Alpha Value MANAGEMENT

Point of View

Analysis, Research and Texts by AVM Market Analysis Unit | September 2015 | Year II – N. 7

In this issue

•••

•••

From the Editor

Portfolio Manager point of view

EDITORIAL

A growing number of elements make it plausible that the long wave of new highs that have been seen in stock markets for years is nearly over. The economic cycle is slithering towards a slowdown. Focuses of crisis are seen with increasing frequency: on one hand there are wars being fought on some scale, bomb attacks and people blowing themselves up, the advance of ISIS; on the other, on the economic plane, the emerging economies are experiencing crises. First it was Turkey, more recently Russia and China. What we are told and what then becomes a typical Leitmotif of popular thinking does not always turn out to be true. What is certain is that growth, in the currently less stable world order, takes pauses even while the markets hang on, up at high levels near their maxima, thanks to the support coming from the quantitative easing decreed by the central banks. Now, more than ever, it is important to understand the economic-financial system and take action by applying methods that offer protection from uncertainty and market falls. We have been ready for this new scenario for years.

Giorgio Saronne

Main scenario Hypothesis

MAIN SCENARIO HYPOTHESIS

Premise

As never before, the dynamics of the economic-financial system have shown the strength and the logic of correlations. Every part of the economic system, linked as it is with the financial markets, plays its part in determining the overall situation and the price changes in other sectors. But there is always a starting point, one influence that stands out. In this article I will attempt to interpret the global economic sitation, starting with inflation, or the lack of it, and its impact on the Fed's decisions on interest rates, together with all the secondary influences.

The current economic situation

In my February newsletter I had re-examined my bulllish view of the markets over the medium and the long term, then in June I took the step of modifying my outlook for the medium-to-long term, which had stayed bullish since 2010, by initiating a bearish forecast. From a macrocyclical standpoint, at least with reference to the Eurozone, the context has become one of 'secular stagnation', which has developed in ways and for reasons that have been defined by authors who have become its spokesmen. From a cyclical viewpoint we are still located in the peak phase, which is now bringing this economic cycle to its close. From here the most likely scenario for the next two years is one of a 'controlled slowdown' determined by cyclical and structural factors.

The USA is living through the conditions prevailing in this phase in a much less critical way than the Eurozone. The USA does not have to face the problem of demographic decline that is so troublesome in the Eurozone, while overall demand in the wake of the financial crisis has resumed following the cyclical dynamics of growth vs decline. Things are different in the Eurozone, where we are looking at a structural decline in overall demand, with a tendency for it to fall in a way that continues to keep growth and inflation subdued. For years now both economic blocs (the Eurozone and the USA) have felt the pressure of falling prices that has by now become structural; that pressure derives from imports of cheap goods from China, the emerging countries and all the other Asian countries. In addition, technical and technological advances in the US and the Eurozone over the past few decades have made possible rhythms and mechanisms of production that determine much lower costs than in the past; this exerts extra downward pressure on retail prices. Both America and the Eurozone are primary target areas for huge flows of immigrants that are increasing the supply of unqualified, low-paid workers. This puts pressure on production costs and, therefore, on inflation itself. For over a year now, the price of crude oil has stayed very low and has played a major role in pushing inflation down.

It can therefore be said that in the Eurozone and the USA there is a series of shared causes (in addition to those that only affect the Eurozone, such as its demographic decline, the progressive disintegration of its values and rules, and the general inefficiency of the system) that determine a structurally low pattern of levels of inflation. In this way a new nexus of correlation has begun between the two benchmark systems, so that the problem of the level of inflation has become a shared feature: everything that improves or that worsens this context is operative on both sides of the Atlantic. As a result, the two central banks (Fed and ECB) some time ago decided to face the situation in a way that was, in fact, jointly agreed and that presupposed jointly approved monetary policies, whether of conventional or non-conventional type.

