Global Connections

Itaú BBA

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2016 Outlook: And the Chickens Come Home to Roost

Given how many bright minds have been at work crafting year-ahead pieces, an outsized ego is required to think one can add something new. In this case, let's hope the title at least qualifies. What does it mean? The phrase "chickens coming home to roost" is an old saying that implies bad things done in the past will have to be paid for in the present. The chickens in the title represent the tough choices that were not addressed in 2015 and will come home to roost in 2016.

There are at least three tough choices that investors and policy makers alike need to carefully consider in 2016. All were mistakenly avoided in 2015 (See "2015 Outlook: Tough Choices Ahead," December 2, 2014) and will come home to roost in 2016. They are: the implications of the Fed's decision to enter a rate-tightening cycle, the prospects for State-Owned Enterprise (SOEs) reform in China and sovereign/corporate decision making within the commodity complex. In addition, there are a couple of dog-and-tail relationships, where the traditional dog wagging the tail may be replaced by the tail wagging the dog.

The key takeaway is this: there are a number of negative feedback loops (Forces of Recession) operating in the global economy with very little being done to offset them. These include: China's economic slowdown and its effect on the global commodity markets; commodity market dysfunction and implications for EM consumption; and the Fed's decision to enter a tightening cycle, which in turn suggests further dollar strength and thus further commodity and EM economic weakness.

The commodity adjustment process is a long-tailed one, where mines and projects begun years ago need to move to completion even in an oversupplied market facing weak demand. China's economic rebalancing is also long-tailed and provides negative reinforcement to the commodity-price adjustment process. A super cycle followed by a super bust. A Fed-led tightening cycle provides further negative reinforcement to these two processes – perhaps the most important point to consider post Fed lift-off.

In fact, one can argue that what the global economy needs right now is not a strong dollar but a weak dollar. A weak dollar helps commodity prices, commodity producers, EM banks and consumers, U.S. manufacturers and exporters, and DM inflation. From a global perspective, the Fed is providing the opposite of what is needed, even if arguably it is doing what is correct for the U.S. economy. This environment reflects both dollar power and Fed limits to what the U.S. can achieve on a geo-economic basis. The U.S. economy is no longer capable of acting as global locomotive but it can act as a global growth inhibitor and it is.

These three negative-feedback loops are moving in the same direction, and while all offer potential long-term positives, they are individually and collectively negative for short-term global growth and inflation. The mental image of a slow-moving deflationary wave emanating from the emerging world and washing across the developed economies remains very much front-of-mind. The lack of a pro-growth policy-led offset, from anyone, anywhere, is a grave concern. One can point to India as a beacon of growth, but India, where external trade is down roughly 25% year over year, is not China and is not a global growth locomotive.

There is one big 2016 surprise: the prospect that the USD has peaked for the near term, which would imply a market-based reversal of the most heavily established positions and a significant, counter-trend rally in commodities, EM currencies and equities, U.S. HY and other beaten-up financial assets. This would be for a trade only, though – the forces aligned against such a move being sustained are too strong.

Chickens Come Home to Roost

The Fed has waited all year to raise rates and while lift-off has finally been achieved, the bigger question is what comes next? Markets expect multiple hikes in 2016, and such expectations clearly underpin the USD, which is near all-time highs on a trade-weighted basis though it has done little versus the majors. The problem for the Fed is that while it can make the case to tighten on domestic grounds (barely), the external environment is not supportive of a hike at all. This conundrum raises the risk of a policy mistake whereby the Fed might be forced to reverse course (See "The Big Fear," September 24, 2015).

Year V

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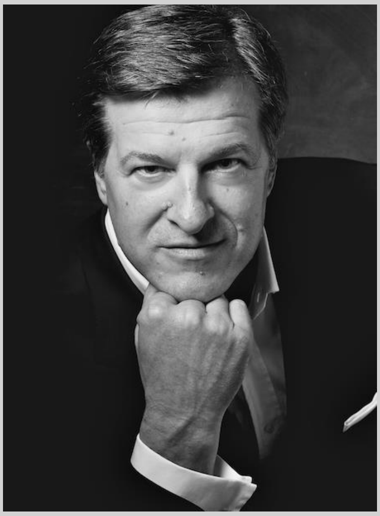

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The expectation alone of a Fed hike has been enough to keep other central banks on hold, hoping a Fed hike will lead to USD strength thereby allowing their currencies to weaken. The forces of reflation (See "The Global Battle Between Reflation and Recession," July 31, 2015) seem underpowered, however, with the ECB's latest decision underwhelming markets, while the Bank of Japan (BOJ) is on hold and contemplating what comes next in its policy machinations. The Fed has begun a rate-tightening cycle while China is losing reserves and allowing its currency to weaken…none of that is reflationary.

