Market Outlook

A monthly commentary on financial markets
written on December 30th, 2015

2016 : THE GREAT CONFUSION

Generalities (1-7)

1. Regardless of the economic environment, some situations reappear regularly enough in financial markets to attract attention and even more so as it seems that they cannot be explained in a rational way.

2. One of the best known is the fact that historically stocks perform better between November and April than from May to October and which is summed up in the saying, "Sell in May and go away."

3. A less popular one is the fact that the January performance of the US stock market heralds if the year will be good or bad.

4. And this was again confirmed in 2015 since the S&P 500 index fell 3.1% in January and the performance for the year was an insignificant one: +0.25 %. The Nasdaq fared better with an increase of 7.50 %. But as we mentioned last month, the performance of the indices was only due to the fact that for example 2 % of the shares in the S&P 500 advanced so much that they were able to offset declines elsewhere.

5. The situation was somewhat better for other developed countries with an increase of 9 % for the Nikkei 225 and unlike 2014 the result in 2015 is almost identical when calculated in USD.

6. And if in Europe markets rose (+9.5 % for the Dax and +4.5 % for the Euro Stoxx 50), we are far from the 20 % + rise of the first quarter of the year. 2015 should have been the year of Europe and this is a disappointment.

7. The disappointment came from the fact that Europe clearly suffered from the third consecutive year of decline in emerging markets. And even if this was expected at the beginning of 2015, the 17 % fall worried investors in particular because they believe it is a sign that China's slowdown is gaining momentum.

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Generalities (8-12)

8. And in the last quarter of the year we witnessed a surprising correlation between oil prices and stock markets. Normally an oil price fall is positive for equities but the 30 % decline in the price of a barrel to USD 37.- in 2015 reversed the relationship, the market considering that such an important move confirmed that global growth continues to decelerate.

9. Regardless, the year was dramatic for the commodity sector with a decrease of 25 %; the biggest drop being for nickel (-40 %), but copper (-25 %) or coffee (-26 %) also suffered a lot.

10. In the foreign exchange market, if the yen remained surprisingly stable against the dollar at 120 at the end of 2014 against 120.50 now, the euro continued to fall against the greenback to 1.09. This is due to the fact that the European Central Bank is continuing its policy of quantitative easing while the Fed has begun to tighten its monetary policy.

11. However, despite the 0.25 % December rise of the Fed's benchmark interest rate, the market is not convinced that this rising phase will last long. Indeed, if the yield of the US sovereign 10-year bond closed the year at 2.30 against 2.17 % at the beginning of the year, we ae still far away, for example, from the 3 % level at the end of 2013. Slight increase also for the German equivalent's yield (0.60 %), while the Japanese one stay unchanged (0.27 %).

12. The situation is different for junk bonds where both the decline in energy prices - which threatens small US oil producers - and the poor health of emerging countries, pushed yields higher. Thus the largest index fund in this sector iBoxx USD High Yield Corporate Bond (HYG) ended the year down 5 % including dividends. The fall is of 15 % for the Market Vectors Emerging Markets Local Currency Bond ETF (EMLC) quoted in USD.

Bonds (13-20)

13. At the beginning of 2016 the Great Confusion reigns in investors' minds. What should they believe ? Is the economy getting better or worse? Are we on the brink of disaster or on the opposite are we seeing the end of the consequences of the 2008 crisis?

14. Rarely has the overall picture been so mixed and we have been using to describe it the image of a glass half empty or half filled.

15. On the one hand we have the Fed raising, for the first time in over a decade, its interest rate, a sign of confidence in the strength of the US economy.

16. But on the other the vision which prevails is that the United States cannot remain an island of tranquility in a sea of chaos and that the warning signs are already visible.

17. For example, all commodities - not just oil - have collapsed. This demonstrates that there is a widespread deceleration in demand.

18. This is confirmed by the fact that the OECD economic leading indicators are predicting a slowdown in global growth.

19. And even in the US the danger is visible since the growth of the economy and of profits remains anemic. If indexes are holding up it is only thanks to a few superstars.

20. Finally, the Fed's increase comes at a time when the bond market is in bad shape. The yield of the Bloomberg USD High Yield Corporate Bond Index which was still at 5 % six months ago now exceeds 9 %.

Bonds (21-28)

21. And for the first time since the 2008 crisis a bond fund with USD 800 million of assets, Third Avenue Focused Credit, froze redemptions and announced that the fund would be liquidated. It is true that its 2015 performance was remarkably bad, down more than 30%. But this announcement has nevertheless shaken the bond market because participants are aware of the sector's weaknesses.

22. The Office of Financial Research (OFR), an analytical agency created by the US Treasury after the 2008 crisis, has just published a report on the health of American finance where it appears that the credit risk in the non-US financial sector is very high partly because the quality of the bonds held by investors has declined to the point that higher interest rates could create refinancing problems and cause a self-feeding cycle of defaults.

