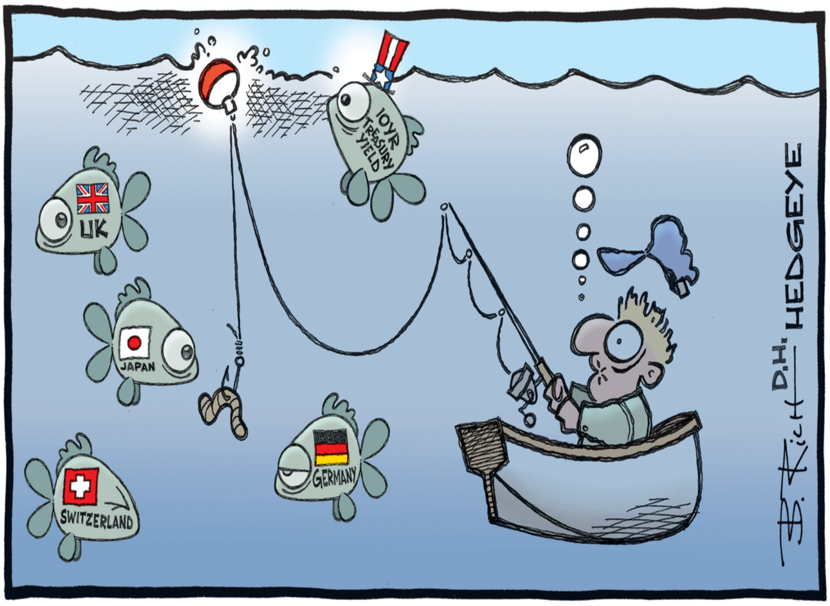
Market review August 2019



August was marked by various records:

- The Chinese currency experienced its largest monthly decline since 1994.
- The yield on 30-year US government bonds fell under less than 2% for the first time in history.
- The yield on the 10-year German bund also hit its all-time low at -0.71%.

These signs are not insignificant and leave us perplexed. Over the past 10 years, the European Central Bank, the Swiss National Bank, the Bank of Japan and a few others have set up an unprecedented monetary experiment. This concept of lowering interest rates below zero and buying assets is intended to remunerate the borrower and penalize the saver. If these temporary measures can initially boost credit and the economy, they become addictive in the long term, distort economic market conditions and create aberrations.
Always expecting more from central bankers, we have put into practice a theoretical system that has never been proven.

There are currently more than USD 16 000 billions of negative-yielding bonds in the world! The entire German interest rate curve yields negative returns (from short-term time deposit up to 30-year maturities)! For a German investor, this is a bargain if he can find properties at reasonable prices. For an investor, he knows that his savings will melt a little each year. The same applies to banks, insurance companies and pension funds. The collateral damage of this monetary policy is coming to light. Greece, which is on the verge of bankruptcy, borrows at 10 years at a rate (1.57%) barely higher than that of the United States (1.48%), which is the world's leading economic power! What about Italy, whose 10-year rates are below 1%!

If this type of monetary policy was to spread and become the norm, most economic theories would have to be rewritten. It is as if human beings must learn to live in a continent immersed in water (the melting of the ice may one day push us to do so!). Men should become amphibians. These mutations do not happen overnight.

In the economic world, changing conditions benefit some and penalize others. The low interest rate environment allows indebted players to stay alive and others to justify valuations that have never been seen before. This applies to both companies and states. In 2018, in OECD countries, the cost of debt interest represented only 1.77% of GDP compared to 3.9% at its highest in the 1990s, while debt increased on average from 45% to 75% of GDP in 40 years.

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The mountains of debt incurred by governments make a significant interest rate hike by central bankers unlikely (except in isolated cases of bankruptcy, such as Argentina). The resulting crisis would be devastating. So for now we need to learn to live in this environment.

Lower interest rates have produced extraordinary returns on long maturities this year.