The real risk is that the Fed continues to tighten and the USD rises further. Such a combination would imply weaker commodity prices coupled with further weakness in the emerging economies, a continued manufacturing recession within the U.S. and further pain within the credit universe. Such a course of action could potentially create a negative turn in the credit cycle, thus heralding a broad recession in the U.S. With the industrial side of the U.S. economy effectively already in recession (even with an 18-million auto build – has such a thing ever happened before?), one wonders what happens if rate hikes cool the boom in sub-prime auto loans?

Alternatively, should market expectations of the Fed's path change and the USD weaken, then commodity prices would enjoy a sizable rally, and inflation may pick up, leading to fears of a Fed behind the curve and a possible inverted yield curve that would in turn also herald a possible U.S. recession and stock-market sell-off. Such an environment also implies limits to USD weakness given the huge short-term rate advantage the USD enjoys. Two-year UST bonds yield 1%, a huge premium over ten-year Bunds and JGBs. Net net, the Fed appears boxed in – it's hard to see a lot of upside for the U.S. economy while recession risk remains quite visible.

China – SOE Reform Is THE Key Policy Issue

China spent 2015 on its gradual-rebalancing path and largely avoided any major moves. Most of its policy actions were reactive, including rate cuts, a mishandled attempt to prop up its stock market and some slight FX weakness. No real decision on the currency, no real action taken to reform the State-Owned Enterprises (SOEs) amid continued deepening of the anti-pollution, anti-corruption campaigns, but that's about it.

THE policy issue to get right in 2016 may well be China's effort to reform the SOE space – maybe even more important than Fed policy. Recent policy statements have suggested that 2016 will be the year of forceful SOE reform. If true, such a policy mix would have massive implications for commodity demand and pricing, global inflation and growth, currency movements and just about everything else.

Should China really take the task in hand and substantially shrink the SOE sector, the economic pain in 2016 will be significant (for China and the global economy), but the stage might then be set for a true recovery in the next few years. Absent, such implies just more of the same, a grinding-down of growth expectations with knock-on effects across the commodity and emerging economy space and thus into the U.S., EU and Japan.

Either way, it's quite likely that the yuan continues its gradual weakening as an offset to the tremendous deflationary pressure felt in the production side of the Chinese economy where PPI is -6% year over year and getting worse, not better. The recent inclusion of the yuan into the SDR basket should facilitate such gradual weakening, as it provides a natural buyer in the form of central bank reserve managers, who will spend the next few years building up yuan-denominated positions. Given the yuan's trade-weighted strength, some gradual weakness is appropriate – a large one-off devaluation remains less likely.

A weak yuan also implies continued downward pressure on other Asian currencies and hence, continued import deflation in the developed economies.

Commodities

Price action within the commodity markets was certainly aggressive in 2015, even if tough decisions were put off until just as year-end was coming into view. Much remains to be done, as exemplified by the iron ore market, where huge new low-cost mines open in Australia even as prices plumb depths not seen in decades. OPEC, a somewhat global body, did nothing for the global economy when it met earlier this month and basically ended up with an everyone-pump-as-you-like policy – the oil price collapse that has followed makes perfect sense. Oil seems intent on retracing all the way back to the 2008-09 lows, some 10%-15% below current levels.

Difficult choices have begun to be made in the commodity space, especially where corporate actors are in the lead. Production shut-ins, asset sales, huge layoffs, dividend cuts & suspensions are all part of the news flow in the space. All that's to the good, but it implies near-term pain (where are 85,000 laid off Anglo American workers going to find work?), which is exacerbated by the continued expansion of supply driven by projects that were approved years ago. A key question in this regard is the health of emerging-market banks that are on the hook for much of the debt that underpins these projects. Recall that financials represent roughly 25%-30% of many EM equity ETFs.

Commodities need to bottom before the downward adjustment cycle is complete. This bottoming will support a bottoming in the EM economic cycle as well. More has to happen – more production shut-ins, dividend cuts, more bank loans called and more assets sold at fire-sale prices. Will 2016 be the bottom? Possibly.

