Market Outlook

A monthly commentary on financial markets written on March 1st, 2013

THE COBRA EFFECT

Generalities (1-7)

1. After a good start of the year, February was a consolidation month with no major events, even if the Italian elections added some spice.

2. Thus, the FTSE World Index in dollars was unchanged, with a positive return from Japan (Nikkei +3.8 %) and the US (S&P +1.1 %, Nasdaq +0.6 %), whereas Europe moved down (Euro-Stoxx 50 -2.6 %).

3. But in the rather optimistic context of the beginning of this year, where many analysts are expecting the start of a move that they have called “the great rotation” from bonds towards equities, the emerging market’s behavior is worrisome. Indeed, the MSCI Emerging Markets Index in USD fell by 2.1 % with noticeable declines in China (Hang Seng -5.7 %), Brazil (Bovespa -3.9 %) and Mexico (-2.6 %). Weren’t emerging countries supposed to be the driving force of global growth ?

4. Regarding bond yields, they continue to remain in a relatively narrow trading range. It should be noted, with regard to the 10-year US sovereign bond, that on the upside the 2 % yield level remains for the moment a very strong resistance and it would take at least a clear break of 2.15 % to indicate an important trend's reversal. So, at the end of the month the yield was at 1.88 % and for the German equivalent at 1.45 %. Regarding the risk premiums on investment grade bonds, they have remained largely unchanged.

5. After 6 months of consecutive increases, the euro fell against the dollar to 1.3060, probably as a result of the confirmation that there would be no growth in 2013 in the euro area. The yen also continued to fall against the greenback and this for the fifth month to 92.60. It should be noted that since the beginning of the year both the Euro Index (+1.6 %) and the Dollar Index (+2.7 %) are up. This is a rather rare phenomenon, mainly due to the sharp decline of the yen.

6. But the evolution of the yen cannot hide the fact that, globally, there was no significant decline of the dollar, which should be interpreted as a sign that global growth is not strengthening.

IN THIS ISSUE

P1 Generalities (1-6)

P2 Generalities (7-8), Bonds (9-14)

P3 Bonds (15-25)

P4 Bonds (26-34)

P5 Equities

P6 Currencies, Commodities

P7 Conclusion

Generalities (7-8)

7. This is also confirmed by another decline in the CRB/Thompson/Reuters commodities index (-3.6 %), as in February only orange juice (+6.2 %) and natural gas (+4.4 %) increased, while precious metals (silver, for example : -11.1 %), industrial metals (nickel : -11.3 %), as well as agricultural commodities (wheat : -10.3 %) clearly fell.

8. The picture that seems to emerge is that if investors' expectations have risen, reality is lagging.

Bonds (9-14)

9. One of the main criticisms of the FED's quantitative easing policy (which also forces sooner or later all the other central banks to follow it) is that this strategy could end up by having unintended consequences, and even to such an extent that the cure could become worse than the disease.

10. And at this point the mention of the Cobra effect is usually never far-away.

11. This is an episode which occurred in Delhi during the British colonial period. The governor, considering that there were too many poisonous cobras in the city, decided to offer a reward for each dead cobra. And therefore the most entrepreneurial citizens of the city decided to respond positively to the incentive created by their governor, and they began to breed cobras in order to meet the demand created by the state. Then, just as logically, after a certain time, the administration discovered that the idea was perhaps not as smart as it seemed and, having no use for all these dead cobras, it decided to stop the measure. Thus, deprived of their selling market, our good breeders were forced to release the snakes so that they could try to survive by their own means. And this is how the state became poorer, and Delhi richer of a significant increase in small and large cobras.

12. Another famous anecdote occurred a few years ago in Israel, where in order to induce parents to be on time when picking up their children from the day-care center, the establishment decided to fine those who would be late. But the unintended consequence of this measure was that, far from contributing to a reduction in the number of late arrivals, it had exactly the opposite effect with a substantial increase of latecomers. And the reason was simple : from the moment the center assigned an economic value for being late, parents could objectively, and without bad conscience, decide to pay an extra for the provided "service" of taking care of the child for longer.

13. Time will tell, but no matter what, until now we lack evidence of the true effectiveness of quantitative easing. Certainly these policies had the great advantage of allowing, in a rather discreet way, the recapitalization of banks by providing them unlimited amounts at 0 % interest rate, so that they could afterwards buy government bonds and therefore obtain a 3 % spread with no risk.

14. However, it should be noted that this was done to the detriment of the taxpayer. Indeed, under normal circumstances banks should have been nationalized, and only then recapitalized in the same way as they have been through unlimited loans. But the great difference would have appeared at the end of the operation, once the banks were healthy again. At that point, they could have been re-privatized, thus allowing the state to reimburse itself of the costs linked to the deficits' increase due to the recession which followed the financial crisis. However in our case, governments have kept the burden of the repayment of this additional debt, while maintaining in private hands the future profits of the banks.