Market trends at end of August 2019

			Equities in Local Currencies					
End of June	MSCI World	S&P 500	EuroStoxx	CAC	Spain	Switzerland	UK	Hong Kong
Perf 1 Month	-2.24%	-1.81%	-1.16%	-0.70%	-1.76%	-0.24%	-5.00%	-7.39%
Perf 3 Month	4.51%	6.34%	4.46%	5.24%	-2.12%	3.90%	0.63%	-4.37%
Perf YTD	13.52%	16.74%	14.17%	15.85%	3.20%	17.40%	7.12%	-0.47%

		Commodities				Currencies vs EUR		
End of June	WTI Oil	Brent Oil	Gold	Copper	USD	JPY	GBP	CHF
Perf 1 Month	-5.94%	-7.27%	7.53%	-4.23%	1.29%	3.43%	0.85%	1.20%
Perf 3 Month	2.99%	-6.30%	16.46%	-2.64%	1.65%	-3.41%	-2.11%	-2.60%
Perf YTD	21.34%	12.32%	18.55%	-4.84%	4.20%	7.52%	-0.56%	3.38%

			Bloomberg Indices Bonds Total returns					
End of June	Global Aggregate	US Aggregate	Euro Aggregate	US 10 Year Treasury	German 10 Year Bund	Global Credit	Global High Yield	Emerging Sovereign $
Perf 1 Month	2.03%	2.59%	1.91%	4.01%	5.53%	1.95%	-1.56%	0.25%
Perf 3 Month	4.01%	4.11%	5.36%	5.32%	10.93%	4.64%	2.01%	3.99%
Perf YTD	7.42%	9.10%	9.00%	11.14%	19.53%	9.86%	8.24%	10.75%

Source : Bloomberg 30/08/19.

But let us go back to the basic reasoning:
Today, a German 10-year government bond does not pay interest (0% annual coupon) and is purchased at a price of 107. In 10 years, this bond will be repaid at a price of 100 and will have generated no interest. So a current buyer is certain to lose 7% over 10 years, or 0.7% per year (if we add 1.7% annual inflation, the loss is stagering, -16.86% cumulative loss over 10 years). Why would an investor buy any asset today with a certain loss of this order? This is beyond comprehension! Unless we believe that all other assets will lose even more over the same period. This implies a disaster scenario that we do not conceive, especially over such a long period.

Do investors who rush to this type of investment have these figures in mind or do they think only in terms of alignment with a benchmark to which they temporarily compare themselves? A further reduction in interest rates would allow them to resell these bonds at a higher price; like in a board game. Woe to the last holder, however, who will only receive 100 for his purchase! This small calculation also tells you the challenge facing pension and insurance funds.

US interest rates are heading in the same direction as European or Japanese interest rates. Will they also fall below the waterline? One can bet that in the event of a crisis, government rates could approach it. But corporate borrowing could have a different trajectory.

Europe and Asia are economies whose development is supported by their banks. It is therefore relatively simple for the ECB and the BoJ to impose negative interest rates on its national central banks (for the ECB) that regulate their national banks. In the United States, loans are securitised. This involves transferring financial assets (receivables, loans) to investors. Such securitisation is achieved by bundling a portfolio (i.e. a pool) of similar types of receivables (real estate loans, consumer loans, etc.). This portfolio of securitised receivables gives investors the right to receive payments of receivables (for example, when invoices are paid, or when real estate loans pay monthly payments) in the form of interest and principal repayment.

