Market Outlook

A monthly commentary on financial markets written on November 3rd, 2014

COMMODITIES BEAR MARKET = RECESSION ?

Generalities (1-8)

1. October has been so far the most exciting month of the year, with ample daily movements.

2. We concluded our last month report by stating that "The recent fall of bond yields, of gold, and the need for China to provide oxygen to its economy has put us back in a position more uncomfortable than the one we were hoping to be today".

3. And it was this increase in uncertainty which impacted financial markets during the first half of the month.

4. Thus, the 10-year US government bond yield declined dramatically from 2.49 % below 2 %, before ending the month at 2.33 %. Same development for its German equivalent, which fell from 0.95 % to 0.76 % to end at 0.84 %. On the other hand, the Bloomberg USD High Yield Index yield moved in the opposite direction : from 6.26 % to 6.60 % and 6 % by the end of October.

5. In relation to equities, this led to a sell-off of major European markets which are now in a correction phase with a decline just below 15 % from the year's high to the level reached on October 15th. For the month, the DAX was down 1.6 % and the Euro-Stoxx 3.5 %.

6. The maximum decline was much more modest for the major US indices (about 7 %) and we even closed at a record level for the S&P 500 which for the month was up 2.3 % while the Nasdaq was up 3.1 %. The Nikkei (1.5 %) and the MSCI Emerging markets index in USD (1.4 %) also rose.

7. Meanwhile, commodities continued to decline (-2.75 %) with, in particular, a much noticed drop of oil to USD 80.-/barrel.

8. And if, during the month, the currency market was the quietest one, the announcement on October 31 by the Bank of Japan (BOJ) of an increase of its quantitative easing (QE) policy allowed the dollar to rise both against the yen (112.3) and the euro (1.2525).

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Commodities (9-18)

9. Traders are still quite confused by the recent moves and the increased volatility which came with it. This is probably due to the fact that this happened because of an accumulation of various factors rather than for a specific reason.

10. Indeed, in the United States, October marked the end of the QE policy and uncertainty is growing regarding how interest rates will evolve in the future. In Europe, deflation fears have become a favorite economic topic for the media. Finally, many emerging countries continue to suffer a deterioration of their economic situation.

11. All these elements triggered a fall of equity markets in the first half of the month. For bears, this move had been announced by the continuous decline in commodity prices which, from the 2011 peak currently exceeds 30 %. They believe that it shows that the global economy is ever more fragile and that the low demand for these products, especially from China, is an advanced signal of a coming sharp slowdown in global growth, which could even bring a new recession to the western world.

12. The problem with this argument is that the correlation between a fall of commodity prices and an economic slowdown is historically quite low. Indeed, since any significant increase in the demand of a particular commodity leads to a sharp rise in supply, it is common in the sector to have dramatic increases followed by equally noticeable falls.

13. Currently, there is no doubt that a lasting slowdown in Chinese growth has occurred as witnessed by the fall of nickel (-41 % since 2011) and copper (-27 %). But this is quite natural and countries like Japan and Korea also experienced it, once they had reached the same stage of development as China today. Therefore, the slowdown is not problematic in itself and this as long as China's growth can remain at the current annual level of 7.5 %.

14. But what the market fears today is that growth will fall even more for a reason which has nothing to do with commodities : the country's debt level. Indeed, from the end of 2008 until today, public and private indebtedness has risen from 100 % to 250 % of GDP. Normally this should have boosted growth but it is the opposite which has happened. Thus, the market is wondering what will happen when it will be necessary to reduce this excess of credit.

15. And for this reason, the risk of a potential crash in China has been in investors' minds for at least three years. This was one reason, alongside the situation in the Eurozone, which did not allow us at that time to be aggressively invested in equities.

16. On this subject, let us just mention the fact that, since the Chinese government controls all political and economic levers, it is probably quite futile to try to predict how the situation will evolve, with what consequences and for whom. We must live with this uncertainty.

17. Another segment which is heavily down in the commodity world since 2011 is agricultural products, such as corn (-50 %) and soybeans (-25 %). But this decline comes more from an increase in production than from lower consumption. It certainly impacts negatively a major producer country like Brazil, but this also reduces the financial stress for many third world countries needing to feed their population.

18. Precious metals also fell since 2011 (silver -67 % and gold -25 %) and this is a sign of increased deflationary pressures, as we mentioned last month.

Commodities (19-22)

19. And, finally, there is the drop in oil prices (-32 % for Brent since 2011). It is quite difficult for us to consider this to be bad news. Indeed, any increase in the price of oil is equivalent to a tax rise paid by all consumers in favor of a few producers. And, therefore, any decrease has the opposite effect. For example, if the barrel remains at USD 80.- during the next twelve months, each US household stands to benefit from the equivalent of a tax cut of USD 600.-.

