Market Outlook

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

INVESTING ON ONLY ONE LEG

Generalities (1-5)

1. The FED's decision in September not to stop its purchases of securities continued to positively influence equities in October since all major indices, except one, are positive for the month : Nasdaq : +3.9 %, S&P : +4.5 %, DAX : +5.1 %, Euro-Stoxx50 : +6.0 % and emerging countries index in USD : +4.2 %.

2. The only notable exception was Japan, with a relatively poor performance of the Nikkei : -0.9 %. This is mainly due to the fact that despite the weaker yen, export and import volumes have not increased. Normally, the fall of the yen should have boosted exports and it has not happened yet. Similarly, one should have expected to see higher import volumes, indicating that the main objective of the reflationary policy - increased domestic demand - was achieved. But here too this evolution is not happening.

3. The continuation of the FED's policy was also favorable to bonds, as the yield on the 10-year US Treasury fell to 2.55 % against 3 % in early September. Identical evolution for the German 10-year, which ended the month at 1.67 %. And at 0.595 %, even the Japanese 10-year continued its fall from the 0.93 % level reached in late May 2013 . This is another sign that investors do not believe that reflation will last in Japan and that therefore the current inflation rise of 1.1 % over the last twelve months is only temporary.

4. Another sign of the absence of inflation : another CRB Commodity Index decline which this month was of 2.70 %.

5. Finally, the US dollar continued to weaken against all currencies, reflecting the fact that the FED has by far the most expansionist monetary policy among central banks. Thus, the dollar index fell once again to 80.20, while the euro, after having risen to 1.38, ended the month almost unchanged at 1.3580, as was also the case for the yen at 98.

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Equities (6-20)

6. With the end of the shutdown, we have therefore increased our equity exposure, which is the asset that we have recommended the most since 2009.

7. And the current consensus is now that the FED will not reduce its purchases for at least 6 months, which the market is considering as a green light to increase risk exposure in general, and to equities in particular.

8. And stocks still have ample room to rise particularly because the current low growth is sufficient to slightly increase profits, but insufficient to allow even just taking the foot off the monetary accelerator. It is therefore also completely excluded to start to brake before at least the last third of 2014.

9. In addition, the end of the recession in Europe and some re-acceleration of growth in China is also contributing to this investors' optimism.

10. And there is another important element : investors have no other alternative.

11. Historically, to invest relied on a tripod and all the talent of the manager was to allocate the available assets between fixed yield (deposits and bonds), variable income (equities) and monetary allocation (exposure out of the base currency).

12. Today, from this tripod, only one leg remains : equities, since the policy of quantitative easing (QE) kills yield and with short-term interest rates close to 0 %, monetary diversification has become much more uncertain.

13. Thus, all the profitability effort needs to be done by equities alone. But the level of exposure in this area is currently not easy to establish.

14. The fact that investors have become optimistic brought a sharp decline in volatility and this mechanically is leading to an increase in equity allocation.

15. The notion of volatility is fundamental, since the most popular risk management tool is the one called "value at risk" (Var). Its aim is to establish what should be level of risk so that, with a confidence level of 99 %, the maximum loss cannot exceed a predefined amount over a specified period. Thus, the exposure to risk, is directly linked to volatility and therefore the more it falls, the greater risk-taking can be.

16. But of course, this mechanism works both ways : for example, when the stock market drops 10 % Var automatically goes up, forcing managers to reduce their exposure and thus creating a vicious cycle of sales.

17. In reality, Var is a lazy concept much loved by regulators because it gives the impression of a scientific management of risk, while in reality it is a time bomb, since it is disconnected from the real value of assets.

18. Thus, one should be careful of not falling in this low volatility trap by increasing risk beyond what is reasonable. And this is all the more difficult as this situation can continue for a long time, until an unexpected element forces investors to hastily rethink their strategy.