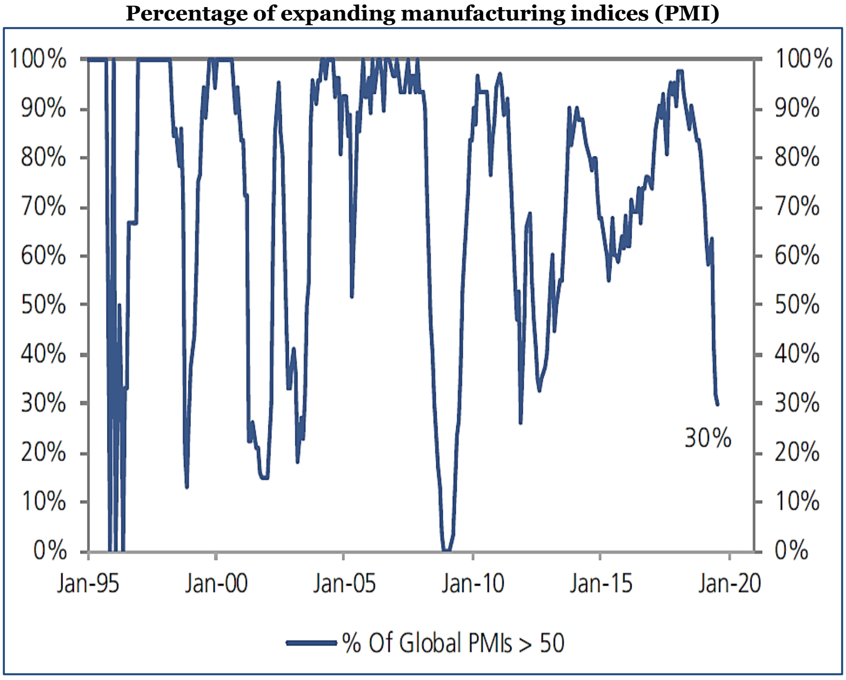
The size and diversity of this securitised debt market is very large. Receivables and loans are resold to investors and do not remain on the banks' balance sheets. No rational private investor would sponsor his neighbour's mortgage at his own expense by buying negative-yielding debts!

This economic logic shows the limits of these "unconventional monetary policies". Central bankers are not superhumans capable of solving all economic problems. They have inoculated the virus of negative interest rates thinking they would find a vaccine against the structural ills of certain countries: high debt, low growth and lack of reforms. In fact, this virus did not stimulate the natural defenses of these countries because their structural problems were already too important. This has only prolonged these economies in the same sluggish state. The salutary shock did not occur. On the other hand, debts are accumulating...in a context of deceleration.

What is the solution? A further reduction in interest rates in even more negative territory? After all, in the Mariana trench of the Pacific Ocean, we found the presence of living creatures! However, it is likely that this would eventually trigger a cascade of bank failures. The "debt restructuring" (a civilized term to avoid pronouncing the word bankruptcy) of some countries, such as Italy, seems more likely. This will have a financial and political cost, but if the problem had been addressed in the previous decade, these problems would be behind us, as evidenced by Ireland and Portugal.

The trade war between the United States and China is in no man's land at this stage. Business investment decisions are frozen in the face of this uncertainty. If at the beginning of the year, 76% of the world's manufacturing indices were still expanding, that number has now fallen below 30%. For the United States too, we are in a contraction phase of the manufacturing industry. Inventories are at higher levels than order books.

Percentage of expanding manufacturing indices (PMI)



Source Factset, UBS

The Tariffs imposed by the US administration must, in the first instance, be absorbed by companies so as not to penalise the consumer. But companies'profits are in a phase of compression. The possibilities of additional debt also seem limited, so sooner or later, the consumer will have to bear these additional taxes.

