

Ten Seconds Into The Future 2016. Investment Strategy In A Clouded Outlook.

In financial markets perception drives reality.

China:

China has been on a campaign of international engagement and integration. This opportunity has emerged as America has become more self-sufficient and insular and China has not wasted it. The desire to engage and adopt international protocols and norms is driven by self-interest. China knows that it can best influence and author these protocols and norms if it engages early, actively and constructively rather than antagonistically.

The Chinese people, however, suffer from a persecution complex precipitated by years of humiliation. As the Chinese government engages internationally it needs to maintain a show of strength for domestic consumption. This has taken the form of belligerence in the South China Sea and in its relations with Japan.

If, however, this thesis is correct, then the risks of escalation in the region are or can be contained. Some care still needs to be taken on all sides to avoid accidents and trembling hands.

China's foreign policy has domestic implications. It needs to shape domestic rules and regulations to be aligned with international standards including adopting rule of law over rule of Party and increased market discipline in equity, credit, money and currency markets.

The decision to reform is, however, a unilateral and central decision and not an evolutionary product of a democratic or capitalist process. This contradiction introduces additional unpredictability to the implementation and progress of reform. The potential for turbulence, miscommunication and mistakes is high. Take for example the change in exchange rate

determination in early August 2015 which was miscommunicated and set of considerable market volatility, or the way the equity market crash was handled in the middle of the year. China is still centrally planned if not centrally controlled and reform can be temporarily rolled back if need be to manage turbulence and uncertainty. Stability is still the priority on the road to reform.

At the same time, as America relies less on Chinese production, so China must rely less on exports. A large scale rebalancing of the economy away from heavy industry and investment, and away from SOEs towards consumption, services and private enterprise. Stage two of the rebalancing will be China's response to the self-sufficiency of her erstwhile major trading partners. **Expect investment in intellectual property and technology, in soft infrastructure and institutions.** It is not enough that China turns to consumption but China must have the means to supply that demand as well without being overly dependent on foreign technology. Especially since the currency might not be as strong as expected in future.

An endeavour of such scale, and the cost of coincident reforms are naturally a drag on economic growth. The government has stated that it will target moderate growth despite this drag, probably at levels it deems sufficient to generate employment and growth so as to maintain social stability. Maintaining growth at or just below current levels will be challenging as the reforms are implemented and as the economy is rebalanced.

The Chinese government has a list of sometimes contradictory items to do.

- Instill rule of law and institutions.
- Reform economy towards market discipline.
- Maintain growth.
- Reduce debt or debt service for local governments and over-levered sectors.
- Encourage credit availability for private enterprise, especially small and medium enterprise.
- Encourage consumption including consumer credit.
- Maintain stability in economy and markets as much as possible.

This will likely force the government into another list of actions.

- Maintain loose monetary policy. Cut interest rates and reserve requirements.
- Engage fiscal policy to boost demand.

- Intervene in equity and credit markets to ensure no repeat inflation of a bubble in asset prices.
- Intervene in equity and credit markets to prevent any collapses or crashes.
- Intervene in foreign exchange market to slow the natural weakness of the currency against the dollar.
- Bailout systemically important companies if they fail.

The contradictory forces in China will make it difficult to read the markets and assess business prospects. **When does market discipline apply and when is it too much?** Answering this question will be very important in determining the fortunes of Chinese assets and businesses.

US:

The Fed has signaled its intention to raise rates slowly, specifically 4 quarterly rate hikes of 0.25% for a year end Fed Funds Rate of 1.375%. Market expectations are for 2 to 3 rate hikes for a year end Fed Funds Rate of 0.87%.

The Fed focuses on the domestic economy when making policy but will consider external factors such as international growth, trade and financial markets. These factors are diminishing in influence as the US becomes more self-reliant. However, the Fed does have to consider the reactions and actions of other central banks insofar as they impact policy second order variables such as exchange rates and interest rate differentials.

The Fed may have to consider that trend growth has been reduced due to the stagnation of global trade and the frictions in credit transmission from new banking and financial market regulations. If true this **implies a smaller output gap and would support the Fed's more hawkish stance compared with market expectations.**

The Fed normalizes policy at a time when markets have already tightened credit conditions ahead of expectations. This could exacerbate the current slowdown. The risk of recession remains low, however.

