euro-zone countries - but also the markets - have been willing not to ask any new austerity measures from Spain despite its recent fiscal slippage. Even if the economic situation will continue to be difficult in the coming months, it is likely that without any new shock investors will focus on the future peaks rather than on the present valley in which Europe is currently engaged.

17. And as the European stock market is cheaper than the US one, we could then see a significant outperformance of the old continent compared to America.

18. In China, the political transition is finally over and salvation could come from the fact that the Chinese authorities will now want that the first months of the new elected leaders go on smoothly. They should therefore take aggressive measures in order to ensure that growth remains well supported.

19. From this point of view, it is interesting to note that if in 1992 the military accounted for more than 80 % of the Chinese politburo, they are just 30 % this year. And they have been replaced by representatives of the provinces, which political weight has now reached a level indicating that the process of redistribution of resources from the rich coastal areas towards the poor areas inside the country will keep on growing. Such a scenario would be good for the economy since it would allow an increase of domestic demand and would also help to reduce political tensions.

20. Damnation would obviously be that the measures that will be taken to boost growth will be insufficient, with an economy showing signs of weakness, which if they are not well contained, would weaken even more the patient. Another risk would be that the escalation in geopolitical tensions would reach a point where investors become scared.

21. Finally, in the United States the situation is clear. Salvation would be an agreement on the fiscal cliff by the end of the year, with the main obstacle on the road to higher growth thus lifted. And ideally it would be coupled with a compromise between the two major parties during the first quarter to control the deficit over the long-term in a credible way. This would be very positive for US assets and the dollar.

22. Damnation would obviously be a bad remake of the farce that we witnessed in August 2011, with stalled negotiations on the fiscal cliff extending until the end of March which is the deadline for the approval of a new increase of the debt ceiling.

23. And, taking into consideration the pros and cons, we believe that the time has come to gradually raise our risk in the portfolios by increasing the equity allocation.

24. Several factors justify this decision. In the US, President Obama has just been re-elected and members of Congress have interest in solving the fiscal cliff as quickly as possible. They should not want to relive the previous episode of the debt ceiling rise. We also believe that the decision to move to a policy of unlimited monetary easing - and this until unemployment has significantly dropped - is revolutionary. Clearly, the inflation issue has been relegated to the background and everything will be done to accelerate growth.

Equities (25-28)

25. In Europe, despite the fact that the recent negotiations regarding Greece have been long and difficult, they had no influence on the markets. This is a sign that the debt issue should not have an economic impact in 2013. This means that the euro zone could emerge from recession in the second half of 2013.

26. In China, one must be aware that its leadership has become conservative, i.e. that its main objective is to satisfy its population in order to prevent unrest. It can also be noted that for several months the country is engaged in an experiment which consists in allowing - and sometime even encouraging - criticisms of regional leaders and their policies, while keeping a lid at the national level.

27. Finally, one must always keep in mind 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. An example of this situation is Switzerland, which had to inject billions of francs in order to maintain the 1.20 level between the euro and the Swiss franc.

28. Thus, all these factors justify the increase in our equity exposure and if all countries choose salvation to damnation, global growth in 2013 could be much better than what is currently expected.

Bonds (29-33)

29. The current consensus among investors is that because interest rates will remain low for a long time, any bond, regardless of its quality, duration or yield, must be purchased. And since they are all geniuses, they will be able to get out in time, just before the yields' rise.

30. The only small problem is that they completely ignore which will be the factor that will trigger the rise.

31. As we have mentioned previously, only the scenario that prevailed in 2012 of poor growth coupled to the memory of the 2008 debacle has enabled this sector to reward the investor and particularly in its most risky part, the high yield one. These bonds were previously called "junk" and there is no doubt that when the market reverses they will regain their original denomination.

32. Typically, we are here at the end of a bull cycle where it is the worst quality assets which rise the most and it is probable that some of these high-yield bonds will prove to be as toxic as were some equities of the Internet bubble.

33. But back to quality bonds. A US government 10-year bond has therefore a yield of 1.60 %. In 10 years, USD 1'000'000.- will provide a total return of USD 172'025.55, including interests on interests. If today an investor positions himself for a rise of this yield, this amount of USD 172'025.55 represents the loss that he would suffer on the trade if the yield remained unchanged for 10 years. But it would be sufficient for the yield to move at that moment back to 3.75 %, the level at the end of 2009, in order to recover its loss, despite 10 years of error.

