

Market Outlook

A monthly commentary on financial markets written on December 1st, 2014

50 %

Generalities (1-8)

1. If, during the entire month of October, the decline in European equities seemed to herald a more widespread downward move, the dramatic announcement in the last day of that month by the Bank of Japan (BoJ) of a significant increase in its quantitative easing policy (QE) changed investors' perception.

2. In fact, this announcement, once again, demonstrated the shared goal of central banks to boost economic activity by all available means. Thus, stock markets in developed countries rose markedly in November with, in particular, the US market regularly breaking its records.

3. For the month, the increase was 2.5 % for the S&P500, 3.5 % for the Nasdaq, 4.4 % for the Euro-Stoxx50 and 7 % for the Dax.

4. But emerging markets continued to suffer : -1.5 % for the MSCI Emerging Markets index in dollars. Only a few emerging countries, such as India (+35.5 % in USD since the beginning of the year) are on a positive trend.

5. Regarding Japan, if once again the Nikkei moved up (+11.5 %) in JPY terms, almost all the profit disappeared in USD terms (0.5 %). Thus, the stock market is signaling that the QE policy has not yet had the desired effect, since not only there is no outperformance of the Japanese index, but it is even the opposite which is occurring with the Nikkei down by 5.1 % since the beginning of the year in USD terms.

6. This indicates that if the Japanese QE policy led to a sharp fall of the yen, which against the dollar for example, has moved down from 100 in mid-July to 118.6 at the end of November, it has not yet brought an improvement to the economy. This can be illustrated by the fact that the GDP in real terms was in contraction at the end of the third quarter of 2014 by 1.2 % over the last 12 months.

7. At the monetary level, it should also be mentioned that the relatively better situation of the United States in comparison to other countries has allowed the dollar to broadly rise : +10.4 % since the beginning of the year for the dollar index. And during the month the euro was down from 1.2525 to 1.2450.

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Generalities (8-10)

8. Regarding bonds, the Japanese non-recovery partially explains why the yield of the 10-year Japanese sovereign bond reached in November its lowest level ever at 0.42 %. This was also the case for the German 10-year bond, at 0.70 %. And even the yield of the US 10-year bond dropped from 2.33 % to 2.16 % despite an improved US economic situation.

9. Interestingly, the yield level of the Bloomberg USD High Yield Index moved in the opposite direction rising from 6 % to 6.3 %.

10. Finally, once again, commodities continued their fall in November, -6.5 % for the CRB Index, with a spectacular move of oil (-18.4 %).

Bonds (11-18)

11. 50 % : this is the proportion of US sovereign debt held by the FED at the end of its QE program in October 2014. In comparison, this figure was only 18 % in 2008, when purchases began.

12. In total, if we add the asset-backed securities purchases, the FED has acquired USD 4 trillion of bonds, quadrupling its assets in 6 years.

13. This situation is criticized by some who consider that the FED has now become a leverage hedge fund. This, however, is a little bit excessive, because even if rates move up, the central bank will not lose money over time. Indeed, having created, at no cost, money that it used to buy interest bearing bonds, it is sufficient that the FED continues to value these securities at their historic price until their maturity to show a profit on any transaction.

14. A more appropriate criticism would probably be that this policy enabled banks to be recapitalized at the expense of savers who have experienced a significant decline in their bonds' revenues. This loss is estimated by some analysts at more than USD 400 billion.

15. And the yields' fall also obliged investors to take on much more risk than

in the past, including the indiscriminate purchase of junk bonds. This is a topic we have often discussed.

16. But there was also, in this quest for yield at any price, the creation of derivatives products linked to bonds. For example, there are currently more than USD 12 trillion derivative contracts only on US interest rates. Therefore, should the volatility of interest rates increase, now that the FED has ended its purchases, significant losses may occur.

17. It is therefore important that rates fluctuate in an orderly manner so that investors have time to adjust their risk exposure. And from this point of view, the first test of the consequences of an increase in volatility has brought much concern to the market.