23. And the OFR also notes that currently investors are holding bonds in their portfolios with much longer maturities than usual and consequently an increase of 100 bp of long-term interest rates could generate losses of more than USD 200 billion and this just for US bond funds.

24. At the beginning of this new year the question is whether investors will be attracted by returns which are the highest since 2011 or whether bond funds redemption requests will accelerate leading to an upward pressure on interest rates all the more stronger as the number of market makers has fallen sharply since 2008.

25. What can be presently mentioned is that the 3 years annual return (including interest) of the HYG index is only 0.8 % and 4 % in the last 5 years. As a matter of comparison the respective figures for the S&P 500 are 16 % and 13.3 %.

26. These numbers validate our long held view that it is better to be a little invested in equities rather than quite a lot in high yield bonds. Indeed, during the last 5 years, it would have been sufficient to be invested only 25 % in shares, holding the balance in cash yielding 0 %, to obtain an identical performance to 100% of the portfolio being invested in bad quality bonds.

27. The challenge for 2016 is that yields have now reached a level high enough to ensure that any subsequent rise increases the probability that the impact on the stock market could be much stronger than before. In other words, higher yields may lead to proportionately higher losses for equities than for bonds.

28. Thus, has the moment arrived to sell everything and go fishing for one year ?

Equities (29-39)

29. For four years now since December 2011 we present a rather optimistic year-end view regarding the US situation, always hoping for a faster growth which unfortunately does not materialize.

30. Jeremy Grantham one of the most respected US financiers and founder of the investment company GMO, with assets under management of USD 120 billion, recently published an article where this English born praises…. France.

31. Indeed, he wrote: "For the 50 years I have been in America, Business Week and the Wall Street Journal have been telling us how incompetent at business the French are and how persistently we have been kicking their bottoms. If only they could get over their state socialism and their acute Eurosclerosis. And as far as I can tell we have generally accepted this thesis. Yet ... France's median hourly wage in real terms has risen since 1970 from a base of 100 to 280. An increase of 180 % in 45 years! Japan is up 140 % and even the often sluggish Brits are up 60 %. But the killer is the US median wage : dead flat for 45 years !"

32. And a recent study by the Pew Research Center confirms it : there has been in the last 40 years a collapse of the middle class in America. However, the report does not support the traditional view of the far left - where everyone loses except a small minority - because a significant number of those who left the middle class have in fact become richer.

33. But the remaining middle class who fears being demoted and who has not received for decades a real increase of his wages explains the current success of Donald Trump.

34. And one should remember that a large portion of US growth in the decades 1990 and 2000 happened only because of the growing indebtedness of the middle class which now represents less than 50% of the population against over 60% in 1970. And we know how this ended.

35. Jeremy Grantham also mentions that currently the number of people aged between 25 and 54 who do not work for any reason whatsoever is 21% in the US and 20.5% in the Eurozone. And indeed we have already mentioned that the low level of US unemployment rate (5.17% presently) concealed the fact that the percentage of the working population was still insufficient. And the figure of Mr. Grantham confirms that contrary to a superficial impression the US has not been able to create more jobs than the Europeans.

36. Furthermore he notices that the trend in the US is going in the wrong direction. In the late 1990's the US had the highest participation rate of all the major developed countries. However today the country is significantly behind not only Germany and Japan but also France!

37. It is this broad picture which explains why growth has not accelerated in the US.

38. But - and we come back to our image of a glass half full or half empty - this bleak situation also reveals the significant development potential of both the US and Europe if the number of workers increases and / or real income improves.

39. Thus for the fifth consecutive year we are going to hope that growth in the US finally surprises in a positive way and this year we will also include Europe.

Equities (40-53)

40. In the US growth is sufficiently well established to be self-sustaining and in Europe the decline of the euro is a positive factor.

41. Furthermore the only benefit of the rise of populists such as Donald Trump or Marine Le Pen is to wake up Western politicians who, feeling the breath down their necks, will be pushed to increase government spending and stop any overly restrictive fiscal budgetary policy.

42. This is what we have just seen for example in the US. The press regularly mentions how much the Congress has become dysfunctional. Yet it has just voted an important bipartisan spending program and this despite the opposition from members of the tea party. For example President Obama signed a law on December 4th allocating USD 305 billion over 5 years to improve the roads' infrastructure.

43. Also in Europe the result of the recent elections in Spain and France will push politicians in the Eurozone to spend more and even more so as Germany will be more favorable since its exports to emerging countries have become much more difficult.

44. And everyone, except the producers, will continue to benefit from lower oil prices, which currently represents the main source of improvement in purchasing power.

45. We are thus ready to repeat what we have been writing for years now : if there was only the US (and now Europe) one should be heavily invested in equities.