Bonds (15-25)

15. But let's go back to the question of the usefulness of the current monetary policy as it is fair to question whether the cure is that effective. Certainly, it has effectively reduced by around 2 % the yield on all maturities. However, this does not fundamentally change anything for corporations, since a 2 % difference on the cost of borrowing has practically no influence on an investment decision, which, by happening over many years, is linked to far more important factors, such as the economic growth potential and the regulatory environment stability.

16. However the 2 % reduction is having quite a negative impact on the income of investors, both private and institutional such as pension funds.

17. Thus, it is possible that any benefit which may come from these abnormal low levels is neutralized by the creditors' loss of purchasing power.

18. But where the cure could even became worse than the disease, is that the yields' decline enabled governments to heavily borrow without paying the price today. And the problem is that the indebtedness by itself does not provide a solution to the economic problems of a country. In fact, Japan is maintaining for years its short-term rate at 0 % and its 10-year rate below 1 %, and for what result ? Public debt is 22 times higher than government tax revenues, the service of the debt costs 47 % of tax revenues and 52 % of expenditures are financed through debt issuance.

19. We have previously indicated that this situation should have been "impossible" from an economic point of view, since this is the equivalent in terms of physics of being able to move at a speed greater than light.

20. And yet, this is what is going on, and if rates can remain so low despite the indebtedness level, it is thanks to the extraordinary surplus of the Japanese balance of payments.

21. Those who read us regularly know that if we have been negative on bonds, we haven't yet recommended being short bonds and therefore positioned for higher yield rates. Our point of view is simply that the prevailing yield since the 2008 crisis is insufficient to justify an exposure to this sector.

22. Moreover, those who would be tempted - only on the basis of the Japanese fundamentals that we have mentioned above - to bet on a rise of Japanese yields, should know that the market calls this trade "the widow maker", because of the continuous losses it inflicted to investors for over a decade now.

23. The Japanese bond market is an accident waiting to happen. But as with any accident, the timing remains unpredictable.

24. Another reason for our caution towards rising yields is the fact that until now the quantitative easing policy has not yet led to an increase in the velocity of money circulation. And without this, the inflation risk remains low.

25. However, when the speed will increase, consequences could be unpredictable as the liquidity increase linked to this policy has pushed up the cash holdings in developed countries from 10 % of GDP in 2000 to 205 % today.

Bonds (26-34)

26. Anyway, a recent study by James Montier - from the investment firm GMO - titled "Hyperinflations, hysteria and false memories", shows that hyperinflation cannot occur by the mere fact that a government finances its deficits by printing money. Much more severe cumulative conditions are needed - such as a massive shock on the productive capacity of a country, debt issued in foreign currencies or major social unrests - in order for this phenomenon to occur.

27. From this point of view, a candidate for hyperinflation would be today for example, Greece if it left the Eurozone.

28. The closure of the nuclear power stations in Japan is also potentially one of these supply shocks which leaves the country more vulnerable since the energy bill rocketed, substantially reducing therefore the surplus of the balance of payments, which could make debt financing more difficult in the future. As such this is manageable, but the danger is that this is happening just when the government wants to act in order to create inflation. However, if the authorities miscalculate in the measures they want to take, then there is a risk that at a certain point there will be no buyers for the government bonds, except the Bank of Japan. Given the level of debt, if this situation were to last, it would eventually lead to a collapse of the yen and of the financial system and this would be sufficient to move the country from deflation to hyperinflation. Think of an anorexic that would become obese.

29. Fortunately, we are far away from this situation and it is even the opposite, since with a yield on the 10-year bond at 0.66 %, the bond market is indicating that it does not believe in the possibility of a quick return of inflation.

30. And now it is the time to remember that the deflation threat has not yet been defeated. If quantitative easing is not a solution sufficiently effective, deflation could therefore spread to countries, which contrary to Japan, do not have a strong surplus in their balance of payments and would therefore be unable to honor their large debt. Indeed, such a country would be in the situation of a person who, having a mortgage, loses his job; whatever he does to cut his spending, it will be insufficient to honor his credit.

31. We did not make a lot of predictions in our year-end report; but one of them was that the terms of the Irish debt towards Europe would be improved, as it was done with Greece. And this is what has just happened. At the beginning of its crisis, Ireland received loans for a period of 7 to 8 years with a rate of 8 % per year. These loans have just been replaced by bonds maturing between 2038 and 2053, giving an average lifetime of 34 years. And the interest rate was fixed at 3 %.

32. In a deflationary scenario, this is the best one can hope for a creditor. The worst being obviously an immediate cancellation of a more or less significant portion of the debt.

33. And one should not consider corporate bonds as a safe haven in such a scenario, because to reach the Irish conclusion, it will be necessary to go through a severe economic crisis. This will also weaken companies, especially those with the weakest balance sheets which had issued previously high yield bonds.

34. In conclusion, risk for bonds also comes from a deterioration of the economic situation and not just from a return of growth and of normalization of the level of interest rates.

Equities (35-45)

35. At the highest of February - 1'530 - the S&P was only 2.3 % below its historical peak of October 2007; 1'530 was also the peak reached by the index in 2000. The moment is thus important.

