

## 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.

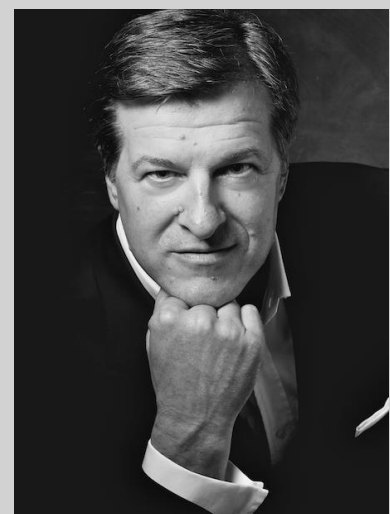
### Chickens Come Home to Roost

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

### Issue #199

Itaú Global Connections presents independent perspectives on economic issues and market forces that affect your current investments and strategies for the future.



Jay Pelosky is Principal of J2Z Advisory, LLC.

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!

Jay Pelosky is Principal of J2Z Advisory, LLC, a global asset allocation and portfolio strategy consultancy for institutional investors. Jay advises clients and invests personally based on insights gained from 30 years of financial market experience in over 45 countries. For the past decade, he has invested his own capital in a global, multi-asset, ETF-based Asset Allocation strategy. He sits on the board of Franklin Holdings (Bermuda) Ltd. and serves on the advisory board of Carmel Asset Management. Jay teaches a graduate level course, The Art and Practice of Global Investing, at The George Washington University and is a founding member of the New America Foundation's World Economic Roundtable. His formal Wall Street career spanned twenty years and included positions on both the buy-side and sell-side. At Morgan Stanley, he launched the Firm's global asset allocation and global equity strategy research products. He also formed and co-chaired the research department's asset allocation committee. Jay created the firm's Global Emerging Market Strategy (GEMS) product and initiated its equity investment, research, and strategy efforts in Latin America.

[jaypelosky@pelosky.com](mailto:jaypelosky@pelosky.com)

### Itaú Global Connections – Recent Issues

Date		
12/16/15	Issue # 198, by Stephen L. Jen	CNY Basket – A Transitional Framework à la Singapore
12/10/15	Issue # 197, by Felix W. Zulauf	Buy The Rumor, Sell The Fact?
12/1/15	Issue # 196, by Jay Pelosky	Talkin' Bout a Revolution (With a Nod to the Beatles)
11/16/15	Issue # 195, by Stephen L. Jen	The SDR and the CNY
10/29/15	Issue # 194, by Jay Pelosky	Seeking Inspiration
10/19/15	Issue # 193, by Felix W. Zulauf	Temporary Rally in Risk
10/15/15	Issue # 192, by Stephen L. Jen	My Thoughts on Currencies
9/24/15	Issue # 191, by Jay Pelosky	The Big Fear
9/15/15	Issue # 190, by Stephen L. Jen	China's Landing: Hard on the Outside, Soft on the Inside

Source: Itaú BBA

## DISCLAIMER

### Itaú BBA is a brand name of Itaú Corretora de Valores S.A.

#### Ratings: Definitions, Dispersion and Banking Relationships

Ratings (1)	Definition (2)	Coverage (3)	Banking Relationship (4)
Outperform	The analyst expects the stock to perform better than the market average.	54%	50%
Market Perform	The analyst expects the stock to perform in line with the market average.	37%	34%
Underperform	The analyst expects the stock to perform below the market average.	10%	9%

- The ratings used herein (Outperform, Market Perform and Underperform) correspond approximately to Buy, Hold and Sell, respectively.
- Ratings reflect the analyst's assessment of the stock price performance in the medium term compared with market average. Recommendations will remain valid until the analyst changes the rating, which may happen as a result of news or simply due to a change in the stock price (there is no defined time horizon). Companies are grouped into industries, according to their similarities. The industries are: (i) Banking & Financial Services, (ii) Consumer Goods & Retail + Food & Beverage, (iii) Healthcare + Education, (iv) Steel & Mining + Pulp & Paper, (v) Oil, Gas & Petrochemicals + Agribusiness, (vi) Real Estate, (vii) Telecommunications, Media and Technology, (viii) Transportation, Manufacturing and Logistics, (ix) Utilities, and (x) Equity Strategy.
- Percentage of companies covered by Itaú Corretora de Valores S.A. within this rating category.
- Percentage of companies within this rating category, for which Itaú Unibanco S.A. or any of its affiliated companies provided investment banking services over the last 12 (twelve) months, or which may be provided during the next 3 (three) months.

