Elgin asset management

investment commentary monthly

Monthly Commentary 1st August 2016

We ended our early June monthly commentary with the following sentence:

“But then again, that is what markets do - they frustrate the maximum number of participants…”

And indeed financial markets have been surprising the large number of pessimists. In what has been a complex year of further monetary easing, divergent credit and currency markets, political shocks and human tragedies, equity markets are climbing the proverbial wall of worry.
July was a good month for almost all risk assets except for oil and energy shares. Both equities and bonds marched higher. The former by an impressive 3-4% with the likes of technology and biotech leading the advance.

As for bonds, they continue their march well into negative territory.

On bonds, vanishing yields and humility

A few years ago not even the biggest bond bull would have thought that more than a third of outstanding sovereign debt would be yielding below zero. How wrong they all were. When we say “all”, we mean everyone. This reminds us of a quote by Morris Udall, the late American politician who said:

If you can find something everyone agrees on, it’s wrong.

So how big a story is this? Very, very big. On one hand it is a gift to governments that borrow to fund their budget deficits (while kicking the can further away). On the other, it is anathema to savers and pension funds who have to go very high up the risk spectrum in search of yield.

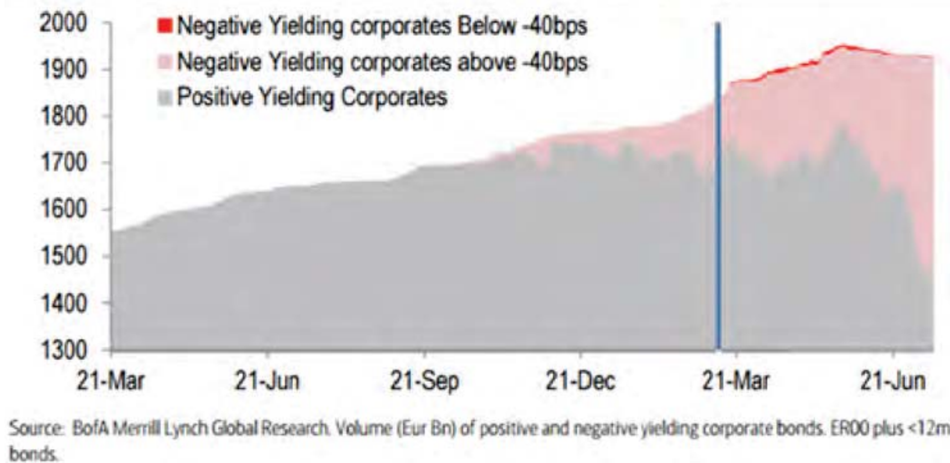
Consider the following facts.

The 5-year bonds of fourteen (14) countries are now showing negative yields. And it is not just the usual suspects like Germany, Switzerland and Japan that are the leaders of the pack. In that list you will find names like Latvia, Slovakia and the Czech Republic, whose finance ministers must be smiling but whose savers are not.

For 2-year bonds, the list is even longer. Can you imagine that even Bulgarian 2-yr bonds have a negative yield!

And it is not just countries. Many corporations also have outstanding bond that have negative yields. These include companies from diverse sectors such as Nestle, Johnson & Johnson, Unilever, BNP Paribas, Microsoft, Glaxo etc etc.

In fact in Europe, as the graph below from Merrill Lynch indicates, a sizeable chunk of almost a quarter of the almost-EUR 1.9 trillion of outstanding investment grade bonds have negative yields.



In fact the average yield available on the Bloomberg Euro Investment Grade Corporate bond index is now only 0.47%.

So one might very well ask why should someone buy the bond when they can buy the same company's equity that yields multiple times the current bond yield?

Difference in yield between Euro equities and IG corporate bonds

Source: FactSet as of July 22, 2016. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

The graph above from Citi shows the big gap in yield between Euro equities (as measured by the Euro Stoxx 50 index) and Investment grade corporate bond yields. Dividends give 4% vs 0.47% for bonds.

Negative yields and bank stocks

One of the unwelcome effects of such low bond yields is that they hurt bank profitability at a time when banks can least afford to have reduced equity.

In fact the bank shares have been badly hit so far this year, especially in Europe (including the UK) where their shares have fallen more than 20%. Even in the US, where banks have much healthier balance sheets, and US Treasury yields are not (yet) negative, banks have underperformed the S&P 500 by 12% YTD.

The graphic below from the Wall St Journal paints a worrying story.

Big Banks, Big Losses

Twenty of the world's big banks have lost nearly half a trillion dollars in value this year.

Market value at the start of 2016
Wednesday's market value
Change this year
Wells Fargo −14%
Société Générale −37%
Banco Santander −26%
Europe
Credit Agricole −29%
Morgan Stanley −20%
Barclays −47%
HSBC −24%
UBS −38%
Standard Chartered −12%
Citigroup −21%
Bank of America −24%
Royal Bank of Scotland −56%
BNP Paribas −25%
Deutsche Bank −47%
UniCredit −64%
Credit Suisse −50%
Goldman Sachs −20%
U.S.
JP Morgan Chase −9%
Mitsubishi −31%
Asia
Industrial and Commercial Bank of China −11%

Percentage change in market value for the twenty banks
0
-10
-20
-30%
Jan.
Feb.
March
April
May
June
July

Source: FactSet
Note: Market values are calculated in U.S. dollars.

We are certainly living interesting times…

The Elgin Analyst Team

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