# Market Outlook

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

## ALL-IN?

**Generalities (1-7)**

1. If previously we wrote that "months like May revive our fears that deflation could win", September was on the contrary a month where central banks strongly increased their reflationary efforts. And this was also coupled with quite good news from the political arena.

2. From the decision of the German Supreme Court which not only gave the green light to the European Stability Mechanism (ESM), but also indicated a possible way for a deeper European integration, to the implementation of quantitative easing n° 3 by the FED, through an excellent Dutch elections' result from the point of view of the euro as votes for both extreme parties went down, without forgetting the historic decision of the ECB to buy sovereign bonds in an unlimited way (even if conditions were set for its intervention), all the month's obstacles were successfully overcome.

3. And this allowed equity funds subscriptions in September in the US to reach the highest level in four years.

4. Hence a new rise for the indexes : +0.6 % for the Euro-Stoxx50, + 1.6 % for the Nasdaq, +2.4 % for the S&P and +3.5 % for the DAX,. This allowed most markets to be nicely up since the beginning of the year.

5. As in August, government bonds of major developed countries considerably fluctuated during the month. Such was the case of the 10-year US Treasury bond, which yield climbed from 1.55 % to 1.87 %, to end September at 1.63 %. However, it should also be noted that the current peak yield is lower than the one achieved during the beginning of the year bull move at 2.38 % on March 19th.

6. The risk premium on corporate bonds also decreased once again and for investment grade bonds it went from 42.5bp to 33.4bp in the United States and from 149.2bp to 136.2bp in Europe.

7. And if the CRB/Reuters index in USD remained virtually unchanged during the month (-0.1 %), it conceals a contradictory development among its components; up for nickel (+15.8 %), aluminium (+11.4 %) and silver (+10.2 %), but down for agricultural commodities such as cotton (-9.6%), corn (-5.8 %) or soybeans (-9.3 %). Regarding oil, after having greatly fluctuated, it ended the month down 4.4 % at USD 92.20/barrel.

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## Equities (8-19)

8. In the same way that we warned against an excessive pessimism during the difficult phases in recent months, it seems important to avoid an excessive optimism for the coming weeks.

9. One must first note that the positive markets' reaction is the equivalent to a sigh of relief that the worst did not happen. In addition, they were favourably impressed by the latest monetary measures, which were beyond expectations.

10. Since poker became popular, we all know this phase of the game when a player decides to bet all of his remaining chips by declaring "all-in". And this looks to be what central banks have just done.

11. The ECB declares its readiness to buy, in an unlimited way, sovereign bonds from a euro-zone country, with the secret hope that its credibility is such that it will not be eventually led to do so. For many months we have indicated the need for a buyer of last resort in Europe, as is the FED in the US, to reassure investors which could then buy themselves these securities. The ultra-low current yields on most bonds clearly indicate that there is a multitude of potential buyers.

12. In the US, QE n° 3 consists mainly in the FED's commitment to buy USD 40 billion per month of mortgage-backed securities to lower mortgage costs, thus making housing more affordable. But what enabled the Financial Times to headline "Stunningly bold move" was the fact that the FED committed to unlimited monthly purchases and this as long as the job market does not "substantially" improves.

13. However, it should also be mentioned that an amount of USD 40 billion is relatively not that high, since it would take three years for purchases to reach the same volume as QE n° 1.

14. And even the Japanese central bank increased its bonds purchases by USD 128 billion.

15. All this was necessary to avoid deflation, but is it enough ?

16. What we fear is that with the use of the word "unlimited" central banks have reached the limit of their capabilities, of what can be achieved by monetary policy and of its ability to support growth.

17. In Europe, loose monetary policy is counterbalanced by improper fiscal policy consisting of mainly raising taxes rather than reducing public spending, while historical precedents have shown that the opposite is the most effective way to reduce debt while minimizing the impact on economic activity.

18. In France for example, the economist Nicolas Baverez - who in his book "Wake up!" criticizes both the right and left parties - believes that the economic situation is deteriorating so fast that "the French decline is about to turn into a crash." And he just pointed out that the tax increases decided during the last year of Mr. Sarkozy term and since Mr. Hollande became president will be equivalent to 3 % of GDP and that this figure corresponds to the impact that the oil shock of the seventies had.

19. Sophie Pedder, chief of the Parisian office of The Economist magazine, has published a book entitled "The French denial – Europe's last spoiled children" in which she notices "that France treats itself to a Swedish model with public finances closer to those of Spain" and that if government spending represents in France 56 % of its GDP (52 % in Sweden) it was only 56th in the WEF standings for effectiveness of public spending in 2011 (and we may add 77th in the 2012 report).