18. Let us remind the facts that we have already mentioned last month. On October 15th, at the opening of the US trading day, the yield of the 10-year US sovereign bond stood at 2.20 %. It had fallen to 2.16 % by 8:29 (NY time) when a statistic regarding US retail sales was released, which was considered as disappointing by the market. And, at that moment, began what subsequently has been called a "flash crash", since at 9:39 the yield had fallen to 1.86 %.

Bonds (19-29)

19. It was then followed by a quick rise, since at 11:11 the yield was back at 2.06 %. It then slightly moved down again, before a new surge late in the day brought the yield back to 2.14 %.

20. Thus, for those who did not experience the ride and only saw the opening and closing price, October 15th seemed just like another ordinary day. But the reality was quite different.

21. As we already mentioned last month, this test in real conditions has shown that, in today's after-financial crisis world, liquidity tends to disappear when it is the most needed.

22. This situation is linked among other reasons to the fact that a growing number of transactions are being carried out on private electronic markets. And the problem is that, as soon as volatility exceeds a certain level, some of these exchanges close to avoid the risk of losses. This leads to a further increase in volatility pushing at that moment other exchanges to also suspend their activities, thus creating a self-reinforcing mechanism.

23. What has shocked the most in relation to the events of October 15th is that for an hour we had the disappearance of liquidity, i.e. the ability to easily buy or sell. And this has occurred in a market - US sovereign bonds - which was hitherto considered as being the least likely, because of its size and the number of participants, to experience such an event. But, if even the US bond market is not immune to such accidents, what could happen to the other, less liquid, non-US bond markets ?

24. The decline from 2.20 % to 1.86 % may seem minor, but in fact based on the risk models used by major traders, its size was more than seven times greater than the that of usual intraday move. In statistical terms, such an event is supposed to happen only once every 1.6 billion years.

25. And investors are now starting to understand a little better why a statistic among others (US retail sales) produced such a disruption. The fact was that a significant number of traders were positioned before that day to benefit from an increase in yields. However, the opposite was occurring in the previous days and, after the October 15th statistic, the yield's downward move accelerated. And then, as also happened during the 1987 stock market crash, it appears that because operators were using similar risk models, they all gave almost at the same time the signal to reduce exposure to risk.

26. And those who had leveraged positions were even more vulnerable, since limiting their losses to an acceptable level meant that they could reduce their risk by closing positions at the time and at the price they wish. But with yields declining at a speed which was considered as impossible by their risk models, these investors had effectively lost control over the amount of their losses.

27. Thus, once again, risk models used by banks - and which central banks also love so much - have proved to be inadequate. These models' continuous popularity is quite amazing considering the regularly with which they lead to a crash of the financial aircraft.

28. And yet, in spite of everything, these models continue to play a major role, promising an improvement after each failure. The reason for their success is that they provide an illusion of scientific control of risk, which we translate as follows : why use our brain when the machine can tell us what to do ?

29. Furthermore, these models work 95 % of the time and, when they do, they allow profits to be maximized. And this is what counts for executives who will only be a few years at the head of their banks and who therefore consider that the odds of not running into a major problem are in their favor.

Bonds (30-38)

30. And this is the same reasoning that hedge funds and other management entities adopt.

31. What makes these models dangerous in our view is the fact that they are built on statistics of the past and are thus unable, by definition, to integrate new facts. For example, how can presently a bond risk model take into consideration, in any precise way, the future and unknown effects of the FED's massive intervention in the bond market through its QE policy ?

32. In short, these models are like these generals who are fully prepared to fight the previous war.

33. Certainly, the flash crash did not have major consequences, but this was only because yields dropped and not the opposite. Indeed, a lower yield meant that the number of winners - those who held bonds - was much higher than those who were speculating on their rise. Thus, naturally, at a certain point some investors decided to sell bonds to take profits, thus re-equilibrating the market. But one can imagine what would have happened in the opposite case, with losses increasing by the minute.

