Market Outlook

A monthly commentary on financial markets written on April 2nd, 2012

THE UGLY SISTERS

Generalities (1-5)

1. The bull trend continued in March, but at a slower pace, with the Nikkei (+3.7 %) and the United States (S&P +3.1 % and Nasdaq +4.2 %), having the best performance, followed by the DAX (+1.3 %). However - and this must be considered as a warning - the rest of Europe (Euro-Stoxx50 -1.4 %), as well as emerging markets suffered, notably China with a drop of 6.8 %; globally the MSCI emerging markets index was down 3.1 %. For the quarter, the FTSE World Index in USD moved significantly up 11.3 %.

2. The strong US equity performance led to a further increase in the US bond yields with the 10-year one moving from 1.97 % to 2.21 %. However, the persistent worries in the euro zone kept almost unchanged the yield for its German equivalent at 1.79 %. For the quarter, Italian sovereign bonds were the best performers with the 10-year yield for example falling by 2 % at 5.1 %.. But corporate bonds also benefited with a decrease since the start of the year of the risk premium from 173bp to 125bp for European investment grade Index and from 133bp to 70bp for its US equivalent.

3. This good US behavior slightly reduced the interest in precious metals, even if silver (+16.5 %) and gold (+6.5 %) are still up compared to the beginning of the year. Regarding the CRB/Reuters index itself it was slightly higher for the quarter 1 % with two extremes : gasoline (+26.2 %) and natural gas (-28.9 %).

4. And it should also be noted that the increase in the price of oil was much larger for the European Brent (+15.9 %) compared to the US variety (+4.2 %), which pushed the price of gasoline to record levels in Europe.

5. Regarding currencies, the event of the quarter was a weaker yen, with, a fall for example against the US dollar of 7.7 % at 82.9, thus erasing the whole rise of 2011 of the Japanese currency. And just as for the stock market rally, investors are wondering if what just happened is a sustainable trend reversal or not. As a matter of fact, over the last ten years the yen has appreciated by over 40 % against the greenback. Meanwhile, the euro remained within a fairly narrow range in the first 3 months of the year between 1.2650 and 1.3450 and at 1.334 it ends up 2.9 % against the dollar.

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Currencies (6-16)

6. The Ugly Sisters, this is how the banking world has started to call the currencies which are the most important for the world economy, i.e. the dollar, the euro, the pound and the yen. This is probably the most visible sign of the end of a world - the one which appeared post-world war II - while the new one, with the emerging countries (which quite soon now will have to be characterized as emerged), is only in its early stages.

7. What is striking about the Ugly Sisters is the similarity of their problems, of which excessive debt is the most powerful symbol. And it will be the evolution in the investors' perception of this indebtedness which will mainly influence the moves of these currencies between themselves.

8. This implies that in times of economic stress reduction - such as the one which started at the beginning of this year - volatility in the currency markets will move sharply down as investors do not need to position themselves in relation to currencies where it is difficult to differentiate between them.

9. The second consequence is that investors try to go for "small" currencies, which have either a low level of debt, such as the Swiss franc or the Singapore dollar, or good economic growth, such as the Australian or Canadian dollar, but also the Brazilian real. Hence the notion of "international monetary war" developed by the Brazilian Minister of Finance Guido Mantega.

10. And each of these countries - too small to absorb the amount of available cash - then tries to protect itself in its own way. Switzerland introduced a floor of 1.20 between its currency and the euro; China artificially blocks hers and pays it by high inflation and the need to finance the US budget deficit with its trade surplus; Brazil introduced measure after measure to increase the cost of buying its currency, etc….

11. And this is where gold has a role to play. Faced with the Ugly Sisters, or with alternative currencies that have neither the size nor the power to be a significant safe heaven, gold remains an unavoidable option.

12. Physical gold cannot be devalued, it cannot go bankrupt and for 6'000 years it has faithfully and without fault fulfilled its mission : with an ounce of gold a man gets the only three truly indispensable elements for his survival : a roof, food and clothing.

13. Of course, at times, the meal will be at McDonald's rather than in a three stars restaurant; but the essential is always there.

14. If during the long period of disinflation that began in the 1980s there was no reason to hold gold - that barbarous relic, to use Keynes words - the negative real return on deposits and the uncomfortable level of indebtedness of the Ugly Sisters justify in our view its place in a portfolio.

Currencies (15-20)

15. And this even if it seems possible that a vulnerable phase for gold has arrived. Gold has risen for eleven consecutive years and it becomes increasingly difficult to maintain such a development without a larger correction than what has occurred until now.

16. The first phase of gold's rise began in 1999, as the real return on dollar deposits moved to zero. It was a quiet increase. Then the growth rhythm accelerated in a second phase as the real return became negative following the 2008 financial crisis.

17. And at that moment there were two types of buyers, those who feared the Apocalypse and those who worried that inflation could become uncontrolled. Thus, it is possible that we will see sales from the first category of buyers if the bull trend continues with the world therefor moving away from the precipice which it seemed to be going to.

18. Anyway, historically, the third and final phase of such a rise is characterized by a strong increase of the volatility of said asset.