#### Relevant Information

- This report has been prepared by Mr. Jay Pelosky as a consultant to Itaú Corretora de Valores S.A. ("Itaú BBA"), a subsidiary of Itaú Unibanco S.A., and distributed by Itaú BBA or one of its affiliates (altogether, "Itaú Unibanco Group"). Itaú BBA is the brand name used by Itaú Corretora de Valores S.A., by its affiliated or by other companies of the Itaú Unibanco Group. . This report is being distributed (i) in the United States by Itaú BBA USA Securities Inc., a FINRA/SIPC member firm; (ii) in the United Kingdom and Europe by Itaú BBA UK Securities Limited, regulated by the Financial Services Authority (FSA). Details about the extent of its authorization and regulation by the FSA are available on request; and (iii) in Hong Kong by Itaú Asia Securities Limited, licensed in Hong Kong by the Securities and Futures Commission for Type 1 (dealing in securities) regulated activity (altogether, "Itaú Group"). This report is provided for informational purposes only and does not constitute or should not be construed as an offer to buy or sell or solicitation of an offer to buy or sell any financial instrument or to participate in any particular trading strategy in any jurisdiction. The information herein is believed to be reliable as of the date in which this report was issued and has been obtained from public sources believed to be reliable. Itaú Group does not make any representation or warranty, express or implied, as to the completeness, reliability or accuracy of such information, nor is this report intended to be a complete statement or summary of the securities, markets or developments referred to herein. Opinions, estimates, and projections expressed herein constitute the current judgment of the analyst responsible for the substance of this report as of the date in which it report was issued and are therefore subject to change without notice. Prices and availability of financial instruments are indicative only and subject to change without notice. Itaú Group has no obligation to update, modify or amend this report and inform the reader accordingly, except when terminating coverage of the issuer of the securities discussed in this report.
- This report has been prepared by Mr. Jay Pelosky, who hereby certifies that the views expressed herein accurately and exclusively reflect his personal views and opinions about any and all of the subject matter discussed and that this report was prepared by Mr. Pelosky independently and autonomously, including from Itaú BBA. The views expressed herein do not necessarily reflect the views of Itaú BBA, its subsidiaries and affiliates. Because personal views of analysts may differ from one another, Itaú BBA, its subsidiaries and affiliates may have issued or may issue reports that are inconsistent with, and/or reach different conclusions from, the information presented herein. Mr. Pelosky is not registered and/or qualified as a research analyst with the NYSE or FINRA, and is not associated with Itaú BBA USA Securities Inc. and, therefore, may not be subject to Rule 2711 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account.
- The financial instruments discussed in this report may not be suitable for all investors. This report does not take into account the investment objectives, financial situation or particular needs of any particular investor. Investors should obtain independent financial advice based on their own particular circumstances before making an investment decision based on the information contained herein. If a financial instrument is denominated in a currency other than an investor's currency, a change in exchange rates may adversely affect the price or value of, or the income derived from, the financial instrument, and the reader of this report assumes any currency risk. Income from financial instruments may vary and its price or value, either directly or indirectly, may rise or fall. Past performance is not necessarily indicative of future results, and no representation or warranty, express or implied, is made herein regarding future performances. Itaú Group does not accept any liability whatsoever for any direct or consequential loss arising from any use of this report or its content.
- This report may not be reproduced or redistributed to any other person, in whole or in part, for any purpose, without the prior written consent of Itaú Corretora de Valores S.A. ("Itaú BBA"). Additional information relative to the financial instruments discussed in this report is available upon request.
- This report may contain links to third-party websites. Itaú Corretora de Valores S.A. ("Itaú BBA") is not responsible for the content of any third-party website or any linked content contained in a third-party website. Content contained on such third-party websites is not part of this report and is not incorporated by reference into this report. The inclusion of a link in this report does not imply any endorsement by or any affiliation with Itaú Corretora de Valores S.A. ("Itaú BBA"). Access to any third-party website is at your own risk, and you should always review the terms and privacy policies at third-party websites before submitting any personal information to them. Itaú Corretora de Valores S.A. ("Itaú BBA") is not responsible for such terms and privacy policies and expressly disclaims any liability for them.

