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CORRECTION, OR CHANGE OF CYCLE?

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Will the Fed hike the rates up in September? The probabilities being allocated, as in a betting game for a Champions League match, are getting smaller. In our opinion, not to increase the rates before the end of the year would send a clearly more-negative-than-positive signal and give the impression that things are not on track. But we already know that in recent years the Fed has been more market dependent than data dependent. Some people attribute part of the market corrections to the expected rate hike, and that's when we wonder: if the probability of a hike is going down, why are the markets going down? The failure to answer this question is what exposes the structural imbalances, the huge indebtedness at ultralow rates, and the difficult-to-sustain multiples when the global slowdown is evident, the revisions of estimates are consistently downwards, and some big companies are releasing profit warnings.

I've been hearing many pretexts to label these movements as a "correction". By definition, a correction implies that something falls but will resume its natural upward trend afterwards. The markets are actually "correcting" since May. The more frequent comments I've heard this summer while building sandcastles on the beach were: **1) European markets are far from their 2007 levels** (e.g. Euro Stoxx 50 still has +45% to rise) while US markets have reached historic highs. False. European indexes are highly influenced by the weight of banks. If we adjust prices to recurring capital increases, to the few dividends paid in cash, to the continual programmes of US companies' share buybacks, and to the already recurring European bonus issues, which only contribute to dilute shareholders even more, *voilà!*, European markets are where they should be, probably higher than they ought to. **2) It is just summer volatility**, with little volume. False. It is evident that volumes on strong correction days double or treble volumes of a normal winter trading day. **3) Companies are in much better shape than in 2007**, with lower debt, higher margins, and better balance sheets. Apparently, and partially, true. Margins at historic highs can only deteriorate, debt is the same but at ultralow rates and longer terms, and balance sheets, good as they may be, depend on P&L and cash flow statements that cannot bear any additional stress without causing a complete change in the whole picture. Companies are no less vulnerable today than they were in 2007. **4) The ECB is in full monetary expansion and we have already seen the effect of several QE on US markets.** Furthermore, there could be a QE4 in waiting and China could also announce a stimulus plan along the same lines. Let's not forget the structural problems of a Europe that does not grow and that has just rescued an EU country that has literally pawned its islands. With unjustifiable multiples, even Draghi cannot avoid a bloodshed in the markets. **5) The collapse of oil price is the best tax and rate cut a family can get.** Therefore, more consumption, more growth, etc., etc., will follow. True, but partially too. Let's remember that oil trades in USD; when its exchange rate goes up, the fall in oil price all but disappears. We must also take into account the many ultra leveraged structures resting on a barrel at $ 80-100. When cash flows start to falter, defaults—admittedly, at historic lows—will be continuous and will contribute to stress, as a side effect, the credit spreads of the other issuers.

What can be done to handle this situation? We must start from the premise that all risky assets move more or less in the same direction. Therefore: 1) above all, keep a lot of cash to seize opportunities and carry out structural purchases, even if there are still very few, 2) avoid taking decisions in +/-2% days, and 3) switch off the screens and go on reading balance sheets and cash flow statements. Unfortunately these are no days to buy or sell. It had to done some time ago.