20. Of course, the oil price decline is also linked to sluggish demand, but, on the balance, the above mentioned advantages outweigh this element of weak demand. In the current situation, this is especially true since the price decline is also due, on the one hand, to rising production and, on the other hand, to the fact that Saudi Arabia has not played its usual role of stabilizer by reducing its production. Thus, the magnitude of the decline is not linked, for the time being, to a significant deterioration of the economic situation.

21. Taken together, all these elements indicate that the fall of commodity prices is one of the manifestations of the sluggish global growth, but that it cannot be considered, at this time, as an advanced signal of future deterioration.

22. In conclusion, it would be necessary for the downward trend to continue and even to accelerate in order to be considered as a reliable leading indicator of a sharp slowdown, or even of a recession, in developed countries.

Bonds (23-26)

23. Traders used the term "flash crash" to comment on the US government bonds yield's decline which happened on October 15th. Considering that a 0.05 % move is normally considered to be significant, on that day, in a little more than two hours, the 10-year bond yield dropped from 2.20 % to 1.85 %, before closing at 2.15 %.

24. This event shocked market participants as the US Treasury bond market is deemed to be the most liquid in the world and therefore a move of this magnitude should not have happened and even more so as this investment is considered to be the dullest and safest one.

25. To understand what happened, one must look at the evolution of high-yield bonds. Their yield usually fluctuates according to the evolution of the stock market. If equities are up, the yield drops quickly thus reducing the spread between them and sovereign bonds. And the opposite occurs when shares are performing poorly.

26. In early October, many hedge funds were positioned for a narrowing of the gap between these two types of yield, as they expected Treasury bond yields to move up with the end of QE and the probable rise of the prime rate in 2015. And usually, in this situation, yields on junk bonds move up more slowly as they are protected by their higher coupons and by the improved economic situation.

Bonds (27-35)

27. But between October 6th and 14th, when the stock markets' declined, junk bonds' yield increased from 6 to 6.5 %, while, in contrast, the yield on the 10-year sovereign bond dropped from 2.50 to 2.20 %. And one should remember that the ability to absorb losses in such trades is limited because of the leverage used.

28. In addition, what exacerbated the situation was the fact that traditional investors were also themselves significantly underweight in Treasury bonds, as 100 % of market economists consulted by Bloomberg the week before were expecting higher yields. Thus, when on October 15th the level of 2.20 % gave way to the downside, underweight managers felt compelled to buy bonds at the same time when hedge funds also had to close their losing short Treasury bond positions.

29. Since equity markets recovered nicely after October 15th, this event had, finally, no major consequences. But it is a good illustration of the lack of liquidity in the bond market. Since October 2007, the inventory of bonds held by major market makers is down 70 %. This means that the debt market is even more vulnerable than equities in times of stress, since traders are not able anymore to provide liquidity by buying bonds for their own account in such periods.

30. But things are even worse. A growing number of transactions are executed through automated private exchanges which match buyers and sellers. However, when volatility increases too much, these exchanges quickly stop their activities, thus reducing the market's ability to deal with the flow of orders. One has to imagine a lake from which water flows through channels; channels that would close one after the other once it starts raining too strongly.

31. And this is what occurred on October 15th, giving to the events of that day a magnitude which would not have happened before 2008.

32. We consider this episode to be one of the first tremors allowing us to imagine what will happen with volatility when the inevitable big earthquake, signaling the trend reversal towards higher interest rates, will strike.

33. Most observers believe that this will not occur before many years and that, therefore, bonds remain a compulsory investment despite the risks.

34. Perhaps, but in the meantime, debt, both public and private, continues to grow at a steady rhythm while, on the other side, there are still desperate investors looking for yield and who have an increasingly short memory. Jamaica, for example, defaulted on its domestic debt in February 2013, but in July of this year it was able to issue a USD 800 million bond at 7.625 % with a rating indicating that it is of poor quality and with a high credit risk.

35. The bond market is no different than any other market. As with commodities, sooner or later, the constant increase in supply will eventually meet demand and then the downward trend in yields will reverse and the fact that the bonds' secondary market is broken will be quite painful.

Equities (36-45)

36. But what this month's events also demonstrated is that equity markets will also suffer a severe shock for the simple reason that they are the only ones, today, to be relatively liquid, even if at a lower level than before.

37. As a matter of fact, during crises, you do not sell what you want, but what you can, i.e. quality; since there is always a price for quality, even if it is a low one. But for bad quality, there is a strong probability that it will become impossible to obtain a quotation. Therefore when in need to reduce risk, investors can only sell assets where there is a price and at that moment the drop in value of quality assets hides the fact that the remaining ones are down substantially more.