34. However, there was a positive aspect. Both investors and the FED are now investigating the events of that day and one can hope that steps will be taken to prevent its repetition. The goal is not to limit price fluctuations, but to ensure that this happens in an orderly manner, with buyers and sellers at all times.

35. And given the importance taken by the FED in this sector, one wonders if it is not inevitable that, sooner or later, it will be formally forced to assume a regulatory role, intervening when moves become excessive. This would be the equivalent of the foreign exchange interventions practiced from time to time by central banks to force an adjustment of the exchange rate of their national currency.

36. Should this happen, it would be a sign that, because it holds 50 % of the government debt, the FED is in fact in a position where it finds himself unable to withdraw from the market without creating significant volatility.

37. Anyway, October 15th is one extra reason for the FED to behave quite cautiously in coming months. If it is no longer increasing its bond exposure, it is however continuing to buy bonds to replace those which are maturing. Thus, the next step will be to start reducing its holdings as painlessly as possible.

38. As a matter of fact, the recently published minutes of its 28-29 October meeting indicate its determination to limit as much as possible any future financial instability. And, from this point of view, the FED is still the best friend for those holding assets, starting with equities.

Equities (39-51)

39. Everything which happened in November is likely to reassure stock market investors.

40. In the United States, all the economic signals are in the green mode and nothing seems to be able, within the country, to hinder growth.

41. In Japan, not only has the BoJ increased its QE policy, but the country's largest pension fund - the government one - announced that it would increase its equity holdings from 24 to 50 % (25 % Japanese and 25 % foreign).

42. In addition, the Japanese public only holds 9 % of its saving in equities and a simple increase by 2.5 % implies additional purchases for JPY 40 trillion or 8 % of GDP.

43. In Switzerland, the Euro/Swiss Franc exchange rate peg at 1.20 has inflated the balance sheet of the Swiss National Bank (SNB) to the point that the SNB is buying shares in order to diversify its exposure. And if, currently, only 16 % of the assets are invested in equities, it still represents USD 80 billion, an allocation which did not exist before 2008.

44. And taking into consideration current yields in developed countries, more and more investors will have, like the SNB, to increase their equity investments.

45. Even China seems to have changed course, with the first reduction in its key interest rate since 2008. "

46. With regard to Europe, the European Central Bank (ECB) President - Mr. Mario Draghi - seems to be endowed with a rather unique conviction power towards the market. Indeed, he had previously

managed to put an end to the euro crisis by the mere announcement of a monetary operational program on securities, a program that he did not even have to put in place, the market taking his word for it. Incidentally, the legality of the program has not yet been validated by the judiciary authorities of the Eurozone area.

47. Today, just with a simple and vague promise to increase QE "if necessary", the market took his word for it again. Indeed, by already anticipating what such a program should have brought - i.e. a fall of the euro and of yields - it paradoxically renders unnecessary an expansion of the European QE program.

48. And investors have also noticed that the ECB has already prepared investors for what would be the breaking of the last German taboo : the purchase of sovereign bonds of the Eurozone. Its vice-president Vitor Constancio, in a speech in London on November 26, declared that if all the measures taken until now were to be insufficient : "we will have to consider buying other assets... including sovereign bonds in the secondary market. It would be a pure monetary policy decision, within our mandate and our legal competence."

49. Regardless, recent developments in the Eurozone area are favorable for equities.

50. And finally, there is the commodity prices' decline, so much consumer-friendly.

51. In conclusion, as long as the major central banks' monetary policy remains quite lax, and as long as growth continues, even if at a slow pace, and as long as real bond yields are non-existent, the equity allocation in portfolios can only grow.

Currencies (52-55)

52. The decision of the BoJ's Governor to increase by JPY 80 trillion its balance sheet through bond purchases in order to push the yen down and favour the reappearance of inflation has earned him the nickname of "Kamikaze Kuroda".

