Market Outlook

A monthly commentary on financial markets
written on June 1st, 2012

A GREEK TRAGEDY

Generalities (1-6)

1. The two fears mentioned in our previous letter - the situation in the euro zone and the evolution of the Chinese economy - reappeared during the month of May and raised a storm in financial markets.

2. Thus, equities fell sharply during the month : -10.3 % for the Nikkei, -8.1 % for the Euro-Stoxx 50, -7.3 % for the DAX, -7.2 % for the Nasdaq and -6.3 % for the S&P. Regarding emerging markets, one number can illustrate the turnaround of investors' sentiment : the Bovespa index of the Brazilian stock exchange, which was up 27 % in dollars at the beginning of March, is currently down 11.1 % for 2012 and 31.1 % since its peak ! Broadly, the MSCI Emerging Markets dropped 11.9 % in May.

3. And, as it has been the case since the beginning of the debt crisis, US and German government bonds were once again the main beneficiaries making historic new lows. Thus the yield of the 10-year US government bond declined to 1.56 %, while its German equivalent ended the month at 1.20 % !

4. However, moving in the opposite direction, the risk premium on investment grade European bonds rose from 140bp to 179.3bp and their US equivalent from 66.8bp to 84.2bp.

5. And as usual when things are quite bad, the dollar strengthened in May against almost all currencies with for example, an identical rise of 6.7 % against both Australian dollar and euro. The odd move was a fall of 1.9 % against the yen. One can also notice that the rise against some emerging countries' currencies has been even more dramatic, since it reached 19.3 % against the Brazilian real from late February. For the moment, and contrary to the impression one might have, it is not just the euro moving down, but its rather the dollar which is benefiting from its safe haven status. This is a sign that problems go beyond the situation in the euro zone.

6. Finally, and unsurprisingly as well, the CRB commodity index fell 10.8 %, with quite all its components declining, with the exception of natural gas. One should notice that oil was down 17.5 %.

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Equities (7-18)

7. At the time of choosing the title of this report, several images appeared to us.

8. One was of the serial killer character which the audience believes that the hero had successfully neutralized at the end of an episode, but who is able to return in the following one to terrorize again.

9. Or we could have called it "Groundhog Day", in reference to the 1993 movie in which, as the hero Bill Murray, investors feel that they are reliving the same day over and over, since from the beginning of this crisis the ability of Greece to frighten the markets has remained intact.

10. But we decided to choose the title "A Greek tragedy", a term well suited to the current situation since the very purpose of this theatrical representation was not to tell a mythological story - which was anyway well known to the audience - but to show it, to make it real, to have the viewer feel how close, immediate, contemporary the drama is to him. The goal being that through this experience he will learn a lesson.

11. There is no doubt that what the country has been living in the last two years looks suspiciously like a Greek tragedy, since whatever the actors do, the implacable wheels of destiny seem to be able to inexorably lead to the tragic end, towards this exit of the euro and the massive destruction of its economy.

12. And as was the case for the Athenian audiences of that time, the tragedy being played in front of our eyes vividly illustrates the dangers that lie ahead for other countries and undoubtedly it must now haunt the nights of many European leaders.

13. Everything and its opposite have already been said about this drama and its eventual outcome. It seems therefore unnecessary to us to go into it. Que sera sera.

14. We would simply like to point out that if the leader of the extreme left party Syriza has been so successful, it is because there is effectively a problem regarding what is being asked from Greece in the memorandum the country signed in order to receive an assistance of EUR 130 billion. The European Union has wished to limit the restructuring of the Greek debt to private creditors only and consequently the country continues to suffocate under its debt's weight. In order to comply with the memorandum, Greece will have to maintain a primary budget surplus - i.e. before interest's payments - of 4 % of GDP and this for ten years. And after these ten years it would then be "rewarded" by a stabilization of the debt to GDP ratio at 120 %. It is political-fiction to imagine that a nation can durably accept such a situation.

15. The losses on Greek debt held by public organizations will also have to be recognized and the sooner the better. The only question is to know how it will happen; but a return to normality necessarily means that debt is reduced to a manageable level.

16. But, it is also inevitable that Greece will be obliged to do what it promised and not done yet in terms of reducing the cost of the public sector and the closing of unprofitable state-owned companies.

17. In summary the maintenance of Greece in the euro zone implies that sooner or later this memorandum will be modified to make it more realistic for both sides. And this could happen in the weeks following the Greek elections.

18. Otherwise this Greek tragedy will arrive to its predictable end, with Greece being the designated scapegoat to appease the wrath of the Gods.