38. And this is where the notion of permanent or temporary loss is essential. In 2000, at the peak of the bubble, those who held equities linked to the internet saw the invested capital reduced to dust, without any hope of recovery; while those who bought quality stocks were able at the end to recover their principal and interest on what was originally a bad investment.

39. From this point of view, any equity decline linked to this bond phenomenon will be temporary, while bond damages may be much larger and lasting.

40. Of course in an ideal world equity exposure would be reduced before the earthquake. But experience shows that this is rarely possible in practice, since there may be several episodes such as the October 15th one before the real decline starts. Furthermore, as can be regularly noticed, market price swing occur more violently and at greater speed than in the past.

41. This is the reason why we have continuously advised to hold equities at a level allowing each investor to withstand the inevitable volatility.

42. One word regarding the Eurozone. European equities are today where US stocks were four years ago. At that time, we mentioned that the market was too pessimistic about the US economic situation and that it was sufficient that the worst did not happen to allow equities to rise. And this is what happened; and then the rise continued, thanks to improved growth.

43. Currently, there is too much pessimism about the economic situation in the Eurozone. One must first note that in 2015 no country will enforce a restrictive budgetary or fiscal policy. There will be no cuts in public spending - at most a slowdown in its growth - and no massive tax increases. Mechanically, this will add 0.5 to 1 % to growth.

44. Moreover, the policy followed this year by the European Central Bank (ECB) is correct. It has spent the year obliging banks either to recapitalize themselves or to reduce their balance sheets. And after this month's stress test, the banks' situation has normalized. They are finally sufficiently capitalized and should therefore be able to grant loans again.

45. And banks will lend even more willingly as they now have a buyer for their loans, which is none other than the ECB. Indeed, the central bank has started to buy asset backed securities. The market is skeptical about the effectiveness of this policy, since it considers that there is not enough of this kind of securities in order to have the same impact as that of the American QE policy. But since demand now exists, banks will quickly structure their loans in order to be able to sell them and there is no doubt that asset-backed loans will grow in a big way next year..

Equities (46-49)

46. While this does not mean that, in 2015, European growth will be anything but lackluster, it should be sufficient, as was the case in the United States in 2010, to allow equities to rise, given the current pessimism. And especially so as the European market is one of the cheapest of all.

47. And, in this situation, it seems improbable that Europe could be in deflation next year, both because the euro has fallen this year and also because the media are now regularly mentioning this danger, a sign that everyone is aware of the problem.

48. Thus, if there was only Europe, we would be today much more aggressive towards equities. The difficulty is that, besides the bond issue and the fact that things are looking unfavorable for many emerging countries, the US stock market, unlike Europe, has not gone through a correction phase. Even if temporary, a fall by over 10% from the peak could happen in coming weeks, particularly if the market has an anxiety attack at the idea that the Fed's prime rate could rise next year.

49. In conclusion, like a worn record, we can only repeat that the main risk exposure should be made through equities, but at a reasonable level.

Currencies (50-55)

50. The lack of volatility in this sector until the last day of October was not surprising and reflects the fact that the real drama is elsewhere.

51. As we have already mentioned, volatility, which historically was prevalent in currencies, moved to equities in 2000, with the peak reached in 2008 followed by several after-shocks, and is about to emigrate towards bonds.

52. The fundamental reason for which currency volatility will remain low is the fact that every major developed country has its own problems and that no one is really better than the other.

53. In such a context, the market tends to move mainly because of speculative moves, which are difficult to predict. A good example was the BOJ decision of October 31st.

54. But once the pressure diminishes the exchange rate moves back towards its equilibrium level which for the euro/dollar for example is at around 1.35.

55. It is thus difficult to be strategically positioned in this sector.

Conclusion (56-62)

56. Global growth remains uncomfortably weak, but there is nothing which presently suggests that it could worsen, except for an exogenous shock, which by definition is unpredictable.

57. Actually, it would rather be the opposite. A moderate optimism could be justified by the fact that falling commodity prices help consumers' spending, growth is increasing in the US and now the situation should start to improve in Europe, even if slowly.

58. Certainly we still have the unknown Chinese situation as well as the slowdown of emerging countries, but for the moment the situation seems to be under control.

59. This is positive for equities in the long run.

60. However, in the short-term, the situation is more complex since the events of October have shown that the US stock market has become vulnerable to a corrective move (i.e. a decrease of more than 10 % from the peak). This could occur either because investors will have to face in concrete terms the fact that US monetary policy will become, even passively, more restrictive; or because the slowdown which happened this year in the rest of the world could eventually increase concerns regarding future American growth.

61. If investors do not have an anxiety attack, then it is likely that the US stock market will move sideways in coming weeks, which should allow the European market to start to outperform. And once initiated, this move will last several months.

62. In short, as is frequently the case for financial markets, the goal to be reached is clear, but the path to get there is always complex.