19. And then, Var, linked to the extensive use of index funds, which through their short selling allows an immediate reduction of risk, becomes an explosive cocktail for financial markets. This explains why falls have now become extraordinarily fast

20. And one should expect the fall to be larger after a long period of low volatility, since risk exposure is then at its highest.

Equities (21-31)

21. Thus, this situation leads us to maintain a substantial margin of safety. And our caution also reflects the fact that we are in uncharted territory regarding the consequences of the current monetary policy.

22. From this point of view, the limits of the QE policy should be mentioned. If it helped to stabilize the situation, it has not yet put the world economy out of danger, nor permanently removed the deflation risk.

23. Indeed, for the time being, QE has not resulted in an improvement in the velocity of money in America, which, at 1.54, is well below the 2003 (1.92) and 2008 (1.89) levels.

24. And investments have not increased either. And this has led to a sharp decline in job creation in the US, which went from more than 200'000 during the fourth quarter of 2012 to less than 150'000 this quarter.

25. Thus, from this point of view, the latest employment figures would rather be a favorable sign for an increase of the QE policy than the opposite !

26. The feeble growth situation has also pushed, with the exception of the UK, inflation closer to 1 % than to the 2 % level aimed by central banks. Even if they consider this to be temporary, this still needs to be proved.

27. Certainly it is still likely that with much delay - and now that the economic participants are convinced that the recovery is sustainable - we will have the so much expected acceleration in investments, which is the only way for growth to improve.

28. But it is also a fact that the safety margin is presently quite small, particularly because the average real income in the US is now below the level of 1989.

29. A recent article in the Financial Times pointed out that in 1958 wages accounted for 50 % of US GDP and today, because of globalization and technology, its share has fallen to 42 %.

30. And the journalist to mention the following anecdote. Also in 1958, a powerful syndicalist visited a newly automated Ford car factory and its manager asked him : "Aren't you worried about how you're going to collect union dues from all these machines ?" To which, he answered : "The thought that occurred to me was how are you going to sell cars to these machines ?."

31. Half a century later, the issue is thus identical and in relation to this situation the QE policy cannot do much.

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Bonds (32-41)

32. The IMF estimated that bond investors would globally lose USD 2.3 trillion if interest rates went up one percent.

33. In comparison, during the 2007-2009 financial crisis, losses reported by financial institutions amounted to "only" USD 2.1 trillion.

34. And this regardless of the inherent risk linked to the quality of the bonds. A recent article published by the British magazine "The Economist" pointed out that 50 % of corporate bonds have a "speculative" rating from Standard and Poor's, "a polite term for junk" notes the author of the article.

35. Then he mentions the fact that liquidity has declined since banks have sharply reduced their inventory and he quotes a report of PIMCO - the major bond fund - which considers that this reduced liquidity is an important fundamental trend and that this "will result in higher volatility in times of stress."

36. Finally, he mentions the fact that many of these bonds have a call option, allowing for the borrower to repay the debt at its discretion, and that any increase in their prices is therefore limited. However, they could still fall quite sharply if the financial situation of these companies deteriorates.

37. All this is known to our regular readers.

38. But we are now witnessing an acceleration in risk-taking because of the low volatility. And, paradoxically, as yields move down investors have become more and more willing to accept rules which are to their disadvantage. For example, this year, more than USD 200 billion of so-called "cov-lite" bonds have been issued so far, while at the top of 2007 the amount issued was only of USD 100 billion.

39. This is quite surprising because during the financial crisis, these "cov-lite" bonds were the symbol of the excesses in the credit area. The fact that they have become so popular again illustrates how desperate investors have become to find return.

40. "Cov-lite" is an abbreviation of covenant light, which means that some of the traditional guarantees (covenants) for the holder of these corporate bonds from financially weak debtors have been removed. For example, a company may have the right to stop paying interest and capitalizing them, or restrictions can be lifted regarding the balance sheet, such as the maximum authorized level of debt or the limits on leverage.