46. Unfortunately the global situation calls for caution as there are two dangers which could rain in our parade.

47. The first danger, relatively new, is geopolitical. The decrease in US hegemony opens the door either to chaos as in the Middle East or to the rise of regional powers such as China.

48. Everyone jockeys for position and this leads to increased tensions. Globally the political situation is worsening but it is a slow move; much like the tectonic plates that move a few centimeters per year until the day when the accumulated tensions produce a more or less important earthquake.

49. The problem for investors is that it is very difficult to be positioned for an event which could occur tomorrow or in a few years. From this point of view we must act like the people in Japan or California; to continue to live and when a tremor occurs then manage it.

50. But in the same way that one builds in compliance to quake-proof norms, an investor should structure its portfolio in a manner secure enough to survive a potential earthquake.

51. The second source of danger remains emerging countries as sadly for most of them there is a strong probability that their economic situation will worsen in 2016.

52. This is likely to increase pressure on bond borrowers from these countries to the point that it seems difficult to avoid in 2016 the default of one of these important debtors. And the risk would then be that the bond market freezes thus preventing companies to refinance maturing loans. It would be in fact a scenario similar to 2008 when banks were no longer able to borrow.

53. At that time the problem was only solved by important loans from central banks to their domestic banks. But if the bond market stops functioning for lower-rated debtors who will be ready to respond?

Equities (54-57)

54. This is why, even if rates have become more attractive, as long as the countries where these companies come from are not in the path of economic recovery, the risk of a panic in this sector cannot be discarded. The same applies by the way to US energy companies which have substantially borrowed in recent years.

55. This threat to the bond sector forces investors to be cautious and to invest in equities only up to the level where one can withstand volatility. Any crisis in the high-yield bond market will push shares down hard. Thankfully in the current environment this should be only temporary for good quality stocks of developed countries in which we continue to recommend to be positioned.

56. And even more so as investors are currently positioned in a rather defensive way and therefore it is sufficient that news are less bad than expected to bring a surprising rise of equities.

57. The behavior of commodities will also be very important since the market now considers that it has become the leading indicator of the economic health of the global economy.

Commodities (58-64)

58. This means that if this sector stabilizes or moves up, this will automatically be positive for equities.

59. And at present - and regardless of what happens in the long run - this sector is so much oversold that a counter-move can occur at any time.

60. We must also repeat that, despite everything that has been said in recent times, the drop in energy prices has far more economic benefits than disadvantages as it increases consumers' purchasing power.

61. Furthermore, whereas until recently the Cassandras forecasted the end of cheap energy, technological advances mean that oil is structurally positioned to low prices and this as long as a political crisis does not block a major source of supply.

62. By not reducing its production to maintain prices at a high level, Saudi Arabia has killed the OPEC cartel. Many explanations have been given for this change of attitude, but it is likely that the country has realized that the fight against global warming has become an accelerator for research in the energy area. This allows not only the development of alternative sources of energy but also the continuous improvement of energy efficiency in the use of a barrel of oil.

63. Saudi Arabia must have become aware that time is playing against her and as predicted by Sheikh Yamani, former Saudi oil minister, the Stone Age did not end for lack of stones and the Oil Age will not end for lack of oil.

64. And symbolically OPEC's death has been signified by the decision of the US Congress to lift the ban on the export of US oil in force since 1975 when OPEC became all-powerful.

Currencies (65-67)

65. A brief comment to acknowledge that in the same way as global warming thaws large amounts of ice which will then help strengthen from time to time the most extreme climatic events, a 0 % return or close to it releases significant amounts of capital which have been orphaned and helps accelerate exchange rate moves.

66. Thus the dollar rose in four months in 2015 against the euro from 1.25 to 1.05, whereas before a move of such magnitude would have taken three years.

67. This market has become more unpredictable than usual and its future development is directly related to expectations on the part of investors about the pace at which US interest rates will rise or not.

Conclusion (68-74)

68. Unsurprisingly, since the Fed raised its interest rate, the opponents to the measure are the most vocal ones.

69. It was exactly the opposite when the central bank decided to postpone the rate increase in October.

70. The fact that both sides have good arguments leads to the Great Confusion in investors' minds.

71. And furthermore as we experience low liquidity, moves tend quickly to become bigger.

72. For the time being we remain in the optimistic camp. However investments in equities of developed countries must be done at a reasonable level in order to be able to hold to the positions even in the event of a strong fall.

73. We believe that because investors still remember the painful episodes of 2000 and 2008 they tend to sell first and ask questions later. Downward moves are thus inevitable but at the moment - and this is the case since 2009 - they do not last because, even if growth is unsatisfactory, not only does it exist but it is self-reinforcing. Additionally, all central banks, including the Fed, are still looking to strengthen it and they will continue to use all possible means to promote it.

74. We take this opportunity to wish our readers a new year full of joys, in peace and good health.