Bonds (34-39)

34. One can also analyze the operation from another angle: an investor who chooses to leave his money in the bank at 0% will receive the same amount of USD 172'025.55 as the initial investor if in 5 years the yield on the same bond, which has then only 5 years to maturity, is at 4.60%. And 4.60 % was the "normal" rate before the crisis as it was composed of a 2 % real rate to which an inflation of 2 to 2.5 % was added.

35. And we consider that the potential risk / reward is such that the smarter investors are just waiting for the right moment to position themselves to benefit from higher yields. This is one of the reasons why we believe that volatility will go well beyond expectations in this sector.

36. Presently, institutions, and the public in general, have reduced their equity holdings by more than 90% compared to 2000 and therefore the exposure in their portfolios is mainly in bonds and equivalents. For example, UK pension funds hold more bonds than equities for the first time in more than 50 years.

37. By following a rearview mirror policy they feel reassured given the performance of the fixed income sector in recent years. And once again they are forgetting one of the most important laws of nature: the regression to the mean. Over the last 30 years, the average yield on the 10-year bond U.S. government is 6.2 %.

38. We therefore reiterate caution once again. An exposure to long-term bonds or to "bad debtors" is justified only in special cases and investors should focus on fixed income debt of countries with sound fundamentals.

39. And as the concept of "bad debtor" varies according to each investor, there is a simple rule to apply: a bad debtor is one from which the investor would not have bought bonds before the crisis of 2008, because it did not fit his risk profile at that time. If this was the case, these bonds should not be in his portfolio today.

Currencies (40-44)

40. This sector continues to be quite serene since the major currency countries have strengths and weaknesses which tend to neutralize each other.

41. Therefore we do not see presently any screaming opportunity.

42. But in the long run, we can envision a scenario that could lead the euro to become the strongest currency in the world.

43. From the start of the single currency, we regularly mentioned the fact that sooner or later the euro would have to prove its worth on the battlefield and it is only then that we could assess its true value. And as a matter of fact, until now during the Battle of the Debt, the soldier euro sometimes yielded ground under the onslaught, but did not fall apart.

44. The calm in which the latest negotiations regarding Greece took place could be the first sign that the Battle of the Debt, at least in its present form exclusively concentrated in the euro zone, may be close to an end.

Currencies (45-47)

45. And paradoxically the euro would then emerge stronger. We mentioned last month that following this crisis the euro zone found itself with a model equivalent to the gold standard one. Indeed, the lack of cross-border credit requires each country to have at a minimum a flat balance of payments. For example, the Irish balance of payments is positive since the third quarter of 2010, the Spanish and Greek ones since July 2012 and the Portuguese and Italian are very close of being in equilibrium. Only France is the black sheep with a strong deterioration since 2008 and this is a major source of concern regarding this country.

46. The bad news for the Mediterranean countries which are members of the euro is that they will have to adapt to a structurally strong currency. Growth through devaluation is well and truly over as long as they remain in the single currency.

47. And it is therefore their ability to demonstrate that they can adapt to the new rules of the game which will strengthen investor's confidence in the survival of the euro. But with the paradoxical result of having the euro rising even more.

Commodities (48-51)

48. It was a rather quiet month in this sector but the same worry remains : the evolution of the industrial commodities prices are not pointing to a growth acceleration in the emerging countries.

49. We interpret this to be a sign that these stock markets will underperform the developed countries ones in coming months.

50. With a rise close to 10 % for 2012, gold should be once again one of the winners of the year. And it has been by far the best investment of the decade in terms of risk / reward with a return of 16 % in dollars per year. And this should continue as long as real yields remain negative.

51. It is interesting to note that silver had the same performance as gold over the decade. Thus, investors are not being paid for its much higher volatility than the yellow metal.

Conclusion (52-56)

52. It is always dangerous to be against central banks and this is why, despite our dislike of most bonds we do not want, for the time being, to position ourselves towards higher yields.

53. But we are even more willing to take advantage of the other central banks' objective which is to obtain a stronger growth at any cost.

54. This has led us to increase our equity allocation. It should also be noted that despite the bad mood in developed countries, the FT World index is up more than 10% for the year. This silent rise, almost clandestine, indicates that we are far from any exaggerated euphoria.

55. And this increase is even more remarkable because it took place despite strong sales of equity funds by investors. It is a sign that we are in an accumulation phase by the so-called strong hands.

56. However, while defending this hope of salvation for the world economy, we are aware that damnation is always possible. This is the reason why we are not increasing risk in an aggressive way and the present move could quickly be reverted if politicians of the various countries are unable to take the right measures for their economies.

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