41. In conclusion, unfortunately this asset class is to be forgotten for the moment, except for very specific bonds.

Currencies (42-53)

42. And regarding currencies the situation is not much better.

43. Historically, monetary diversification allowed an exposure to risk with a rather low correlation to equities and bonds.

44. The fact of investing in currencies of countries with higher interest rates than their competitors, as well as the momentum of a trend, enabled investors to obtain an always welcome additional income.

45. But, distortions of monetary policy because of QE are currently making this strategy impractical.

46. All major countries have their short-term rates close to zero : so there is no interest rate differential to exploit.

47. Also, all major economies are in the hospital ward with various diseases, and there is not one fitter than the other.

48. In this context, currency moves are mainly based on the more or less aggressive monetary policy of central banks.

49. Currently, the FED is the most aggressive one and the ECB the least, so we have a steady rise - without volatility - of the euro, which is not justified by the economic situation in the euro zone.

50. And one should expect that if the euro/dollar parity moves much above the 1.40 level, that the ECB would then be forced to inject massive amounts of liquidity, as was the case of the Bank of Japan (BOJ).

51. Finally, as mentioned previously, the yen/dollar exchange rate has become technically vulnerable to a massive intervention from hedge funds, which could try to buy yen in order to trigger stop losses levels on speculative short positions in the yen.

52. If they are hesitating, it is mainly because the BOJ could intervene by injecting more liquidity to prevent any appreciation of the yen.

53. In conclusion, this sector will continue to offer few prospects, and this will be the case until interest rates reflect again economic fundamentals.

Commodities (54-64)

54. Another strange element in the scenario of improved global growth is the fact that commodities are not rising as is also the case with the currencies which are sensitive to moves in this sector, such as the Australian dollar.

55. The CRB is down 6.1 % over the last twelve months, and this despite a rise of the price of its main component, oil, up 11.8 %. Also all industrial metals - such as copper (-6.2 %) - are down.

56. And even if the bull trend of the first decade of this century is over, a rebound was to have been expected.

57. It did not happen and this is even more puzzling because the weak dollar should have almost mechanically pushed prices up. Thus, in euro, the CRB is down 10.4 % over the same period.

58. It is possible that this situation is linked to the fact that, in the last twelve months, developed economies - which are consumers of fewer commodities - improved, while the situation in the emerging world rather deteriorated.

59. But it could also be that the price of commodities is anticipating vulnerabilities in the current scenario of a modest but steady global growth acceleration.

60. It is therefore essential that there is, between late 2013 and early 2014, a recovery in this area in order to confirm that the expected resynchronization to the upside of the economic cycle is happening.

61. Regarding gold, technical analysis indicates a likely return to the USD 1'500.-/ounce level, which could economically be justified by the continuation of the QE policy.

62. Certainly, gold and gold mine shares are largely oversold, but in the absence of inflationary pressures or fears about the strength of the economy, this move could be long to occur.

63. Consequently, for the moment, we are not increasing our exposure to the sector.

64. One final note : only an increase above USD 1'500.-/ounce would indicate a return of the bull trend. Thus, up to that level the move would only be a correction of the sharp fall of recent months.

Conclusion (65-69)

65. What would harm the market the most today would not be a reduction of FED buying. And the recent events in the QE area have also allowed the market to be well prepared for it.

66. This can been confirmed by the fact that if bond yields have moved back down - 2.55 % for the 10-year US Treasury bond - we are still quite away from the 1.60 % level of May of this year.

67. The risk today would rather come from bad economic figures which could instill doubts in the minds of investors about the future evolution of the global economy.

68. And the risk of deflation should also be monitored, especially in the euro zone.

69. But otherwise, today, "the trend is your friend" and we are therefore reasonably invested in equities while keeping our eyes wide open.

Important Information
The value of an investment may fall as well as rise and an investor may not get back the amount invested. Exchange rate movements may also cause the value of your investments to fluctuate. Past performance does not guarantee future returns. This document is for information only and does not by itself constitute an offering. Information used herein has been obtained from sources believed to be reliable.