All these factors help to determine a general perception of the problem of low inflation (which had never been experienced in Western economies for a great many years, although it was just that anomaly that had situated Japan at the periphery of the system). As has already been noted, the factor of low inflation calls on the Fed and the ECB to sustain and coordinate an expansionary monetary policy for growth. To keep up the efficiency of that policy, it has had to be made non-conventional, after the Fed applied for several years the lever of interest rates that were close to zero. In this repect the Fed's role was taken over by the ECB early in 2015 when, after the Fed's three phases of quantitative easing (QE), the European Central Bank began its own QE. At present, interest rates for risk-free bonds, both in the USA and the Eurozone, are almost at zero. What is most worrying is that interest rates have been falling for years and, in some cases, will stay at those low levels for a long time. The business cycle is in trouble, after moving beyond the peaks of possible growth in this phase, and it now seems to be slipping into a new cyclical slowdown phase. Within this system, the periphery of the Eurozone is a bit worse off, whereas the USA certainly occupies a better position. The price of crude oil close to its recent minima and the Baltic Shipping Index at minimal levels are other worrying signs. In mid-2014 the Fed had, correctly, let it be understood that, after the third phase of quantitative easing, it intended to start a 'normalisation' phase, in other words a period of 'getting back to normal business', in which, in line with the evolution of the classic economic cycle, it was only normal to expect interest rates to rise after a period of falling rates. When the time was ripe, a few months ago – when that condition had moved closer to being implemented – it was enough for the sensation to be felt that the Fed was ready to begin a serious attempt to tighten monetary policy to stir up feelings of pessimism in the markets, so making them turn down, while raising their volatility and vulnerability to any speculative shock and/or attack. All the events seen in the markets so far have largely arisen from this new cyclical condition, where the monetary policy of the central banks is (rightly) attempting to become normal again, while experiencing all the difficulties of markets that had been basing their stability on the constant presence of QE.

In the meantime, the idea that the Fed would be raising interest rates had strengthened the dollar, taking the EUR/USD cross-rate down from its maximum around 1.40 at the start of 2014 to a minimum of 1.0460 a few months ago. During the earnings season the quarterly company results that have generally been better than expected have confirmed the refound strength of corporate America and, to a lesser degree, of European firms, too. After the major financial crisis a strong process of natural selection took place; that selection of the fit eliminated companies that were incurably inefficient and/or companies suffering from ineffective management, as was the case in the majority of those firms. At the same time, as mentioned above, the Western economic system has, during the last few decades, been 'colonised' by cheap exports from China and other emerging nations. Initially that was a problem for Western firms, which discovered they risked becoming uncompetitive in their own home market; at a later stage many of those firms made the effort to restructure in preparation for the new forms taken by global competition, but the price that had to be paid was a sudden, structural narrowing of profit margins. By now those companies have restructured by cutting inessential costs and optimising the budget ratios that express the relationship between revenues, expenditures and costs. That explains how they have been able to continue to generate rising profits despite a systemic context that is not showing growth at a pace that would satisfy academic models, nor economic analysts, especially those working as policy-makers or at central banks. So much so that we could say that it is the systemic side that is the weakest facet of the whole economy, as it is unable to move forward, considering that the economic indicators and the values that measure gross demand are flat or slightly negative (more conspicuously in the Eurozone than in the US). That is why inflation is staying low and will continue to stay low. Quite apart from policy-makers' hopes, analytical outlooks and declared intentions, the Fed no longer has either the motivation nor the opportunity to significantly raise the benchmark interest rate, thus initiating a cycle of hikes, because it has always stated that it will only intervene when inflation rises above 2%, whereas for now inflation is running well below 2%. The factor that has undermined the previous consensus scenarios is the oil glut. If we accept the principle that the price of crude only depends on the relationship between supply and demand, we can follow up by saying that the 'fair price' for WTI crude oil, in other words the correct theoretical level of equilibrium between demand and supply should fall within the \$50-70 range. The Italian oil giant ENI, in line with other oil companies, has based its estimates of future oil prices on forward guidance that sets a target for WTI at \$60 for the end of 2016. Until a short time ago many commentators (ourselves included) thought that a fair estimate for the period between the present and the end of 2016 would be an average price around \$70. That price level would have had a significantly bullish impact on the inflation rate, which, when combined with the much hoped for increase in overall demand for goods, would have quickly pushed inflation beyond the threshold of 2% that might, or should, or could trigger the start of the cycle of interest rate rises by the Fed. In re-

ality, however, the past few weeks have seen the price of crude oil fall back again to the lowest price zone seen since 2008, in response to the agreement with Iran over its nuclear programme, which has allowed Iran to resume exporting its oil (so relaunching production, too). That meant raising supply in a situation of slowing – or at most stable – demand.