19. Therefore, there is currently a window of opportunity for a fall of around 10 to 20 % from the current price.

20. But insofar as the long-term trend remains unchanged, any eventual decline should be considered as a buying opportunity.

Equities (21-26)

21. Bloomberg Magazine has perfectly summarized the situation in an article published in mid-March and entitled : "The Bull Turns Three. Where's the Party ?" And as subtitle it states "A 99 percent gain since March, 2009 has not restored Americans' trust in stocks. There are a lot of individuals that are terrified investors". And indeed they are. Until February there were 10 consecutive months of redemptions for US equity funds. And just for the first two months of the year withdrawals were USD 5.4 billion while for the same period, investment in bond funds totaled USD 43.6 billion.

22. But it wasn't only limited private investors : the Financial Times mentions that "Ford moves pension fund assets to bonds to limit risk."

23. Hence this comment from an FT journalist regarding the bull move which began in late November : "This must be one of the least enthusiastic market rallies in history."

24. In short, investors have used this rise to sell. And this has led to a weak turnover; it is for example the lowest for the New York Stock Exchange in 13 years.

25. And the current situation provides arguments to both camps.

26. For the bears, the way this rise is happening with such a small volume proves that this increase is only temporary, as was the case in 2011. And especially so since the evolution of household discretionary income argues against a durable move.

Equities (27-33)

27. Moreover, they believe, profit margins are at a record level; it can thus only decrease. And in such a context, not only the expectations of earnings growth are unrealistic, but on the contrary the market should have been discounting declines.

28. For bulls, instead, all this is excellent as it shows that there are a multitude of potential buyers and in the same way that when the bubble was expanding in the late 1990s investors had "learned" that every drop was a buying opportunity, the end of a bear market is illustrated by the fact that investors have now "learned" that each increase is a selling opportunity. This can be illustrated by the fact that short options on equities of the S&P index are at their highest level in five years which is an indicator of an exaggerated pessimism, hardly compatible with the end of a bull market.

29. They also have noticed that equities never reached a peak when there were valued at 14x earnings and that despite the financial Western crisis the world continued to grow in recent years.

30. And they even dare to compare 2012 to 1995, since currently equity volatility has declined in a manner identical to what happened in 1995. Also, the price/earnings ratio of the S&P fell from 24.2 in December 2009 to 14.5 currently, while it contracted from 26.5 to 16 in the previous 32 months to January 1995.

31. Therefore, they consider that in the same way that in 1995 the S&P rose by 34 %, a similar surprise could happen this year.

32. Such an increase cannot be ruled out if everything that could go well ends up by going well. It will be a sort of inverted mirror of the recent bad years where everything that could go wrong went wrong.

33. This bull move must now be tested. And it will be the ability of the market to resist to bad news which will increase investor confidence. Only then, we shall be able to judge the sustainability of the current trend.

Bonds (34-36)

34. And this is specially so as the current rise in bond yields is not unlike the one from last year, when the US 10-year bond rose by 1% between September 2009 and April 2010 to 4 %, before going down to a level that had not been reached since the 1950s. And bears have noticed that the current increase is even smaller, since currently it barely reaching 0.5 %. In a "normal" context (i.e. without Fed intervention), this is a very bad sign, as it means that bondholders do not believe in the recovery and historically they have been right more often than the stock market.

35. As we mentioned previously, we do not expect great changes in this sector for the time being, as central banks will act to prevent any significant rise in yields and this as long as there will not be a significant increase in inflation.

36. Anyway, inflation or not, fixed income potential is poor. According to GMO's model, which is quite reliable, in late February US quality equities as well as foreign shares had the potential to rise in real terms by 4 to 5 % per year over the next seven years, while bonds should fall also in real terms between 1 and 2.5 % per year depending its type.

Bonds (37-38)

37. Finally, it is interesting to note that if, taking into consideration the current economic situation, our models continue to indicate that interest rates should still be negative for the euro area and Japan, for the first time since the beginning of the crisis the United States has returned to positive territory with a Fed Fund rate that should be at 1 % instead of the current 0.25 %, thus joining the UK, which moved to the + side over a year ago.

38. And this allows us to mention that any economic policy that could be followed will be harmful to creditors, as the excess of debt must be cleared from the system and this can only be done at the creditor's detriment. The only real unknown is whether this will be done through bankruptcies such as what happened with Greece or through inflation with negative real returns as the UK did for ten years after the war.

Conclusion (45-46)

38. Even if the previous months have been enjoyable for investors, one should always keep in mind that the crisis will really be over only when interest rates have been normalized. And we are far away from such an event.

39. However, as even illustrated by the cover of The Economist magazine, US news have been better - or to be precise - there were much less worse than expected.

40. And if there was only the US situation, we would already have raised the risk allocation in the portfolios.

But the increase of energy prices, due among other elements to the Iranian crisis, the austerity policies in the euro area and the inability to make a reasonable judgment about what is happening in China justify that the equity allocation remains unchanged for the time being.

41. With the improvement of the US situation, the normalization phase after the crisis seems finally to have begun. But to paraphrase Churchill : "Now this is not the end. It is not even the beginning of the end. But it is perhaps, the end of the beginning."