Equities (19-28)

19. And the sad irony is that this could happen at the same time when all are acknowledging that, under the leadership of Germany, the deflationary policy consisting of just putting into place austerity plans has run its course. And the Europeans are increasingly attracted by the very lax US monetary and budgetary policy which seems to be working since currently the US is enjoying decent growth and falling unemployment. Even the SPD, the left opposition party in Germany is demanding reflationary measures.

20. Thus, the war between deflation and inflation is hotter than ever and one can expect that sooner or later the deflationary impact of the current situation will necessarily bring a counter-attack - in a manner that will allow Mrs Merkel to save face - but with new aggressive reflationary measures.

21. In the same way that we had warned earlier this year against an excessive optimism, we can only recommend today that investors remain cool in relation to present events.

22. If one should never underestimate the ability of European leaders to act in an insufficient manner and always late, it is also inevitable that any negative effect linked to the Greek situation will be fought vigorously. Europeans will not let their economies collapse into monetary chaos without having tried everything.

23. One last word concerning Greece. The entry in the European Union was how Europeans supported the return of democracy in the country in 1974. And this model was afterwards used in Spain and Portugal, and then with the former Soviet bloc countries. Therefore, it would be a strange turn of circumstances if the euro became the instrument that would bring chaos to the country, thus opening a path for the appearance of an authoritarian government.

24. This means that, regardless if it is in the euro or not, the Greek problem will not disappear for the other European countries. It will even become more and more political.

25. The uncertainty linked to this situation will continue to impact markets, but unfortunately it is not the only cause of concern : the weakness observed in May is also due to fears of a greater slowdown than desired in emerging countries.

26. We have already mentioned the case of Brazil. There is no doubt that the dramatic trend's reversal is a very bad sign; and this especially at a time when interest rates are declining in the country. A market which goes down with interest rates going down is a sign that the economy is in poor health.

27. And regrettably, China is also in the same situation : the monetary easing that was done until now by the Chinese authorities did not result in a bull market. Another barometer of economic activity, the price of copper - which was up mid-February by 10 % for the year - is currently down 4.9 %.

28. It is known that China presently has a problem in its real estate sector : prices are too expensive relative to purchasing power and inventories are high. What is less known is that there is also a significant financial leverage in this sector. Unlike the US - where debt was at the individual level through mortgages - indebtedness in China is currently located with property developers who not being able to sell their finished products anymore, are unable to reimburse their loans. For now, banks are in the "pretend" phase : loans are extended to give an impression of normality.

Equities (29-35)

29. Even worse, companies in this field of activity continue to act as if nothing happened. The market mentions for example, the case of the company Zoomlion Heavy Industry, which manufactures construction equipment and which is currently selling its machines with a vendor loan of 100 %; this means that there isn't any payment on delivery. And those who purchased these machines can at that moment use them as collateral to obtain loans from the banks for themselves.

30. We know that China is currently in a transition political phase with the change of their leaders and they probably have other concerns than the economy. Furthermore, Chinese authorities remember that after the 2008 crisis they had boosted too strongly the economy, thus creating both inflation and a real estate bubble. They will therefore probably make the opposite mistake this time.

31. We therefore consider that the current market decline is also due to the discounting of a sharper slowdown than expected of the Chinese economy and which should become visible this summer.

32. This situation can only bring a strong reaction from the Chinese authorities by the end of autumn at the latest. As it will be the case with the European Union, China will respond to the current deflationary pressures.

33. The only unknown is therefore to establish what will be the intensity of the downward pressure that markets will have to exercise in order for governments to react.

34. In democratic countries citizens currently often feel that it is markets which are deciding rather than their elected representatives. The reality is more complex since it takes two to dance a tango. In the same way that by street demonstrations pressure is put on a government to move in the direction desired by the protesters, markets "demonstrate" in their own way, by falling, in order to make a problem visible and painful. In reality, by their actions but also by their inaction, never in a generation the political class has had such an influence on markets and thus on the economy.

35. And by the way this situation is a real nightmare for money managers, since it is totally unpredictable. Markets fall until they get a political reaction, and when it happens, they move back up. This is why the stock market is currently performing in an abnormal way. Ordinarily a downward move is twice as fast as the upward one, but actually declining phases tend to go on for a while, whereas rising ones are compressed and brutal, as we witnessed at the beginning of the year.