One possible strategy for raising rates without creating undue turbulence is to allow the market to digest and tighten ahead of each planned rate hike. Each rate hike itself should not

move market rates but would instead lag the market. This is a practical solution for the Fed and has important trading implications.

The dollar has been strong for over a year and this strength has exerted some braking power on the economy. In terms of risk, however, the long dollar trade is getting crowded and long in the tooth. Dollar strength against JPY may abate as the BoJ maintains but does not accelerate QE. The same analysis could apply to the euro and the ECB. Sterling might be weak against the dollar on Brexit risk but this is highly political and difficult to assess.

Where the dollar is more likely to see continued strength is in emerging markets. Emerging markets have slowed and do not look likely to recover quickly. Emerging market assets may be cheap but suffer from a fundamental weakness in business model. Supplying China with more basic resources when the economy is turning towards consumption and services is no longer viable and such economies struggle at reinvention.

Another **potential source of dollar strength is volatility**. The overwhelming consensus is that 2016 will be a volatile year for financial markets. Uncertainty, volatility and crises favour dollars and US treasuries. Unless the crisis or volatility are domestically generated in the US it is difficult to envisage a better hedge than dollars and treasuries. Sometimes, even US originated crises can buoy dollars and treasuries. In fact the more severe the crisis, the more robust is the hedge.

In the past 7 years corporate profits have grown at a decent pace but of late earnings growth has lagged expectations and equity markets have risen on multiple expansion. Part of this is fueled by the demand for yield driving bond issuance which is used to finance special dividends, share buybacks and M&A. Top line growth has been more sluggish and companies have been eking out efficiencies and cost savings instead of innovating and investing. This is not very encouraging for future growth.

The US has always been a source of innovation and technology. Innovation will be required to drive corporate profits if equity markets are to rise further. While the US remains the centre for innovation and research regulation and ethics can slow the pace of innovation in certain sectors such as healthcare and artificial intelligence. AI is probably where the most significant innovation will occur. Some of this innovation will be driven away by overly complex and burdensome regulation. US companies may seek regulatory arbitrage by relocating

their R&D to countries with less restrictive regulations.

Generally, US companies have a lower propensity to invest and a preference to return capital to shareholders. In the long run this is detrimental to the growth potential of the economy further compressing the output gap.

Investment opportunities in the US will emerge more from idiosyncratic mispricing than from growth. Certain pockets of credit markets such as the high yield market are already priced for close to recessionary conditions. High yield markets have sold off sharply on concerns about the energy market, some 16% of the high yield bond market, as well as concerns over liquidity or lack thereof as regulations deter primary dealers from holding inventory. A related market is the loan market where energy is less represented (4.5%), but where liquidity is thinner. Structured credit wrappers of high yield offer even more attractive returns but are complex and can be daunting for the uninitiated. Here, fortune favors the brave.

Whereas the long duration trade was driven by falling long term bond yields, the curve may more accurately be characterised by a bear flattening than an outright lower long bond rally. Arguing for a lower yield are the current absence of inflation, weak energy prices, a strong dollar, and tighter credit conditions. Arguing for higher yields are the risk of a smaller output gap, the risk that energy prices stabilise and base effects fade, the depletion of foreign reserves in the emerging markets and China, an important source of demand for treasuries. The factors are evenly balanced.

Europe:

The European economy was already recovering at the start of 2015 when the ECB decided to embark on QE. A weak Euro and falling interest rates had already done part of the job for the ECB. Three years of open market operations to infuse liquidity while stopping short of outright asset purchases had some positive impact. QE therefore was in part symbolic and likely timed to coincide with the results from the earlier LTROs.

The Greek economy is but 2% of Eurozone output and unlike a bank, especially an investment bank, it is not a hub for financial risks. Yet when Syriza won control of the country and threatened to renege on the existing debt reduction and austerity plans agreed with creditors,

it sent ripples through the Eurozone markets out of proportion to its real economic influence. Greece was challenging a status quo and a European financial orthodoxy that shoehorned financial reality into a dogma built upon deep European history and psyche. Greece was eventually forced to accept the status quo which meant no debt relief, and renewed austerity, in return for continued financial analgesic ad infinitum. The situation remains unresolved as Greece cannot reduce its debt quickly enough, if at all, it's economy is recovering too slowly, if at all, and it's economy is not evolving to the new realities of trade war and insularity even as the EU strives for greater union.