## Equities (20-29)

20. And the denial of reality is such that the French government has simply closed the door to shale gas, which is the only true asset available in the short-term for the country. For comparison, one expects within five years that in the US the development of this resource will directly add 1 % of growth to the GDP while creating 3 million jobs. Indirectly, it will help reduce the trade deficit, lower the cost of energy and will invigorate the petrochemical and manufacturing industries.

21. What we fear today is that as France goes into recession, a move which seems inevitable, this may create a shockwave in the euro zone which will even be stronger than the previous ones, given the importance of this country.

22. It is also interesting to note that if the French tax increases - which represent 3 % of GDP -provoked little reaction among economists, it is quite the opposite regarding what is called in the US "fiscal cliff ", which we have already previously mentioned. Let's recall that if the law is not changed ,at the end of the year there will be automatic tax increases and spending cuts equivalent to 3.2 % of the US GDP.

23. So the question needs to be asked : why are economists worried by the US fiscal cliff and not by the French one, despite the fact that their impact on GDP is quite similar ?

24. But to come back to the US situation, the market's Zen attitude towards the fiscal cliff indicates that investors remain confident that the law will be greatly softened between the presidential election and the end of the year.

25. We are not so sure of that. Currently, Mr. Obama's re-election seems to be the most likely outcome and he will then have no reason to give in too much to a polarized Congress. As time plays in his favor, he could simply allow for the law to come into force in order to oblige Republicans to negotiate a balanced agreement regarding long-term deficit reduction. And from this point of view such a goal could justify "hurting" the economy for a few months and especially since he no longer has to worry about getting re-elected.

26. And since the stock market has not even started to price in such a slowdown, the adjustment could be brutal.

27. Lastly, lets add that a statistic published in September illustrates the US situation, and by extension that of other European countries. The US median income adjusted for inflation is at its lowest since 1995. It is a number like this one which vividly illuminates the impact that globalization has had on Western middle classes and explain the poor growth of these economies.

28. And it is to compensate for this income weakness that governments have been pushed to increase their social spending, financing them with debt.

29. Finally, it should be noted that the third factor of concern that we have identified for months - China - remains valid. The Chinese stock market is still in the red this year (-5.1 % for the Shanghai Composite index), a sign that to a minimum the economic situation is not improving. Furthermore, the recent attacks against Japanese companies in China indicate that the political transition which must take place in the last quarter of the year is not yet a done deal and that the various factions continue to jockey for a better position. Therefore, lots of unknown remain regarding what will be the Chinese policy under the new leadership, including from an economic point of view.

**Equities (30-36)**

30. Anyway, regardless of the outcome, more bad economic news from China cannot be excluded in the near future, which will then mechanically impact other emerging countries.

31. In conclusion, all this explains why, despite all the good news during the month, we still have not increased the risk in the portfolios.

32. And now we would like to repeat what we wrote in March 2012 : "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."

33. The market has a saying : "Don't fight the FED". We have seen in recent months that this saying must now be extended to other central banks, which, in one way or another, have all massively increased their balance sheets, thus injecting billions into the financial system.

34. Therefore, it is not our intention to fight them. Simply, the willingness of central banks may be tested by the hard reality of economic facts in coming weeks.

35. Over time, we remain convinced that this very lax monetary policy will mechanically push equities up if global growth, even quite low, can be achieved. This is due to the fact that equity valuations are not excessive and that the amount of coming maturing bonds is such that if only a small part of it is directed towards shares, it will be more than enough to allow stocks to do quite well.

36. But in the short-term, a deterioration of the economic situation can only have a negative impact.

**Bonds (37-47)**

37. A recent Deutsche Bank study shows the current revolutionary situation of the fixed income market.

38. Yields are at their lowest in the US since the government started issuing bonds in 1790 and in Holland it is the case for 495 years. The base rate of the Bank of England is at its lowest level since its inception 318 years ago.

39. And while this happens, indebtedness is moving sharply up. In the last years the US budget deficit was the largest in its peacetime history. And as a matter of fact, the budget was in deficit for 40 of these past 44 years. In France, the last balanced budget was in 1978.

40. This debt increase to excessive levels should have led to higher yields and therefore it is only the massive intervention of central banks which prevents it of doing so.

41. This means that, as in any revolution, one should expect unintended and surprising consequences at the economic and finance level.

42. It is also probable that the influence of politics on markets will continue to grow, and eventually it will be even larger than what we have experienced in the past thirty years. We have often mentioned that markets have become hostages of politics and this is just the beginning.

43. One example : currently, a disproportionate portion of national wealth can be found in the balance sheets of large companies in the form of cash and equivalents. And until now they have refused to use them to make investments. However, the longer they remain passive in this area, the higher the risks of reprisals from governments. And if that happens, what will be the impact on corporate bonds ?

