Monthly Outlook - June

András Cserháti: Overdose on a role

The “national gallops” are not over yet: with the rally that began in early March, most equity markets exceeded their 200-day moving average in the last third of May, and even stepped up their earlier pace to start soaring. No small achievement in a post-Lehman Brothers, post-General Motors environment, but while the former made huge waves on the financial markets, the latter appears to have made little more than a few ripples – from which we should be able to escape dry-footed. What accounts for the difference between the two events? The fact that the power of surprise had gone, for one, and therefore the negative effects – or some of them at least – had already been priced in by the market. The bankruptcy of the US car giant, founded in 1908 and once the world’s biggest auto manufacturer, had become inevitable – the question was no longer if, but when it would happen. That “when” was June 1, and although GM finally filed for bankruptcy protection, the financial independence of the 100-year-old company, regarded as a symbol of US industrial might, came to an end, which also meant its automatic exclusion from the Dow Jones Industrial Average (DJIA) index, of which it had been a key component since 1915. Three replacements took place in the index in 2008. The food company Altria Group Inc. and the industrial equipment manufacturer Honeywell International Inc. were replaced by Bank of America Corp. and the oil company Chevron Corp., and last September the food company Kraft Foods replaced the insurer American International Group, Inc. (AIG), which then accepted the USD 85bn government rescue package offered, the amount of which has almost doubled since then. The stock-exchange authority has said that, in addition to General Motors, Citigroup was also removed, on June 8, from the index comprising the 30 leading industrial companies of the New York stock exchange. While the place of the former was taken by Cisco Systems, the latter was replaced by Travelers Companies. Unlike GM, Citigroup was removed from the leading stock-exchange index because it is in the middle of a major restructuring program combined with substantial government co-ownership, which may help the banking giant to get back on steady feet.

The world got over GM shockingly calmly, but the question arises whether it has really been that easy to get over its demise. Almost 40% of the company’s heavily unionised jobs will be terminated, with 21,000 people being laid off. Up to 15-20 plants will be closed, as well as 40% of the brand dealership network, which means a death sentence for 2,400 brand dealers. GM’s bankruptcy procedure will have an immediate impact in several federal states, since the hour of literally hundreds of the company’s suppliers has also struck due to the closures and lay-offs. Naturally, this must have had an impact on the US jobless figures released on Friday, June 5, since the rate rose from the earlier 8.9% to 9.4%, exceeding expectations by 0.2%. The trend, which does not seem to be slowing down for the moment, will result in unemployment of over 10% in the United States as early as this year (within a few months) – not to mention the fact that the Detroit giant has accumulated debts of USD 172.8bn, and, in addition to the government loans of USD 20bn so far, it can expect to receive a further USD 30bn in US federal aid, which will be complemented by an additional 9.5bn pledged by the Canadian government. The bad news is that GM is not the only company vegetating on the taxpayers’ life-support machine. A staggering amount of money is therefore needed to boost the economy and restore these ailing companies to health. All that money must somehow be raised, and, for example, although the 10-year US government bond is offering an almost 75% higher yield compared with the beginning of this year, US government securities have become less and less attractive since the start of the March rally. Therefore, money has to be printed; the problem will have to be inflated away. Investors’ risk appetite has increased again; the VIX “fear index” has fallen steeply, oscillating around the 30 mark. This seems different to what happened at the time of the Lehman bankruptcy, since, on September 15, 2008 the VIX rose 23.54% within one day (from 25.66 to 31.70) under the effect of the event, and never stopped until the end of October when it reached its record high of 89.53 points. Following last year’s major flight into USD-denominated government bonds, investors have since March been increasingly looking for new, riskier markets that have not yet taken off. These markets, however, are typically not USD-denominated. These processes are naturally pointing towards a spectacular weakening of the USD. The awaited turn on the US housing market has not taken place either: both the number of constructions started and the number of permits have fallen to record lows. Both figures – published on May 9 – have been the worst in almost half a century. The market has selective hearing – it will not listen to bad figures, only to good ones. Accordingly, the markets took off at the news that the US consumer confidence index, calculated by the Conference Board, had risen well beyond expectations to an eight-month high and in response to the extremely positive results of China's Purchasing Managers Index (which suggested that the Chinese economy had been growing for a third consecutive month in May).

The Central and Eastern European region turned in a mixed performance in May. The oil price, which jumped almost 30% over the month, put further upward pressure on the Russian stock ex-change (RTSI$ Index), which rose 30.58% in dollar terms. In forint terms, the same performance amounted to "just" 20.14%, because the forint had strengthened significantly against the dollar. As a result, the price of the AEGON Russia Equity Investment Fund, which invests in the Russian equity market, rose 59.84% nominally from the start of the year to the end of May. The Turkish market also performed well; the TR20I Index rose 10.43% in Turkish lira terms and 5.67% in forint terms. Sadly, the "Visegrád" countries did not fair so favourably this month. They only managed to achieve an average growth of 1.12% in forint terms (CETOP20 Index), well below the 7.33% emerging markets average in forint terms (MXEF Index). The stocks we favour most from the region are currently the following: CEZ, Erste Bank, TPSA, KGHM, Magyar Telekom, Állami Nyomda, Komerční Banka, OMV, MOL, Cesky Telekom, and Hrvatski Telekom.