Going back again to the supply side, it should be kept in mind that the US, thanks to its new techniques for extracting shale oil, has evidently become a net exporter of oil – an innovation that has further raised (by now in a structural way) the global supply of crude oil. That in itself has modified in a more than marginal way American foreign policy and international political equilibria. In a different way, the slowdown in demand for crude oil is connected with the scenario of a possible cyclical slowdown that we discussed at the start of this article. This is where the Chinese economy comes in, with its more or less objectively falling industrial output and an annual economic growth rate that appears to be slipping back from 10% to 7% – and some analysts estimate an even lower figure – which is a view that presupposes a fall in the consumption of oil. On the topic of the Chinese economy there is much mythology: on one hand one can breathe in a widespread feeling of admiration for its efficient economic system, which grows and changes rapidly, while, on the other, much uncertainty is being felt about economic data that are made public with little transparency or, more exactly, with that red thread of reticence that distinguishes political systems that are not quite perfectly democratic. In any case, Chna is going through a transition phase in its own economic model, which, up to the present, had always made exports its top priority, so neglecting a home market with huge potential upside that is still mostly unexploited. On the reality of China, there is still a lot of organised disinformation, which is made worse by China itself, because of its curtain of reticence, which icould be called typical of regimes belonging to earlier times. There are other important players on the world scene that depend on the oil price, because their economies are exclusively based on exporting oil or because they at least qualify as oil exporters. Thus, even if Russia is in deep rouble because of the low level of current oil prices, little joy is felt either by Arab countries that extract oil, or by other OPEC members. All these situations have contributed for months now to a heated debate on whether OPEC production quotas should be cut as soon as possible. In any case, one outcome is a negative situation for all those emerging countries whose economies are based on oil production. Conversely, for us Europeans, a crude oil price that stays as low as it is now provides formidable help towards economic recovery, an opportunity to be seized for improving the productive structure of companies, and for revitalising public finances, while simultaneously alleviating the problems affecting family budgets (and those of firms, too), through a significant fall in energy costs. In practice, all these windfall benefits will function as a kind of unscheduled budget manoeuvre directed towards economic expansion. Will we be capable of taking advantage of that opportunity?

The Fed has just stated that there will be an increase in interest rates by the end of 2015, and it cannot afford to put its credibility at risk, as that is the one last strong weapon left in the hands of the central banks. That means an increase will happen – possibly in October, more likely in December. But it will be the one and only increase for quite a while – putting it clearly, for as long as the crude oil price stays as low as it is now – I would say at least until the summer of next year, 2016. Stock markets wil be left half way between a feeble attempt at economic growth (which will itself pull markets lower) and a European QE that will persist and continue to be referred to,so limiting market falls. There are some analysts who go so far as to speak of a QE4 coming from the Fed, but even in that case there will be no chance of a cycle of new highs. On present evidence it is impossible to tell whether a QE4 might occur, but what has already become clear to many observers, if not all market watchers, is that the current equilibrium between stock markets that have risen dizzily over the last 15 years and weak economic growth, which by now can be described as unstable and/or asymmetric across the various zones of the Western system, is able to hold up not only but mainly due to the asset purchases made by the central banks in implementing QE strategies. This instrument actually makes the markets inefficient, by impeding them from continually renewing the levels of equilibrium that would be most appropriate to the unfolding economic situation.

Monetary Policy

The situation of baton-changing between the Fed and the ECB on the issue of taking the initiative in applying an expansive monetary policy with worldwide ramifications continues to unfold. While the Fed has by now decided to gradually phase out its expansive monetary policy, which had lasted for years, in Europe the ECB, spurred into action by a general picture that is still far from its objectives, has begun to deploy both conventional and non-conventional policy instruments.

To sum up, the Fed's monetary policy is still expansive, but shows a bias (future orientation) that indicates future tightening.

The ECB's monetary policy is strongly expansive, while its bias is expansive, too.

Stefano Bagnoli
Market Analysis Unit

SCHEME OF MARKETS

Medium Term Focus

The **trend of medium-term** in the equity markets remains bullish, and the flows ranging from no risk to the risk, and then from the bond, from the areas no risk and defensive currencies (as JPY and CHF), to the stock, areas and growth-sensitive currencies (such as AUD and GBP).

Short Term Focus

The **short term trend** has returned bullish. The flows ranging from no-risk to the risk, and then from the bond risk free to the stock, and from the defensive currencies towards the growth sensitive.

FED's monetary policy is still expansive,
with restrictive bias.
ECB's monetary policy is still strongly expansive,
with expansive bias.

