Market **Outlook**

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

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Generalities (1-5)

1. At the beginning of October, equities continued to move up following the announcements of new expansionary measures by central banks. But, afterwards, markets corrected as it is now necessary for the real economy to show signs of improvement.

2. Thus, for the month, while the S&P fell by 2 % and the Nasdaq by 4.5 % in Europe, the DAX moved up 0.6 % and the Euro-Stoxx50 2 %. In Japan, the Nikkei was up 0.6 %. Finally, the emerging market index in dollars was down 0.4 %.

3. A slight increase in bond yields with the 10-years German government bond ending the month at 1.46 % and at 1.69 % for its American equivalent. As for the risk premium on corporate bonds, it fell 129.9bp for the European investment grade index but increased to 41.7bp for the US one.

4. The month has been quiet for the foreign exchange market with a dollar index unchanged at 79.9 and against the euro the greenback ended the month at 1.2960.

5. Finally, a sharp decline (-3.1 %) of the CRB/Reuters commodity index with a decline for the month of 12.34 % for the Nikkei, of 6.5 % for the silver and of 6.4 % for oil.

IN THIS ISSUE

P1 Generalities

P2 Bonds (6-20)

P3 Bonds (21-26), Currencies (27-28)

P4 Currencies (29-38)

P5 Currencies (39-43), Equities (44-47)

P6 Equities (48-52), Commodities

P7 Conclusion

Bonds (6-20)

6. When the bond bull market began 31 years ago, US debt was at USD 789 billion. The site usdebtclock.org vividly illustrates the fact that the debt has currently reached USD 16 trillion, or as we indicated in our title 16 followed by 12 zeros !

7. With a projected deficit of 7.3 % of GDP in 2012, debt is increasing at the rate of USD 3.5 billion per day. As a remainder, the deficit was respectively in 2009, 2010 and 2011 of 10.1 %, 9 % and 8.7 %.

8. To this we can add the fact that the government future commitments under the current laws, adjusted to the present value, represents over USD 100 trillion.

9. Finally, the deficit of the balance of payments exceeds USD 100 billion per quarter which means, that every quarter, foreign investors must agree to keep an extra USD 100 billion to avoid a fall of the greenback.

10. All these figures are known and have been known for so long that we may believe that they are of no significance.

11. And all the more so that the FED has decided to artificially lower interest rates by massively purchasing bonds, thereby encouraging investors to do the same.

12. Thus, net inflows to U.S. bond funds were USD 237 billion for the first 9 months of the year, while for the same period outflows from US equity funds were at USD 78 billion, with also large direct purchases from individual investors. And this massive buying has spread to all other bond markets.

13. We already mentioned previously, how difficult it will be to find buyers once the move reverses as banks can no longer ensure a market in this sector.

14. And one must also remember that the low level of interest rates increases the risk in a bond. For a 10-year bond issued at 2 %, if the yield were to increase to 3% it will reduce its price from 100 % to 92.2 % if there are still 9 years to maturity. This means that it will take three years to recover from the decline given the 2 % rate.

15. Today investors are reassured by the fact that an increase in either inflation or interest rates seems far away.

16. The trouble is that we really can't be sure of that. Never has a central bank tried such a strategy and therefore we ignore the effects that it will have on the economy.

17. The analyst James Grant recently recalled two statements by Mr. Ben Bernanke. On 28 March 2007 the Fed chief said: "Yes, house prices had begun to weaken - they were down 1 % from the peak. At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained".

18. Then, in a speech he declared : "The Federal Reserve is not currently forecasting a recession". This was in January 10, 2008, one month before the beginning of what Americans now call The Great Recession.

19. And it took only 10 months for the Queen of England, in November 2008 on a visit to the London School of Economics, to ask why economists had been unable to foresee the crisis.

20. If we recall these facts, it is not to suggest that we are in a similar environment, but only to point out that if the Fed could have been so seriously wrong in a "traditional" situation, the possibility of a mistake is much greater with this "revolutionary" policy and it would be odd that there will not be unexpected and surprising consequences.

Bonds (21-26)

21. There is also an irony to the fact that, by its massive purchases, the FED is contributing to the overvaluation of an asset - bonds - as was previously the case with the real estate market.

22. If it is too early to make a judgment on this policy, some observations can be made. The zero interest rate policy poses a serious problem to savers because it greatly reduces their income from this source and thus their ability to consume without reducing their capital. However, it is not that obvious that this policy is so helpful to debtors.

23. As a matter of fact, after a financial crisis it is not the level of interest rates which is problematic and could explain why the demand for credit is as low as it is currently the case in the United States. Quite simply, households after having spent too much during the phase of the housing bubble need to reduce their indebtedness (and they continue to need to do so). Thus, they do not seek to borrow but to reimburse and this also takes time. Therefore, this phenomenon is largely independent of the level of interest rates.