Bonds (36-42)

36. In the same way as governments, investors do not want to repeat the mistake they made recently and thus they usually fall in the opposite extreme. So, right now, the cost to protect against an extreme event like the one they suffered in 2008, i.e. a decrease of 50 % of the US stock market, is very expensive.

37. Or, on the contrary, because it worked last time, investors looking for protection are rushing to buy US and German government bonds at whatever yield.

38. Germany has even issued a 0 % bond for two years. If for the moment the bond is trading below par for an annual yield of 0.05 %, it would not be surprising if the yield became negative in coming weeks.

39. And all this is happening despite the high debt level of all developed countries. And the paradox is of course that if investors' fears were to happen, this will lead to a worsening of the economic situation, thus substantially increasing the size of the debt.

40. And if months like this May rekindle our fears that deflation could prevail, we believe that sooner or later popular pressure will be such that, each one in its own way, countries will move towards substantial reflationist policies.

41. Finally, it should be noted that the 0 % interest rate is inducing investors to do a lot of foolish things because there is nothing more annoying than having money in a current account earning nothing. But patience is essential in the current context. Too many things can go wrong and one must keep its powder dry. Maintaining a rather liquid portfolio is thus necessary.

42. This is the reason why we continue to hold an important cash position at 0 % without taking a bond risk as it is more and more insufficiently remunerated.

Commodities (43-44)

43. The decline in industrial raw materials signals the end of a cycle in China. As it was previously the case for Japan and South Korea at this stage of their development, China's economic growth will slow to around 7 % against a double-digit figure previously. Furthermore, it will move towards the domestic market, in order to meet the needs of the population in consumer goods as well as products and services linked to health and technology.

44. The early 21st century has been an extraordinary decade for commodities with the CRB index more than doubling thanks to Chinese demand. This growth is now coming to an end because, on the one hand, this demand will not increase at the same pace than before and, on the other, the high prices of previous years allowed the necessary investments to be made in order to increase supply.

Commodities (45-48)

45. Anyway, presently industrial commodities remain vulnerable to the current slowdown in China.

46. Regarding gold, its decline is a testimony of the new deflationary wave which is now impacting markets. At this moment, gold is back to its beginning of the year level, but even if it would end 2012 with a negative return, this would not be serious after eleven consecutive years of increases.

47. As long as real yields continue to be negative and that the debt levels of developed countries remain at current levels, the bull market will be intact. And when it will start advancing again, the move could be explosive.

48. Finally, we must note that the decline in the gold mining sector is excessive as illustrated by the fact that this sector is valued at half the level of where the stock market is trading at.

Currencies (49-52)

49. The current rise of the dollar reflects the fact that presently the US economy is doing relatively better than the others.

50. Insofar as the crisis of 2008 broke the credit's mechanisms, money is not properly circulating and it remains often trapped with banks. And the FED realized that in such a context it could make massive cash injections in order to stabilize the financial situation, and this without increasing inflation, since what is important is not the absolute amount of money introduced in the system, but the speed at which it circulates in the economy.

51. However, we consider probable that the FED will have great difficulties in removing these liquidities at the right moment. If it is done too early, the economy will relapse and if it is done too late, inflation will have taken hold. Personally, we believe that since the FED will be quite cautious in order not to damage the economy, the second option is more likely.

52. Meanwhile, in the currency market the situation is simple : as long as reflationist measures are not taken by the rest of the world, the dollar will continue to behave well in relation to most of the other currencies.

Conclusion (53-59)

53. While developed countries economies have been rather stable, with almost no growth but also without any severe recession, financial markets have been moving from euphoria to depression and then reversing again in just a few weeks. This has led to dramatic moves, but almost randomly, with at the end no real progression in one direction or the other. Hence, a frustrating stagnation of performance, since with a 0 % interest rate the waiting time is not remunerated.

54. But unfortunately there is no other choice. Patience is needed until the situation has clarified.

55. Furthermore, quite a lot of care must be taken in order not to be injured by this volatility. In the same way that we recommended earlier this year not to increase the risk on the upward move - which was much too violent - it seems important to us not to become on the contrary too pessimistic.

56. Markets are still traumatized by the 2008 events and they tend to overreact to many events.

57. Of course, the situation is difficult and may continue to worsen. And from this point of view the markets' behavior in June will provide an indication of the need to reduce risk especially given the aborted bull move of the beginning of the year.

58. But we must not forget that sooner or later aggressive measures to correct the current economic weakness will be taken.

59. Thus, the risks of being wrong-footed in the downwards move, as it could have been the case during the rise earlier this year, are not negligible.

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