53. Indeed, some analysts believe that the BoJ is playing with fire. Not only this policy leads to a real decline in the purchasing power of households by increasing the cost of imports, but, in addition, it could also destabilize the country. Presently, Japan is able to finance without any problem its debt exceeding 200 % of GDP because the country's savings are larger than its debt. By the way, the Japanese case illustrates the fact that the debt/GDP ratio is not decisive in establishing the solvency or not of a country. What matters is the debt/national saving's ratio.

54. And the question which needs to be asked today is the following : knowing that, in the current composition of Japanese savings, over 50 % of the assets are either in physical money or in bank deposits earning 0 %, should Mr. Kuroda be successful in lifting 'the inflation rate, how will investors react ? This question is particularly important because, as we have seen with equities,

a small change in asset allocation has major consequences, taking into consideration the volume of savings which represents 350 % of GDP.

55. For the time being, everything is quiet. But should the population's confidence in their currency decline, we could then see the yen weakening beyond what is desired by the BoJ. And in the worst case scenario, one could imagine that this will further increase investors' distrust, thus causing a renewed downwards move, leading to a self-accelerating mode that the BoJ would be unable to control without serious economic consequences.

56. Obviously, the hope is that the over 40 % decline of the yen will allow exports to increase, thus boosting growth. And also that the negative real interest rates that will come from a rise in inflation could boost productive investments.

57. Therefore, this is an experience which is followed with interest, since if the chosen policy is identical to that of the FED, its main consequence, the decline of the yen, could have surprising effects and not necessarily in a good way.

Commodities (58-61)

58. The commodities' fall remind us that, as with cholesterol, there is good and bad deflation.

59. The bad deflation is the one linked to a drop in demand, which forces a reduction of the offer through a reduction in the production capacity and a fall in costs, in particular in paid wages.

60. The good deflation comes from lower production costs allowing prices to fall and which is achieved thanks to technology or, as is currently the case, through the decrease in prices of agricultural products and energy.

61. Of course, producing countries suffer; but for consumers this represents a sharp increase of their purchasing power, the positive effects of which are currently, from our point of view, underestimated.

Commodities (62-64)

62. In Europe, for example, it was widely publicized that inflation in the euro zone stands at only 0.3 %, thus very close to deflation.

63. But if we exclude the energy and food components, the inflation core rate is still at 0.8 %, at the same level it was already at the beginning of the year. Therefore, there is no noticeable degradation of the bad deflation for the time being. In

comparison, also excluding the energy and food components, core inflation is currently at 1.5 % in the USA and UK.

64. Anyway, this bearish episode on commodities should be close to the end with most of the move already having happened, in particular after the recent Opec meeting. Indeed, a stable world growth should allow prices to stabilize.

Conclusion (65-70)

65. Will Japan succeed in creating a sustainable rise in prices ?

66. Since it was the first country to have suffered the shock of deflation, it would be logical that it will be the first to reverse the trend.

67. The great challenge for central banks afterwards will be to control the move, so that any rise in yields can be done in an orderly manner.

68. As long as this will be the case, equities will remain the favorite investment and one could even have surprising stock markets rises, as the leverage effect on corporate profits brought by any acceleration in growth should more than compensate the negative effect resulting from any reasonable increase in yields.

69. But one should be aware that we are in uncharted waters, with the FED holding 50 % of the bond market.

Currently, the FED has quite a lot of flexibility, since, on the one hand, inflation is very low and, on the other, the cash it gave to banks in exchange for bonds has been deposited by these same banks, in order not to take any risk, with the FED at an interest rate which is currently of 0.25 %. Having now overcome the effects of the financial crisis and with a normalized US economic situation, it would thus be natural for the banks to increase their lending to the economy in order to get a better return than the 0.25 %. This implies that their deposits with the central bank will decrease proportionally. And, should this happen, the FED will then be obliged to also manage the increase in money supply in the economy, with a risk that at a certain point it becomes incompatible with the objective of an orderly rise in yields.

70. In short, it seems that we are condemned to live in interesting times, to paraphrase a famous Chinese saying.

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