24. In conclusion, instead of wildly expanding the monetary base, it is not impossible that the same result could have been obtained by holding the prime rate at 1% for example while taking steps to reduce the difference between this nominal rate and the effective rate that debtors must pay for their loans as this would have substantially reduced their debt burden. This is what the FED is trying to achieve now with the purchase of mortgage bonds, which will necessarily reduce the cost of a mortgage. And it should be noted that to achieve this goal, the FED purchases in this sector will be far lower than the ones it did with treasury bonds.

25. It is also surprising that the FED did not try to lower the level of the interest rate that the American consumer pays on the outstanding balance of his credit card which remains well above 10 % per year.

26. In conclusion, the current monetary policy brings too many uncertainties and this leads us to avoid bonds issued in currencies of developed countries as yields are quite inadequate and we prefer to focus on the debt of countries with strong economic fundamentals and a positive balance of payments.

Currencies (27-28)

27. The balance of payments is also, in the long run, the main factor explaining the evolution of an exchange rate. A country whose balance is positive becomes richer, while a negative number indicates an impoverishment.

28. This impoverishment leads to a fall in the value of the currency and leads to a higher level of inflation and interest rates. Thus, these two elements help on the one hand to reduce imports as they become more expensive and on the other to promote exports through a more competitive currency. On the opposite, countries with sound fundamentals attract capital and therefore benefit from a lower level of inflation and interest. However, they must deal with a strong currency which increases the export prices of their products and services.

Currenties (29-38)

29. The creation of the euro created a problem, as these rules seemed not to work during the first 10 years of the single currency. Investors during this period acted as if all the members of the single currency were the same since the risk of currency devaluation had disappeared inside the zone.

30. Thus, started for the weaker countries of the area a feast: they not only enjoyed interest rates that were below their inflation level but furthermore investors rushed to lend them money. And so, the yield on the 10-year Greek bond did not exceed 0.5 % per year compared to its German equivalent.

31. Therefore, it is not surprising that these countries became less and less competitive. Using as a base 100 in 2000, ten years later the labor unit cost in Germany was at 105 against 145 in Greece and 135 in Spain. And even worse, with this "easy" credit, many resources were wasted.

32. So when the crisis came in 2009, the deficit of the balance of payments, which had increased year after year, became unmanageable with an annual deficit of more than 10 % of GDP in Greece and Portugal, and 6 % for Spain. At the opposite, countries such as Germany and the Netherlands had a surplus of more than 5 %.

33. It was then that investors realized that they had exchanged the risk of a monetary loss for the risk of default.

34. As a matter of fact, the so-called debt crisis is nothing more than the painful adjustment of this imbalance. Once foreign investors are gone, the deficit countries must correct the imbalance and to the extent that they cannot devalue, the adjustment must be done by deflation. A fall in the purchasing power reduces consumption, and hence imports, whereas a drop of labor costs for the products they have to offer, such as tourism, makes them more affordable.

35. And the adjustment is even more difficult since as a whole, the euro area does not have a deficit in its balance of payments, thanks mainly to the German surplus. This makes the currency attractive when compared to the dollar or the pound. However, a "strong" currency is the reverse of what weaker countries need presently.

36. It is therefore not surprising that the countries around the Mediterranean would like to see a redistribution of resources happening within the area. At their head is France, which alone among the countries in the zone saw the deficit of its balance of payments increase between 2009 and 2012, from 2 % of GDP to a level that should be close to 4 %.

37. Of course those who will be asked to pay are not favorable. As an answer to this request, Germany is proposing to form a kind of fiscal union and this without qualms as it knows that it is quite far away. But, should this option be explored in greater depth, it would quickly become obvious that the German objective would be to prevent the current nation states to raise debt and therefore only the European Union as such should be able to have a budget deficit.

38. Anyway, the peak amplitude of the gap between the strong and weak countries is behind us. Indeed, this gap should gradually decrease as on the one side costs will increase quicker in the north than in the south of the zone, and on the other, domestic consumption is improving in the countries with a better economic situation, such as Germany.

Currencies (39-43)

39. And an interesting test could come from Greece in 2013. If indeed the primary balance of payments (i.e. before the payment of interests to abroad) could be at equilibrium, as it seems that this was the case in recent months, then the most difficult part may have been achieved. And then, the GDP decline in 2013 could even be less than what is expected today; while in recent years the reality was much worse than the expectations.

40. If the internal situation of the area could self-correct in this way – which the richest countries not helping the poorer ones as is commonly done inside a country where for example in Italy the north subsidizes the south - then euro countries may have recreated inside their zone a system similar to that of the gold standard.