36. Pessimists believe that Western stock markets are still in a secular bear cycle and that therefore the American one will not be able to rise much above 1'530 in a sustainable way. They are rather expecting a last major down move towards 777 or lower to complete the cycle.

37. Optimists believe instead that a new long-term bull market began in March 2009 and that the S&P will continue to move up well above the current level.

38. One must therefore closely follow the evolution of the US indexes, taking into consideration the weakness of the other markets in February. This is quite important as America is the country where growth is the most entrenched.

39. For the time being, we remain invested; but we are ready to reduce our positions as investors may today have become too optimistic regarding global growth, as they were previously too pessimistic.

40. The reason for our caution at a time when others are becoming quite euphoric is thus based on our doubts regarding the ability of quantitative easing to support growth.

41. On this matter, we have been in particular quite interested in a long speech given by Mr. Adair Turner, chairman of the Financial Services Authority, which is the British institution responsible for supervising banks. As such, he is one of the most influential persons in the financial world.

42. The title in itself is already very interesting : " Debt, Money and Mephistopheles : How do we get out of this mess ?" First, let's note the use of the present tense ("how do we") which means that the measures taken so far have been insufficient to solve the crisis.

43. But what is the most amazing is that in his presentation he defends an idea hitherto taboo : the only really effective way to stimulate the economy is to print money and give it directly to citizens and the government rather than to banks, so that they can spend it.

44. And his whole speech aimed to demonstrate that this is feasible, desirable and safe, as long as the distribution ends as soon as the economic recovery took place. He therefore strongly opposes himself to Mr. Jens Weidman, president of the Bundesbank, who considered after Mr. Draghi's last July speech, that the ECB president had made a pact with the devil when announcing his policy of buying sovereign bonds of attacked countries of the euro area; hence the reference to Mephistopheles.

45. It is improbable that such a measure could be taken immediately. But Mr. Turner planted an idea that could germinate should the economic situation worsen.

Currencies (46-51)

46. In any case, this speech contributed to a further weakness of the pound, which has lost 7 % since the beginning of the year against the dollar and 30 % since 2007.

47. Even more than the Americans, the British are clearly using monetary devaluation as a weapon to help their economy, generating at the same time an inflation of 2.7 % over the last 12 months and which does not seem to disturb anyone.

48. Despite an interest rate at 0 %, massive purchases of bonds by the central bank and a large monetary devaluation, it is quite remarkable that Mr. Turner felt the need to request a new radical measure to help the UK economy.

49. And meanwhile, in Europe, worries have appeared regarding the rise of the euro, with some countries such as France requesting an intervention in order to prevent the move to continue. Unsurprisingly, Germany is opposed to it.

50. The difficulty for the ECB is that the right level for the euro-dollar rate is different depending on the country. The Wall Street Journal estimates that it is at 1.53 for Germany, 1.23 for France and 1.07 for Greece.

51. Anyway, the euro-zone being in recession, any strengthening of the currency will increase the deflation threat in many countries of the area which could thus bring a return of the single currency crisis. From this point of view, any potential increase of the euro cannot last for long.

Commodities (52-55)

52. We noted in our year-end report that a fall of the price of gold was now possible if those who had bought it because they feared a return of the financial crisis became more confident regarding the banks' health and also more positive towards the economic prospects. And this is what seems to happen and this has led to an avalanche of negative comments towards the yellow metal.

53. On the opposite, those who hold it for fear of a return of inflation will not be sellers.

54. We consider that a return up to USD 1'300.-/ounce is technically possible without calling into question the bull trend that started 12 years ago. Actually the only real surprise was that during these 12 years there has been no negative year. Maybe it will be the case this year.

55. But anyway, given that real yields are expected to remain negative for the major currencies until the end of the decade, it seems unlikely that the bull market on gold is over.

Conclusion (56-64)

56. Let's repeat two points of our January monthly letter.

57. The positive elements mentioned in our previous reports remain valid.

58. However, we are starting to wonder if the actual monetary policy is effectively helping the real economy as much as investors have started to believe it.

59. And it must now be noted that with the exception of the United States, the other stock markets made no headway in February. Simple consolidation phase, or the beginning of something more serious ?

60. Until we have evidence of the contrary, we remain invested; but our conviction level regarding the immediate continuation of the upward move is weaker than the market's one.

61. However, we must now mention that such a move will be more tactical than strategic since the competition coming from cash deposits and bonds is quite weak. Thus, investors will naturally be attracted to increase their equity investments as long as growth, even a feeble one, exists.

62. With Japan moving in the camp of the countries which are willing to take aggressive measures to help their economies, only Europe remains a laggard. But even in the old continent the worst of the austerity phase is behind us.

63. Furthermore, any weakness of stocks will be interpreted by governments as a sign that additional help measures need to be taken, thus naturally limiting the magnitude of an eventual drop.

64. In conclusion, a window of opportunity currently exits for a fall of equities and this is the reason why we are ready to reduce risk in our portfolios, But, if on the contrary the bull market is well entrenched, this should not happen and this will therefore be a strong sign that world growth will continue to improve.

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