Market Outlook 2016. Where To Invest in 2016/2017.

It is now difficult to see more than 10 seconds into the future. What was chosen for a laugh as a blog title has become a reality. Central banks have led the markets if not the economy for the last 8 years out of crisis and are now losing some credibility and control. A quick survey finds weak but positive growth across most countries with the exception of Brazil and Russia in 2016, and positive growth across all countries in 2017. It also finds inflation mercifully low, and positive, even in Japan and the Eurozone. This does not appear to be a dire environment. However, aggregate data hide less tractable problems. If the averages are poor and the inequality is acutely high, it means that the majority of the population are experiencing declining wealth. Mercifully, inflation has been low.

It is always a difficult time to invest. In the 90s we fretted about inflation which in the end failed to materialize. We inflated a tech boom bubble which burst. We inflated a housing bubble which burst. And since then we’ve been led by the nose by central banks cleaning up the debris of the last bust while trying to strengthen the financial system which proved not so robust and simultaneously trying to spur economic growth which sputtered in no small part because of those very efforts at financial market reform.

The US economy is out of the woods and on a stable path of positive if rather tepid growth. The European economy is not far behind. The inefficiencies of the Euro are something they will live with regardless but so much liquidity is bound to spur some growth. China was actually first to lead with unconventional policy. It saw external demand shut down in 2008 and continue to fade as countries engaged in trade war. China is arguably ahead of the cycle in terms of policy,

priming the pump quickly, smoothing the downturn, then tightening prematurely, hopefully not a lesson for the Fed, and finding itself needing to turn on the taps again. Japan is perhaps way ahead of everyone else. Demographically, Japan is the future. We can only hope that it is not also the future in terms of economics and policy.

Policy has targeted an arbitrary rate of growth and in doing so introduced more imbalances which drive delayed oscillations in market prices. At the micro level we already observe that asset prices can deviate from fundamental value for longer and gyrate more substantially as they converge to intrinsic value. Long duration assets are all the more risky in that there is no deadline for convergence. Finite and shorter maturity assets are not immune to volatility. Policy, sentiment and capital flows are the prime determinants of price discovery. Markets fail to bring convergence to intrinsic value quickly and efficiently.

There are several reasons for this. In the past, relative prices were brought into equilibrium or no-arbitrage pricing by traders or groups of traders who traded across capital structures. Most of this capital took the form of bank proprietary trading desks. With Basel III, Dodd-Frank and the Volcker Rule, the capital dedicated to these activities has shriveled. Some of these traders have sought new homes in hedge funds. However, the scale of capital in hedge funds pale in comparison with the practically bottomless pits of capital commanded by prop desks in the past.

In the search for yield, retail investors, through their regulated and sanitized vehicles like mutual funds and ETFs have ventured into markets normally traded by professional investors. The herd mentality and the artificial liquidity created by retail capital has led to more momentum driven markets where undervaluation soon becomes overvaluation and overvaluation becomes undervaluation in a cyclical and volatile fashion. Prop traders accustomed to leveraging small,

predictable deviations now face large, unpredictable deviations, and in their hedge fund formats, face prime brokers who cannot extend the scale of leverage they are accustomed too, or the valuation forbearance of the investment banks of old. Therefore, they struggle. This is the new market, at least for now.

One could play the long game, identify good businesses and invest for the long term. To do this, one needs not only to be right, but one needs stability of capital and the faith of investors. With the current uncertainty, investor loyalty is understandably in short supply. Uncertainty is high. When economic growth is low, small deviations can lead to negative readings. The acute inequality of wealth is slowly translating into the feeling of injustice, and society seems heavy with social tension. Between political factions there is more civil war than inter party conflict. Policy has been deployed bearing such low marginal fruit that it has taken extreme efforts to have an
y effect. The risks of unforeseen side effects proportionate to the scale of the effort, not the effect, are high.

The inescapable reality is that markets have become more volatile and fickle. The patient investor can take advantage of this volatility but this can often be a test of stoic patience. Markets like this also require the investor to be more informed, even if they are outsourcing their investing decisions lest they make mistakes in their capital allocation plans. For investors who need to be invested many opportunities remain, and some very good ones at that. Investors should be careful not to overreach in their thirst for yield. However, there are areas of the market which remain beyond the reach of retail capital and other hot money and where price discovery remains linked to fundamentals. Some of these markets are the way they are because of legacy issues from the 2008 financial crisis, some even performed well through those periods but through guilt by association will

not be revisited even by some institutional investors. Under-owned, under-researched, misunderstood assets represent good opportunities. But even here, markets may not be sufficient to bring price discovery; patience, and duration matching of capital, is necessary.