41. In this system, gold is the means of payment used to settle international trade. In it, mechanically a deficit of the balance of payments corrects itself since countries that have no gold cannot buy foreign goods and must therefore reduce consumption and increase exports to obtain the yellow metal.

42. This system is loved by many because it prevents inflation to appear as the currency of a country is subordinated to its gold reserves. The downside is that it prevents the development of trade and economic growth because the liquidity in the system is dependent on the production of gold.

43. A last word on the fiscal discipline treaty which requires countries to limit their deficit. It is a pity not to have integrated in it a rule limiting the deficit of the balance of payments. Indeed, this new treaty would have not prevented the crisis in Spain since during the real estate bubble its public accounts were quite good, when in fact they hid the important private sector indebtedness and a growing balance of payments deficit.

Equities (44-47)

44. Logically, the equity bull move was stopped by the three uncertainties that we have been mentioning in the past months.

45. In the US, the indecision of the outcome of the U.S. elections and how Congress will address the fiscal cliff justifies the wait and see attitude of investors.

46. In Europe, if the strong words of Mr. Draghi soothed the markets, budgetary policy remain restrictive in many countries.

47. Lastly, China is changing its leadership and therefore many political unknowns remain. In addition, there are still strong divergences regarding the economic situation. For some the most acute phase of the downturn is over, while for others there are no concrete signs that the Chinese economy is about to rebound. They mention the fact that the production of electricity is almost not increasing and that the monetary easing done until now is insufficient.

Equities (48-52)

48. And one should note that on a technical note, the emerging countries index is currently trading inside a band where the bottom is at the 200 days average and the top at the 400 days one. Normally, we should have a significant move of the index once we break out from this range.

49. Therefore, for the time being, we have not modified our conservative risk allocation but this could quickly change during the month.

50. Finally, we would like to mention that we have begun to closely monitor the situation in Japan as the stability phase of the last decade could come to an end in 2013. This phase is characterized by a long deflation period and whose consequences have been a currency which regularly rises, a weak stock market and a 10-year bond yield below 1 %.

51. The change is linked to the Fukushima accident and the subsequent shutdown of the nuclear power plants. The economic consequence is that Japan must now massively import energy and therefore its trade balance has gone into a USD 40 billion deficit for the six months ended September 30. The question is whether the balance of payments will also become negative or not as the monthly trade deficits accumulate.

52. This is essential because Japan has been able to finance its debt, which has reached 240% of its GDP, thanks to the surplus of its balance of payments. Indeed, thanks to this surplus, the currency has a natural tendency to move up. Exporters know that and they quickly sell their foreign currency. And the resulting excess of yens is naturally deposited in the national debt market which is approaching USD 12 trillion.

53. Some argue that even if the balance of payments became negative, reserves outside Japan are such that these assets could easily fill the gap.

54. We're not so sure. When the country is in surplus, an exporter rushes to buy yen because he fears that his neighbour may do so before him. But in case of deficit, the situation changes: the urgency disappears. And if each exporter becomes more cautious, then the yen may fall. Such a scenario is favourable for Japanese equities. But what will be the effect on bond yields and how will the indebtedness be managed ?

55. And will there be an impact on the yields of other countries ?

56. In short, we will follow with interest the indicators coming from Japan in the coming months since surprises are not to be excluded.

Commodities (57-60)

57. Nothing in the behaviour of industrial raw materials indicates a reacceleration of Chinese growth.

58. This is confirmed by the fact that industrial production in emerging countries is not increasing.

59. Similarly, shares of industrial companies in developed countries have so far underperformed their indices. It is a sign that global demand remains weak.

60. In conclusion, without the participation of emerging countries, it will be difficult for equities to rally in a substantial way.

Conclusion (61-66)

61. On the one hand the efforts of central banks are large enough to support equities and it is sufficient that just a small portion of bonds maturing in the next months be invested in shares to be pleasantly surprised by stock markets.

62. But on the other, with the exception of the USA - where growth is well established and where only a political mistake could derail the economy - the world has difficulty in taking the path of a stronger growth.

63. This is what needs to change in the next weeks or we could have a new downturn in equities.

64. However, any decline will be limited in time because as the FED indicated during the launch of its latest quantitative easing program, the priority is not anymore the fight against inflation but the search of a stronger growth to reduce unemployment.

65. As for bonds, we are worried enough by the increase in the debt level of most of the developed countries to take on a risk in this area and in particular at such low yields. This market reminds us of a driver, too confident in his abilities, driving too fast in bad weather. We don't wish him any harm but there is no reason either to be his passenger. An unexpected event - Japan for example - is always possible.

66. To this policy we prefer the Italian saying "Chi va piano, va sano e lontano", which literally means "Who goes slowly, goes safely and goes far." And for us this means deposits and bonds investments in currencies of countries with sound fundamentals.

Marketoutlook

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