**Additional Note to reports distributed in: (i) U.K. and Europe:** This material has been prepared by Itaú BBA International plc (IBBAI) for information purposes only. The sole purpose of this material is to provide information only, and it does not constitute or should be construed as a proposal or request to enter into any financial instrument or to participate in any specific business strategy. The financial instruments discussed in this material may not be suitable for all investors, and are directed solely at Eligible Counterparties and Professionals as defined by the Financial Conduct Authority. This material does not take into consideration the objectives, financial situation or specific needs of any particular client. Clients must obtain financial, legal, accounting, economic, credit and market advice on an individual basis, based on their personal characteristics and objectives, prior to making any decision based on the information contained herein. By accessing the material, you confirm that you are aware of the laws in your jurisdiction relating to the provision and sale of financial service products. You acknowledge that this material contains proprietary information and you agree to keep this information confidential. IBBA UK exempts itself from any liability for any losses, whether direct or indirect, which may arise from the use of this material, from its content and is under no obligation to update the information contained in this document. Additionally, you confirm that you understand the risks related to the financial instruments discussed in this material. Due to international regulations not all financial instruments/services may be available to all clients. You should be aware of and observe any such restrictions when considering a potential investment decision. The information contained herein has been obtained from internal and external sources and is believed to be reliable as of the date in which this material was issued, however IBBA UK does not make any representation or warranty as to the completeness, reliability or accuracy of information obtained by third parties or public sources. Additional information relative to the financial products discussed in this material is available upon request. Itaú BBA International plc registered office is 20<sup>th</sup> floor, 20 Primrose Street, London, United Kingdom, EC2A 2EW and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority (FRN 575225) – Itaú BBA International plc Lisbon Branch is regulated by Banco de Portugal for the conduct of business. Itaú BBA International plc has representative offices in France, Germany, Spain which are authorised to conduct limited activities and the business activities conducted are regulated by Banque de France, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), Banco de España respectively. For any queries please contact your relationship manager; **(ii) U.S.A.:** Itaú BBA USA Securities, Inc., a FINRA/SIPC member firm, is distributing this report and accepts responsibility for the content of this report. Any US investor receiving this report and wishing to effect any transaction in any security discussed herein should do so with Itaú BBA USA Securities, Inc. at 767 Fifth Avenue, 50th Floor, New York, NY 10153; **(iii) Asia:** This report is distributed in Hong Kong by Itaú Asia Securities Limited, which is licensed in Hong Kong by the Securities and Futures Commission for Type 1 (dealing in securities) regulated activity. Itaú Asia Securities Limited accepts all regulatory responsibility for the content of this report. In Hong Kong, any investors wishing to purchase or otherwise deal in the securities covered in this report should contact Itaú Asia Securities Limited at 29th Floor, Two IFC, 8 Finance Street – Central, Hong Kong; **(iv) Japan:** This report is distributed in Japan by Itaú Asia Securities Limited – Tokyo Branch, Registration Number (FIEO) 2154, Director, Kanto Local Finance Bureau, Association: Japan Securities Dealers Association; **(v) Middle East:** This report is distributed by Itaú Middle East Limited. Itaú Middle East Limited is regulated by the Dubai Financial Services Authority and is located at Suite 305, Level 3, Al Fattan Currency House, Dubai International Financial Centre, PO Box 482034, Dubai, United Arab Emirates. This material is intended only for Professional Clients (as defined by the DFSA Conduct of Business module) no other persons should act upon it; **(vi) Brazil:** Itaú Corretora de Valores S.A., a subsidiary of Itaú Unibanco S.A authorized by the Central Bank of Brazil and approved by the Securities and Exchange Commission of Brazil, is distributing this report. If necessary, contact the Client Service Center: 4004-3131\* (capital and metropolitan areas) or 0800-722-3131 (other locations) during business hours, from 9 a.m. to 8 p.m., Brasilia time. If you wish to re-evaluate the suggested solution, after utilizing such channels, please call Itaú's Corporate Complaints Office: 0800-570-0011 (on business days from 9 a.m. to 6 p.m., Brasilia time) or write to Caixa Postal 67.600, São Paulo-SP, CEP 03162-971.\* Cost of a local call.