Economic Highlights

USA

	2007	2008	2009	2010	2011	2012	2013	*2014*	*2015*	*2016*	*2017*
Real GDP (YoY)	1,80	-0,30	-2,80	2,50	1,60	2,30	2,20	2,40	*2,90*	*2,80*	*2,70*
Inflation (YoY)	2,87	3,85	-0,35	1,63	3,17	2,08	1,48	1,63	0,20	*2,20*	*2,30*
Unemployement Rate (%)	4,62	5,80	9,28	9,63	8,93	8,08	7,35	6,15	*5,35*	*5,00*	*4,95*
FED FUND RATE (%)	4,25	0,25	0,25	0,25	0,25	0,25	0,25	0,25	*0,82*	-	-

Eurozone

	2007	2008	2009	2010	2011	2012	2013	*2014*	*2015*	*2016*	*2017*
Real GDP (YoY)	2,90	0,40	-4,40	2,00	1,60	-0,70	-0,40	0,90	*1,40*	*1,70*	*1,55*
Inflation (YoY)	2,13	3,28	0,30	1,61	2,70	2,50	1,34	0,44	*0,10*	*1,20*	*1,60*
Unemployement Rate (%)	7,53	7,58	9,55	10,10	10,12	11,30	11,95	11,58	*11,10*	*10,70*	*10,35*
ECB Rate (%)	4,00	2,50	1,00	1,00	1,00	0,75	0,25	0,05	*0,05*	-	-

Italy

	2007	2008	2009	2010	2011	2012	2013	*2014*	*2015*	*2016*	*2017*
Real GDP (YoY)	1,70	-1,20	-5,50	1,70	0,40	-2,40	-1,90	-0,40	*0,50*	*1,10*	*0,90*
Inflation (YoY)	2,04	3,49	0,77	1,64	2,91	3,31	1,31	0,21	*0,05*	*0,90*	*1,00*
Unemployement Rate (%)	6,11	6,78	7,82	8,42	8,41	10,68	12,21	12,69	*12,69*	*12,25*	*11,90*
ECB Rate (%)	4,00	2,50	1,00	1,00	1,00	0,75	0,25	0,05	*0,05*	-	-

World

	2007	2008	2009	2010	2011	2012	2013	*2014*	*2015*	*2016*	*2017*
Real GDP (YoY)	3,94	1,55	-2,32	3,99	2,96	2,08	2,16	2,52	*2,88*	*3,15*	*3,14*
Unemployement Rate (%)	6,11	6,36	8,18	8,24	7,88	7,82	7,88	7,34	*6,95*	*6,67*	*6,43*

Global Market Overview

	Price as 30th April 2015	Last Month Variation	Year to Date
Stock Indexes			
FTSE Mib	23287,82	0,38%	-0,09%
DAX	11580,71	-1,22%	-3,23%
S&P 500	2108,29	-0,22%	2,00%
Nasdaq 100	4479,06	0,04%	3,78%
Eurostoxx 50	3633,50	-1,74%	-2,20%
Nikkei	19531,63	-3,25%	1,13%
MSCI Emerging Markets	1045,99	-0,75%	5,35%
MSCI World Index	1787,40	-0,27%	2,18%
Global Hedge Fund Index	1246,20	-0,60%	0,16%
Benchmark Stocks			
Microsoft Corp.	48,66	12,26%	20,76%
Apple Inc.	128,95	-0,56%	2,90%
Facebook	78,99	-4,15%	-3,15%
Google	551,16	-1,13%	1,82%
Alibaba	81,17	-1,35%	-1,35%
Intesa San Paolo	3,07	0,99%	-3,39%
Fiat Christler	13,57	-8,31%	-11,19%
Forex and Commodities			
€/£	0,74	2,46%	0,52%
€/$	1,11	2,92%	2,39%
CRB Index	421,31	1,55%	1,77%
Gold	1182,61	-0,78%	-1,45%
Brent	3699,00	-2,25%	0,00%
WTI	59,40	2,87%	20,88%
Yield curves			
T-Bond 10 years	1,96	-	-
Bund 10 years	0,16	-	-
BTP 10 years	1,41	-	-
Spread Btp BUND	124,1	-	-

Contacts

Alpha Value MANAGEMENT

No. 11, Level 2, Casal Naxaro
Labour Avenue Street
Naxxar – NXR 9021 Malta
tel. +35 621 385851
www.avm.com.mt

120/A, Via Marconi
Noventa Padovana (PD)
35027 Italia
tel. +39 049 8934983
www.avm-italy.it
e-mail: info@avm-italy.it