Similar **political schisms have emerged in Spain, Portugal and generally across the union.** Meanwhile Britain contemplates exiting the broader union in an in-out referendum which must occur by the end of 2017.

Europe's problems are hidden behind a strong stock and bond market, the latter especially supported very much by QE. Real growth, however, is weak, struggling along at 1.6% even as PMIs indicate a stable recovery. Spain's unemployment has fallen from over 25% but remains above 20%. National budgets continue to struggle below -3% of GDP. A nascent domestic profits recovery may be threatened by substantial corporate exposure to struggling emerging markets.

The Eurozone's current trajectory is not much more than a continuation of Germany exploiting a weaker currency, and the periphery bouncing back from acute financial conditions. France is beginning to falter, being neither the engine of growth that is Germany, nor having been through a period of distress from which to recover.

The ECB has been the author of much of the recovery from 2011 as it engaged in OMOs on an unprecedented scale. It would have engaged QE earlier had it not been for objections from the Germans. QE1 had pushed rates across the curve lower and had it not been for Greece's adventures in defiance might have led to even lower rates. As investors fretted about the first US rate hike in almost a decade the ECB engaged QE2 or QE1.5 since it disappointed in magnitude. What will the ECB do next? The EUR may not be sufficiently weak for their purpose so it is likely they will watch the Fed to see if the rate trajectory will cause the USD to regain the strength of the last 18 months. If it does the ECB might be able to hold and if not QE may need to be expanded.

Current consumer and business sentiment appear healthy but if these lose steam, QE2 may need

to happen. The ECB is of course hopeful that no further stimulus will be necessary, not only because it would be job done but because it can expect strenuous German resistance.

Despite the importance of the ECB it does not and cannot solve the national balance sheet problems. It cannot monetise debt like other central banks. It cannot stimulate demand and it is demand deficiency that currently plagues Europe. The ECB can supply all the credit it can but without demand it is analogous to attempting to clap with one hand. National debt is constraining fiscal policy, the other hand needed clap. Were the ECB free to monetise debt, investors might allow Europe to spend its way out of weakness but that is a privilege reserved for countries which can print their own money. Thus union imposes discipline upon the central bank which imposes an inconvenient discipline on governments. Without union one could borrow, spend and monetise like the Japanese have done. How successful has that strategy been?

Of late there has been talk that **fiscal policy might be engaged as the pace of growth stagnates**. Some of these expenditures might be passed under extra-budgetary concessions such as military spending to address new threats to security, as well as spending to house, cloth, feed and integrate the exodus of refugees from the Middle East.

The euro has insufficient history to form empirical extrapolations but its structure suggests an accumulation of imbalances that require periodic potentially discontinuous adjustment.

The road to the euro witnessed yield convergence between member states. 2008 and 2011 saw yields diverge reflecting default risk and a test of the strength of union. Given the resolve expressed to maintain the currency union yields should converge again. However, the Greek adventure, and the hairline fractures unveiled during the Portuguese and Spanish elections indicate further volatility along the path to convergence. But converge they will unless the euro breaks. For clarity, national **bond yields will converge unless there is an existential threat to the euro**. National politics can create local yield divergence but these cannot be durable.

Unfortunately, one cannot rule out an eventual break up, even if a partial one, of the euro. Such an eventuality could have a long incubation but would affect asset pricing well in advance.

Europe's equity markets have been among the best performers in 2015 buoyed by lower interest rates across all maturities and a weak euro. For the equity market to continue on course would require more of the same. With the Fed having turned the corner on interest rates it is no longer trivial that euro rates will continue to fall. The US treasury spread over bunds cannot expand continually while growth rates converge. As for the euro, a move to parity with the dollar would not have the same impact as all the weakness in prior years. Corporate Europe's exposure to struggling emerging markets is another concern as they have not been substantially priced in by the markets which have derated emerging market equities while rerating European ones. Corporate Europe earns over a third of revenues from emerging markets.