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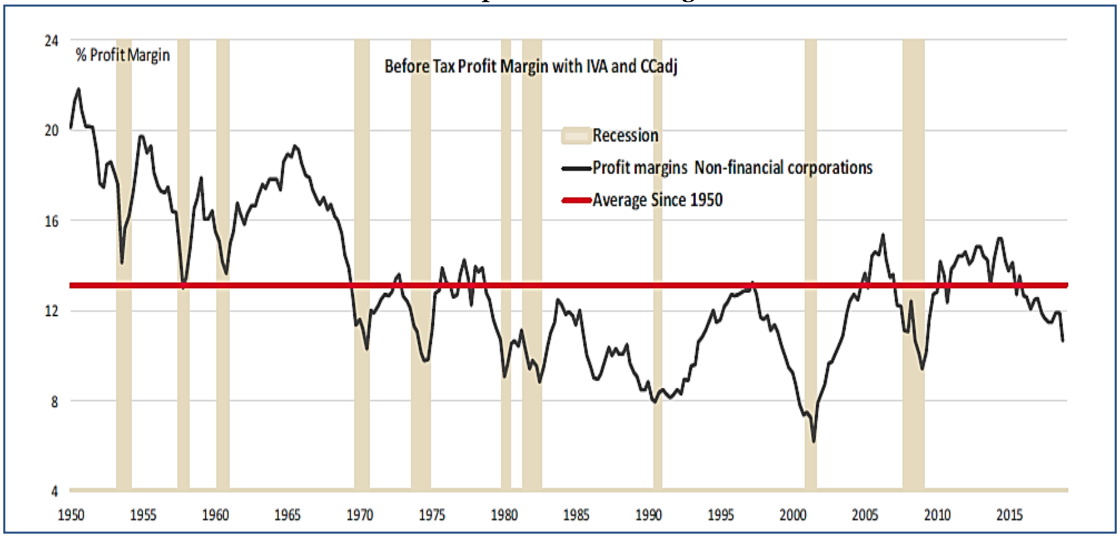
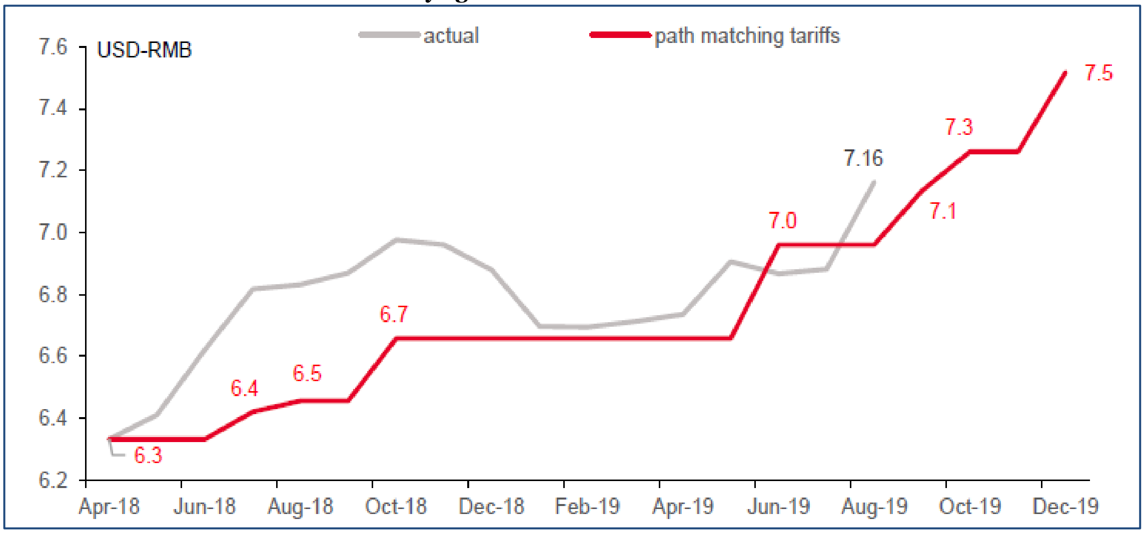
U.S. Corporate Pretax Margins



Source: SG Cross Assets

China had so far reacted only lightly to American decisions. As mentioned in the introduction, the Chinese currency experienced its largest monthly decline since 1994 in August. The Chinese authorities have decided to let their currency slip in order to compensate for the cost of US tariffs (to maintain their competitiveness). The following graph shows the evolution of the Chinese currency against the USD and the theoretical evolution of the latter as a function of tariffs. This decision by the Chinese authorities to devalue their currency has important consequences for all emerging countries that are either suppliers or competitors of China. They are forced to devalue their own currency to remain competitive. With debt denominated in USD and revenues in a depreciating local currency, the cocktail is toxic.

Evolution of the Chinese currency against the USD and theoretical model based on US tariffs



Source: SG Cross Assets

The fall in bond yields is staggering, as we mentioned in the preamble. The yield on the 30-year US bond has fallen to its historical low, below 2%. The dividend yield on S&P 500 Index companies is for the second time in history above the 30-year rate. The first time this happened was during the 2008 financial crisis, when stock markets collapsed, driving dividend yields above 30-year rates. Here the opposite phenomenon has occurred: falling bond yields.

