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WHAT THE MARKETS ARE DISCOUNTING

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In the last months we have explained why financial markets seemed very fragile to us. I remember the January 2015 article where we argued that the existing disconnection between the evolution of the economy and risky assets could not last long. For eight months we've been in a bear market coupled to high volatility, a situation we were not used to. Without doubt, few investors expected a correction of such magnitude at the beginning of this year.

The market corrections are a warning that the economic recovery driven by central banks' lax monetary policy is not working. Furthermore, weak macroeconomic data published these last months undermines the credibility of central banks. The shift towards lower growth is reflected in the GDP figures published recently. In the US, gross domestic product has increased a modest +0.7% (annualised) during the last quarter of 2015, bringing annual growth to +2.4%. In Europe, the deceleration during the last quarter is patent in the reported +0.4% (annualised), which brings the year's increase to +1.5%. Other published indicators related to the European economy show that the deceleration may be deepening. The manufacturing index, the economic sentiment indicator and the German IFO Survey do not bade well for a recovery in the first quarter of 2016.

In my opinion, stock market investors have not totally discounted this economic slowdown. In the 12 months before the demise of Lehman Brothers, equity markets, bond markets, and interest rates were expecting an economic slowdown but not the Lehman effect. In September 2008 the US stock market had accumulated a 20% correction, spreads of high yield corporate bonds had stretched to 600 basis points, and the 10 year US interest rate had lost 75 basis points down to 2.75%. Today, the US stock market correction is not significant. From last year maxima, reached on May 29th, the S&P500 correction adds up to -7% as per end February, high yield corporate bonds have corrected 300 basis points, and Treasury Bills have lost 45 basis points to reach the current 1.84%. Usually, the evolution of the stock market is a lagging indicator of interest rates in order to discount higher or lower financial risks. If we refer to the economic crisis of 2008, it looks like the stock market has not discounted the current economic slowdown enough. In other words, if the slowdown intensifies the stock market should fall further as a result of the revision of future corporate results.

We still think a lax monetary policy is not the right solution to induce a more vigorous and consistent economic recovery. In the recent G-20 meeting in Shanghai there were talks of a coordinated action to compel it, but again the responsibility has been passed to central banks. The world economy needs, among other actions, structural reforms and demand and offer policies fostering prosperous growth.

By now, all portfolio managers are asking themselves whether they should take the buying opportunity offered by the correction, maintain their equity exposure, or rather limit losses. Since the great crisis of 2008, strong market corrections have been contained thanks to the intervention of the European Central Bank or the Federal Reserve which injected liquidity by means of asset buying. As we have mentioned, the current correction is not important enough to justify a new reaction from central banks. Furthermore, in view of their diminished credibility, the risk exists that markets do not deem them capable of stopping a panic. In this case, the assets that have benefited from their intervention are those likely to be more affected.

As we do not believe in the effectiveness of monetary policy to generate the sought-after economic recovery, we are not inclined to increment our exposure to equity notably. Although the economic cycle does not seem to have bottomed out so as to justify the start of a new expansion phase, we continue to analyse assets in order to incorporate them into our portfolios, as long as they sport attractive valuations and fulfil the conditions of our investing philosophy. We are still very much conservative, but during February we have slightly increased our equity and corporate debt exposure, taking advantage of the attractive valuation of old acquaintances.