Corporate credit is but another trade expression for corporate Europe's commercial fortunes. The difference is exposure to duration and to the current fad of balance sheet deleveraging which improves credit quality. Even this has its limits of earnings start to plateau or if rates should rise for whatever reason.

Japan:

Japan is intriguing. It's economy is in the process of rebirth. It was too far gone to call this a recovery. The factors behind this rebirth are a political capitulation resulting in a strong mandate necessary for the radical action which followed; fiscal stimulus, monetary stimulus and difficult reform. The consequences have been a resurgent stock market, falling interest rates and a weak currency. Meanwhile, no one who doesn't have to will hold JPY or JGB's except for quick trades front running the BoJ.

If the Abe government's gamble works, the economy will hold on to its recovery, inflation will rise, and the JPY might recover. Currently JGBs find but one fundamental buyer, the BoJ, monetizing the nation's unsustainable debt load. Foreign investors will only fund the Japanese government if they believe that the fiscal position can improve. Until then JPY will remain weak except in short covering or tactical trading. Foreign demand for JGBs in the meantime will not be to finance Japan but to warehouse bonds for sale to the backstop buyer.

Reform has been slow but the establishment will only budge in the face of success and there has been some. At the same time, QE is highly price distorting but is necessary to monetise debt as well as to reinforce some of the government's reforms.

Towards the end of 2015, the BoJ confounded expectations that it would increase its QE efforts as weak data emerged. So far the central bank has been content with a more optimistic interpretation of data. On current form, it would take a serious deterioration in the economy to spur further action beyond the minor tweaks the BoJ periodically makes. Under these conditions JPY is unlikely to weaken further. On the other hand the conditions for JPY strength are distant.

The equity market has been driven by expectations and hope as well as targeted QE. Until these optimistic expectations are fulfilled valuations have crept higher. Japan trades at a higher multiple than China's domestic shares, remarkable given the relative growth rates of the two economies and their companies' earnings prospects. Further multiple expansion is difficult to justify. For the equity market to advance, returns on equity, top line and earnings growth need to improve. In addition the economy needs to show more resilience. Eking out more returns from existing resources and restructuring has its limits, limits which may have already been reached.

Tail Risks:

It is a positive that 2016 has begun with not much optimism and much caution. Even strong consensus and crowded trades have become clouded in the last days of 2015. These include, **long USD short EUR, JPY and emerging market currencies**. The long USD trade was the one the market was most certain about. That it has become less crowded may actually prolong it, but it is not a tail risk any longer, not unless the market returns overwhelmingly to it.

Deflation is another consensus trade and one that is a bit stronger and thus more of a concern. Global deflation has been exacerbated if not driven by **weak energy prices**. Bond markets and monetary policy are given encouragement and latitude by falling energy prices. Lower interest rates and bond yields support higher equity valuations and compress real estate cap rates. **Energy and inflation could be a serious threat** with implications across all the major asset classes, the correlation 1 factor, in a correction. It is difficult to see core inflation picking up when growth is as tepid as it is, however, headline inflation could easily rise if oil prices rise.

The demand and supply of oil is imbalanced with an oversupply of about 3 million barrels per day, rising from near balance in February of 2015. Oil demand peaked in June 2015 and is not

expected to increase significantly. Greater energy efficiency in the global economy and slow growth will keep growth moderate going forward. The improvements in energy efficiency should not be underestimated. Cars and trucks are significantly more fuel efficient compared with 5 years ago. On the supply side, the same human ingenuity has produced new methods of extraction and lowered costs of production. If OPEC seeks to sweat the high cost producers, they could find thresholds lower than they expect. Fundamentally, therefore, investors are probably right in expecting weaker oil prices, some say 25 USD a barrel, to a moderate recovery if any. Lower oil prices are a sound bet, but the stakes are such that we cannot get it wrong. Going long energy could be a cheap insurance policy against a low probability event.

European equities have been among the most favored of markets, yet risks remain, among them, the risk that the British in-out referendum might result in **Brexit**. It is unclear yet what the implications will be for the UK, let alone the European Union, if Britain leaves the EU. Equity markets, however, loathe uncertainty, and a bad outcome is often better than a clouded one. It is not useful to attempt to assign a probability to Brexit since the decision will be more a political than commercial one.