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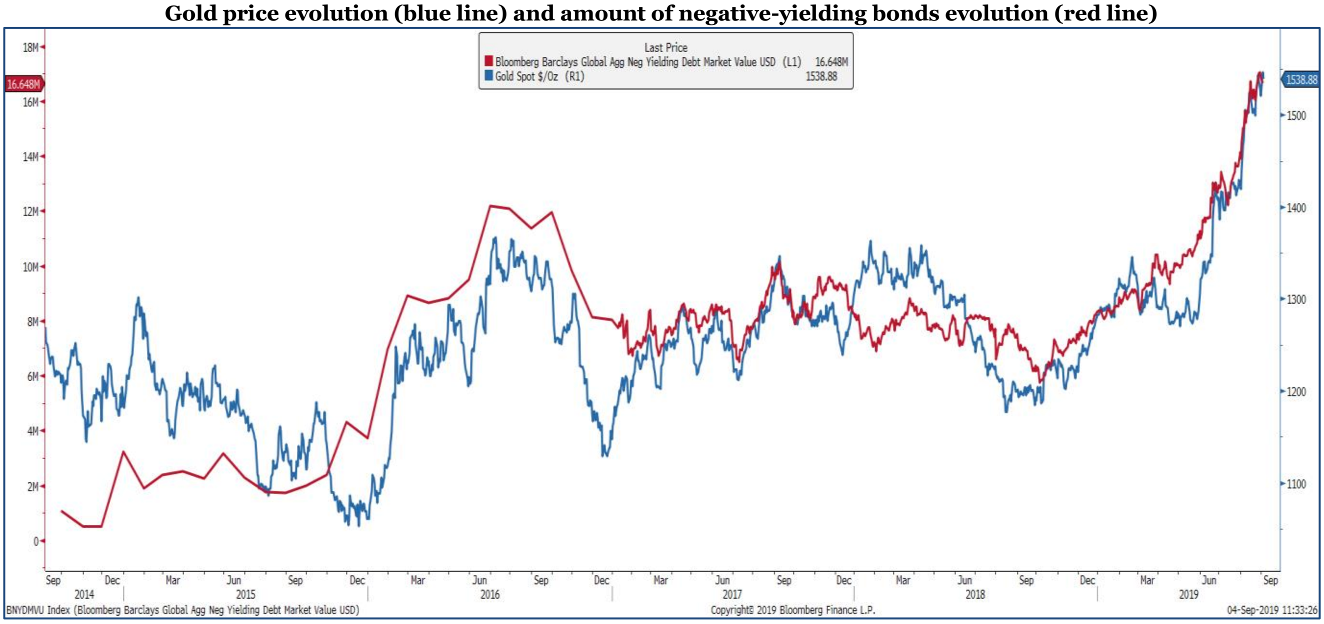
US 30-year Treasury yields, S&P 500 Index dividend yield

Source: Bloomberg

In the current context, the decline in manufacturing indicators and the drop in interest rates seem to point to a future economic recession. Some countries, such as Germany which is highly exposed to world trade and China, will already be in a technical recession in the third quarter. (The recession is characterized by two consecutive quarters of contraction in GDP.) Q2 showed a decline in GDP of -0.1%, it is unlikely that current uncertainties could reverse the trend in Q3.

One asset has stood out since the end of 2018: gold. The following graph is striking. It represents in red line the value of bonds offering a negative yield (this number is constantly increasing) and the evolution of the price of gold. This relationship makes sense. Gold can be a safe haven or a currency of exchange. The major disadvantage of gold is that it does not pay any interest. But when government bond yields, which are also considered safe havens in times of economic contraction, fall below zero, this relative disadvantage (known as the opportunity cost) of gold disappears.

Gold price evolution (blue line) and amount of negative-yielding bonds evolution (red line)



Source: Bloomberg

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We are in a phase of economic deceleration. The indicators are orange. The current economic contraction in some countries may only be temporary.

The trade war between the United States and China will certainly be long and similar to a new cold war. However, it is likely that both actors have a lot to lose from the current uncertainties. On the one hand, it could cost President Trump his re-election and, on the other hand, be a source of considerable tension in China. Economic pressure could lead both sides back to wiser decisions.

The bond market is perceived as a safe haven. But the calculations we mentioned earlier on future returns seem to us to be very unattractive in the long term.
Stock markets are well valued as a whole and are not immune to economic turmoil. Market volatility should provide investment opportunities. During the summer, we took profits on some well-valued stocks. We have reoriented some investments to less cyclical sectors with stable dividends.
In the long term, the timeless themes of Technological Change, Health, Safety and Environment continue to be our guiding principle.

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