Dogs & Tails

The thesis that EM has become the dog and DM the tail is one written about in these pages before (see "Seeking Inspiration," October 29, 2015), but one that remains difficult to grasp. This is not a surprise, given that for most of the past 30 years, the relationship consisted of the DM dog and the EM tail. The EM became the dog post-2009 when China's huge stimulus program, now over and discredited, brought growth to the EM and global economy. Today's EM dog features weak domestic demand, falling commodity prices, declining currency values, slowing growth rates and political and policy crises.

The EM adjustment process is far from over. Given the DM's limited policy response to this reality, it is hard to understand how the DM tail economies plan to overcome this slowdown. 2016 will certainly test the hope that further reflationary efforts in the developed economies will not be needed.

Will the Fed be forced to reverse course and ease in 2016? Quite possibly. Here is one possible time line: the December '15 raise, a Spring '16 pause, a Summer return to zero and the introduction of negative rates in Winter '16-'17. If the Fed were to do so, then the USD would likely weaken considerably, commodities would have a sharp bounce, inflation would pick up a bit and long-term bonds would probably sell off. While Fed Chair Yellen stressed the U.S. growth picture in her post-hike talks, the prospect of negative rates in the U.S. is not negligible. Odds are tricky, but think something like a 33% chance that the Fed introduces negative rates before it gets to 1% Fed funds rate.

Another dog & tail relationship is the oil market, which has become the dog driving the U.S. credit market tail as 2015 expires. The forces driving oil are not corporate and profit-motivated as much as they are sovereign and focused on many issues beyond profit. Many of the leading oil producers are national companies with political imperatives that often don't include pumping less, taking in even less revenue or letting competitors take market share. Many simply have to pump: Russia, Nigeria, Venezuela, Iraq and soon Iran. There is virtually no way Saudi Arabia will cut production to allow Iran to pump more once sanctions are lifted.

The financial market implications have been on display, especially in the credit markets. Fears have spread beyond high yield, with the return of investor gates leading some to recall the dark days of 2008-09 and raising concerns about a bear market in credit. Lack of leadership in the global oil market means it is every producer for itself, and that means lower prices and further weakness in EM demand, U.S. credit etc.

Asset Allocation

What does all this mean for portfolio positioning? It suggests another low-return year with significant implications for investors, especially those in the long-term investment community (See "Talkin' Bout a Revolution (With a Nod to the Beatles)," December 1, 2015). The backdrop suggests a focus on technical analysis, as trading levels will be quite important across assets. Many asset markets traded in quite-tight ranges in 2015…if the tough choices noted above are taken, it is likely that some of those ranges will be broken, and getting those right may well make the difference in the year.

From a global macro perspective, 2015 provides some illustration in this regard. There were several key decisions to get right, including being as light as possible in EM equity and local currency debt, avoiding commodities of virtually all stripes and being long the non-U.S. DM equity markets, especially Europe (hedged) and Japan.

Equities: Continue to express the view that U.S. is giving up leadership to non-U.S. DM markets such as Europe and Japan. Key might be shifting from hedged to unhedged at least for the early part of the year as USD weakness surprises. A sharp U.S. equity market rally early in the year, based on a more benign Fed view, is possible and should be sold, not bought.

Rates/Credit: The surprise will be the lack of supply on the sovereign side and the continued strong demand for long-duration, highly rated securities. Yield curve inversion remains a real possibility in the U.S. U.S. credit is oversold and due for a rally. Look into EU credit, especially in the HY space, which enjoys less energy exposure, better fund flows and technicals. Euro strength may lend further support.

FX: Markets spent 2015 prepping for a rate hike; the opposite may be the case in 2016. Surprise dollar weakness versus the majors would allow China to weaken its currency without a visible devaluation, but throws a wrench in EU growth recovery. USD likely to remain strong versus EM currencies.

Commodities: Surprise dollar weakness gives a bit of a lift but continued weak demand and excess supply keep the lid on any large rallies…a traders' delight. MLPs offering a rare twofer (double-digit discounts and yields) may be a great place to wait for the oil bottom.

Alternatives: Hedge funds continue to disappoint, leading more of the true performers to move to the family office structure and leaving institutions with a problem – what to do with the money? Infrastructure and industrial RE built around the Tri-Polar World's self-consumption theme provide some answers.

Emerging Markets: Equities a big winner in USD weakness phase but remain a value trap while local currency debt remains tricky. USD debt remains preferred investment.

2016 is shaping up to be another tough year – enjoy the holidays, rest up and come back ready to battle!

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