On the Hungarian government securities market, the yields of all the benchmark maturities fell in May. However, with the exception of the 3-month and 6-month discount T-bills, the middle of May saw a major rise in yields, which, however, gradually decreased to the end of the month. The improving market conditions were due to the positive international sentiment, even though the volume of Hungarian government securities held by foreigners fell by a further HUF 45.1bn, reducing the foreign-held portfolio to HUF 2307bn. One could say, of course, that this is still a huge amount, but back in September 2008 the total was still at HUF 3389bn, which has fallen by HUF 1082bn or close to 32% since then. The easing of financial market tensions was also evident in the forint exchange rate (at the end of April the EUR/HUF rate still stood at 288.89, which fell as low as 275.90 over the month, finally closing the month of May at 284.15) as well as in a fall in the cost of foreign currency funding, which was primarily reflected in a decline in short-term yields. Longer-term securities with maturities longer than 7-8 years, sometimes moving in the two-digit range, remain attractive investment targets for longer-term investors.

Thus, the picture we have of the current trends in the market is rather mixed: fundamentally, the market is way overbought, but positive sentiment still persists and the technical picture is also reassuring. Of the key factors moving equity markets, technical factors have gained in importance over the past three months (high cash, low equities weight, exaggerated pessimism among investors), which, combined with better macroeconomic figures, resulted in one of the biggest three-month rises of all time. What we believe is not that the economy is on the verge of recovery from recession – which is currently being priced in by equity markets – but that we are simply witnessing a stabilisation from the economic shock that followed the Lehman collapse. In the Central and Eastern European region, the processes have not yet reached their low, and the threat of another foreign currency crisis could be looming, this time from the Baltic States.

Under the current market conditions, to "close ourselves" into an equity fund pursuing a long only strategy (not capable of short selling) could still hold outstanding returns if the overstretching of the markets continues; however, for longer-term purchases it is worth waiting for the correction, since the downside risk is currently greater than the potential for growth. Accordingly, in the case of Asia, Turkey and Russia, which were favoured earlier, it is worth considering taking our re-turns achieved so far and temporarily moving over to safer waters. Accordingly, it is worth raising the share of the money market fund and the absolute-return funds within the portfolio, over-weighting the derivative absolute-return funds in particular. In these latter, our strategic direction was in May and still is now determined by the appetite for risk and the growth in inflationary risks. Accordingly, anticipating a weakening of the yen and the dollar, we established major EURUSD and EURJPY long positions on the market. And due to the significant inflationary risks, we built up substantial gold long positions. Like a large number of analysts, the Fund Manager can see great upside potential in gold, as the role of the USD as a reserve currency could fall in value due to the relaxed monetary policy, which could produce substantial demand in the gold market. Gold is again moving in close correlation with the dollar exchange rate, with the price of the precious metal going up when the greenback weakens. Due to the rise in risk appetite, we continued over the month to regard our long Hungarian government-bond position as justified; how-ever, in the future, discount T-bills could be more attractive and could become more of a safe haven in the event of a possible deterioration in international sentiment. In the course of June, we shall hold our established position, and will closely watch to ensure that the return achieved so far is maintained or increases further. A key objective of ours is that it should be worth-while for an investor to enter an absolute-return derivative fund at any time. Compared to conventional in-vestment funds that invest for the upside only, it is very difficult to buy "at the top" in these funds, because we are constantly improving and refining their performance. And the results achieved by the funds speak for themselves: the AEGON Alfa Derivative Investment Fund again recorded outstanding performance in May, achieving a return of 3.31% over the month, thereby recording a 12-month return of 19.34%, retaining its place at the top of the table in its category. Its benchmark index (RMAX) had a net return of 7.84% for the past one year, which equals an outperformance of precisely 11.50%. The AEGON Vision Derivative Investment Fund, the "older brother" of the AEGON Alfa Derivative In-vestment Fund, performed even better over the month, achieving a return of 4.77% in May. This makes the Fund's 12-month return 11.51%, which means it outperformed its net benchmark (RMAX+3%) by 0.67% over the same period. There is a substantial difference between the younger brother and the older one in terms of both risk and benchmark (RMAX vs. RMAX+3%), as well as performance. From its October low, Vision rose 33.21% by the end of May, while Alfa rose 17.08%. Our aim is that Vision should achieve an annual return of over 20% over the longer term. To achieve this end, we also undertake riskier positions (in terms of the underlying instruments or the size of the position) compared with the Alfa.

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