44. Meanwhile, most capable companies do what is expected from them; i.e., they borrow long-term at rates that, from their point of view, are quite a bargain. The Financial Times notes that Novartis has issued a 30-year bond at 3.7 % in USD. It then mentions that if in five years the yield has risen just by 2 %, the bond will be quoted at 75 % of it issue level. And the journalist concludes : "Want to see 100 % back? See you in 2042."

45. However, professionals are aware of this danger. And although presently they are following the move and even more so as they are aware of the Japanese situation, where the phenomenon of ultra-low rates has been going on for what seems to be an eternity, each one of them is also convinced that he will be able to close its positions in time.

46. This means that the trend reversal, when it will come, will be quite violent. The danger is that the revolutionary nature of this crisis invalidates any previous experiences and makes it very difficult to determine when and why (deflation or inflation) the move will occur.

47. Thus, with the exception of some investments of tactical nature, we prefer to focus only on bonds issued in currencies of countries with sound fundamentals, or even just to keep it in cash in these currencies. It is the dangerous and unpredictable nature of the current situation which explains our refusal to participate in the purchase of bonds from indebted countries, from companies with poor credit rating or simply those having a too long duration. From our point of view, potential gains are much too low compared to risks.

## Bonds (48-52)

48. And the speed at which bond prices will fall will be even quicker than usual since, as we mentioned in our previous comment, banks are no longer making, as was the case in the past, a market in this sector. Furthermore, a large proportion of recent purchases were made through bond funds and when investors will ask for the reimbursement of their investments, managers will be forced to sell at any price to generate cash.

49. We also believe that it is suicidal to follow the policy which is advocated by some institutional managers in order to compensate for the current low yields. They suggest moving from a traditional allocation, which is a split between stocks and bonds depending on the desired risk, to a risk parity allocation using risk models to determine what should be the mix for a maximum tolerated loss with a 95 % probability.

50. We thought that these models were discarded after contributing to the 2008 meltdown, but here they are back in the bond sector.

51. The danger in following such a model comes from the fact that, because of the low historical volatility of bonds, its ideal solution will be to leverage bonds. In one of the examples we have seen, it leads to allocate 40 % in equity and 160 % in bonds.

52. This is typically management by the rear-view mirror, where the past is used as the reference for the future. It is difficult to know how many are following these models but it will be among them that one will find the dead during the next bond bear phase. We expect that volatility in this sector will rise in the next sell-off phase well above the highest levels recorded in the last fifty years.

## Currencies (53-57)

53. Surprise, surprise. Here is the euro almost back to its level of the beginning of the year, thus burning the wings of many Anglo-Saxon speculators who, having almost dismissed the single currency, were strongly short euro.

54. This illustrates two things. First, there was no mass exodus out of the euro. Secondly, the US trade deficit of more than USD 50 billion per month - while the euro zone is in equilibrium - is a constant weight on the greenback.

55. Nonetheless it seems difficult that the single currency could continue to move substantially up beyond current levels. On the one hand, poor economic health of the zone does not allow it, and on the other, any further increase of the euro will be used by the Swiss National Bank to reduce its exposure to it, which limits its rising potential.

56. As we have already mentioned, all major currencies - USD, EUR, GBP, JPY, etc. ... - are sick and the choice to favor one over the other can only be tactical. We continue to prefer currencies of countries with sound fundamentals.

57. Now that the FED has promised to keep interest rates at zero until 2015 and that it is now focusing on higher employment rather than on inflation control, which could mean that it is ready to tolerate inflation above 2 %, the interesting question is to know until when emerging countries will feel compelled to maintain large reserves in currencies of countries with negative real yields.

## Commodities (58-60)

58. And here is where gold has a role to play. The yellow metal also moved up thanks to new monetary measures and it seems increasingly likely that it will be up again for the year, and this for the twelfth consecutive year.

59. The only disturbing factor is the fact that since 2008 its correlation to the stock market has become quite high and that therefore it tends to behave like a stock market index.

60. But, as mentioned in paragraph 57, monetary policy of the major developed countries could push central banks outside the G7 to substantially increase their gold reserves. And if, for example, Asians wanted to have, like the ECB, 15 % of their reserves in gold, they would need to buy the entire world production of the next seventeen years.

## Conclusion (61-65)

61. Much has been done by central banks, but much remains to be done and the crisis will really be over only when interest rates have been normalized. And according to the latest FED's forecast this will begin to occur only from 2015 onwards.

62. If over time, the current monetary policy will be favorable to markets, we remain concerned about a possible new economic deterioration in coming weeks. This is what makes us still cautious.

63. And even more so as central banks have now used all their ammunitions and besides buying shares or crediting money directly on taxpayers' bank accounts, they really have no more weapons at their disposal.

64. Monetary policy cannot achieve everything and if a loose monetary policy was enough to make an economy function healthily, life would have been much easier.

65. We are therefore waiting to see how markets will react to bad economic news in order to judge whether an adjustment of our strategy, which remains cautious, is justified.



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