

Global Connections

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What's the Bull Case?

It has certainly been a challenging start to the year – even for someone like myself who has been quite cautious (see [“2016 Outlook: And the Chickens Come Home to Roost,”](#) published on December 21, 2015). Bearish predictions abound, and market participants have been shaken by the violent sell-off across risk assets and around the globe.

Market psychology appears damaged, and the muscle memory from the Great Financial Crisis has kicked in like a bad cramp in the middle of the night. Negative feedback loops seems to be trending, and while the bears are loud and proud, the bulls seem to have been taken to slaughter. The good news is that we are set up for a nice bounce in asset prices; the bad news is that such a bounce is likely to be just that – a bounce.

At times like these it often pays to examine the other side. If one sees more downside risk, as I do, it could well pay to study the bull case. No less a market maven than Barton Biggs of Morgan Stanley strategy fame taught me this lesson back in the day. Barton would always travel with stacks of reading material, which itself is not unusual in our profession; what was unusual was that most of the material ran counter to Barton's own point of view. Engaging with opposing research allows one to learn more and understand better both one's own case and the counterarguments, which should make for a stronger investment opinion.

Bulls are hard to find, however, so let's try to construct a bull case and see how convincing we can make it.

The Bull Case

In a nutshell, the bull case would seem to run something like this: the U.S. avoids recession as the Fed goes on hold and dollar strength subsides; China's currency, economy and stock market stabilize; and commodities find a bottom. Taken together, these factors should support an easing of financial conditions, stabilize growth and improve the earnings outlook. In turn, these market positives should encourage investors to put built-up cash positions back to work, leading to higher financial asset prices and a decent return for the year. Let's examine each factor in turn.

U.S. Avoids Recession – Fed on Hold

While the forecasting community sees a roughly 20% chance of a U.S. recession in 2016, many market participants are fearful of such an outcome – if not a GDP recession, then an earnings recession. The Fed weighs heavily here, with its stated desire to raise interest rates four times in 2016. With manufacturing already in recession and its one bright spot, vehicle production, appearing to roll over as inventory levels rise, additional rate hikes would likely lead to a stronger dollar, which would further weaken exports and the manufacturing sector.

There would appear to be several keys for the U.S. economy to avoid a recession: continued employment gains, maintaining consumer confidence around current levels, a stable service sector and the continuation of an upward-sloping yield curve. One can see that these factors are tied together, with much of the job gains likely coming from the service sector, which reinforces consumer confidence and consumption and allows for the upward-sloping yield curve. If consumption were to slow because a loss of confidence leads to fewer job gains in housing, for example, then this process could unwind.

The Fed's role here would be to avoid going too far in either direction: walking back its four-rate hike scenario while not being forced into a policy reversal. A Fed on hold would likely lead to a flat or slightly weaker dollar, helping exports and commodities and alleviating EM credit-crunch concerns.

China Stabilizes Its Currency, Economy and Stock Market

I have never been a fan of the China-shakes-the-world thesis (see [“China – Don't Drop the Ball,”](#) published on May 2, 2014), but it has certainly been front and center over the past month. Should China stabilize its currency – perhaps by introducing capital controls, as suggested by BOJ Governor Kuroda – it could continue its rebalancing effort and start to tackle the SOE reform process. The current process of supporting the yuan by

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selling reserves implies a tighter monetary policy and brings a credit crunch closer to materializing. Capital controls could also have the potentially beneficial effect of channeling capital into the stock market, which might in turn help to stimulate domestic consumption.

A China whose currency was stable, whose economy was not deemed to be in free fall and whose stock market was likewise not gyrating up and down by 20% or so every month would be beneficial for global risk appetite, including in the commodity space.

Commodities Find a Bottom

A stable dollar and a U.S. that avoids recession, together with a China that stabilizes itself, would provide significant support to the commodity complex. A stabilization in commodities would benefit the broad EM universe, which in turn would reduce global recession risks and deflation threats. The commodity complex has led the global economy and financial markets downward over the past few years and is therefore key to understanding how far the adjustment process has come. Corporate action has been significant, with dividend cuts, asset sales, and mine and pit closures all making the news. Perhaps more importantly, the non-economic state actors in the oil patch have started to talk about holding talks aimed at stabilizing oil prices.

A U.S. that avoids recession, a China whose economy stabilizes and an EM universe that gets some breathing room would all help the demand side of the commodity equation. The supply side remains a work in progress, with more to be done, but one could also argue that the complex is already in the sixth or seventh inning (in a nine-inning game) of its adjustment process.

Financial Markets Find Their Footing

Okay, so let's say all the above things happen in the real economy; what is the likely financial market effect? One has to think that it would mean sharply higher prices just about everywhere outside of precious metals and sovereign bonds. With fears of a negative feedback loop alleviated and prices down 10%-20% or more, investors would likely take some of their cash holdings and put them to work.

A Bull Market Portfolio

This is perhaps the easiest part of this piece. Buy everything that has been hammered: EM equity, EM local currency debt, the commodity space (especially oil), U.S. high yield, energy-related MLPs, Japanese and European equity. U.S. equity has been a laggard, outperforming on the way down, so it would not be a first choice in a sharp reversal.

Convinced?

Astute readers will note that much of the bull case noted above implies a stabilization of the three negative feedback loops described in my 2016 outlook piece: the Fed's rate-hiking cycle, China's SOE reform process and the dysfunction in the commodity space. Recall that these loops are mutually reinforcing and are anti-growth and inflation. A stabilization of these loops is perhaps more realistic than a reversal, but stabilization is unlikely to be sufficient to create a real bull case.

The recent weakness in financial asset prices creates the risk of a fourth negative feedback loop directed at the pillar of the U.S. economy, the consumer. Another leg down in equity prices could dampen confidence, reduce consumption and set the stage for recession. This is particularly true given that U.S. household equity holdings as a percentage of overall household wealth are at their highest level in 15 years.

The odds of a U.S. recession have risen in the past month, given the stock market sell-off, declines in energy prices and EM currency values that suggest more imported deflation in the months ahead. Perhaps more importantly, financial conditions have tightened dramatically, with Morgan Stanley suggesting that asset price volatility has tightened such conditions by the equivalent of four rate hikes over the past month. Given the massive increase in U.S. debt, now equal to roughly 375% of GDP, such implicit tightening could have a significant impact. Already, much of the U.S. credit market acts very poorly and the IPO market is shut, and while consumer confidence and job creation remain supportive, the economy is limping into 2016.

The U.S. recession call is quite important, given how much deeper and longer bear markets are in recessions than in non-recessionary bear markets. A U.S. equity bear market that does not include a recessionary environment usually is a 20%-level decline that lasts roughly six to nine months. A U.S. equity bear market in conjunction with recession usually suggests a roughly 40% decline lasting close to two years. Recent work by

JPMorgan suggests that U.S. recessions usually lead to a 20%-plus decline in forward earnings estimates, versus a current decline of less than 5% to date, while forward valuations fall toward 11.5x, versus the current 15x.

In China's case it would seem that the capital-control idea is a sound one that would get at the key issue, namely that it is the locals who are selling the yuan, not foreigners. Old EM hands know that it is key to watch what the locals are doing, and in this case the locals are selling for all sorts of reasons: anti-corruption campaign fears, RE and stock market sell-off fears, a desire to repay USD debt, FDI efforts, et cetera. The surprise isn't that China has become a capital exporter, but rather the size and speed of the outflows, which risk destabilizing China's economic program.

SOE reform is critical to China's rebalancing hopes, and the talk is still of action, especially in the coal and steel sectors. If China walks the walk, then debt defaults and bankruptcies are likely; it's also a likely near-term negative for commodity demand. Over the medium and long term, SOE reform would be a major positive, as it removes uneconomic production and/or supply and allows market pricing to restore itself. Financial market stabilization (including of the currency) would also allow China's leadership to focus on the rebalancing process; given the consolidation of decision-making power in the hands of the president, one can only imagine how challenging the current state of affairs is.

The commodity complex seems to be inching closer to a bottom, with OPEC and Russia talking about holding talks aimed at stabilizing oil prices. Oil prices, and commodity prices in general, are a function of supply and demand. Supply continues to expand, while demand remains on a gentle upswing that has been overwhelmed by the supply increase. Given that our bull case above envisions only a stabilization of current woes rather than a reversal of them, it's difficult to see a large pickup in demand, which leaves the supply side to be the principal actor. Production cuts by any of the major producers remain hard to envision. One can envision oil bottoming out this year; to say it has already bottomed at USD 27 or so in Brent terms is much harder (at least for me).

Current Positioning

The disposition of the three and possibly four negative feedback loops noted above is critical to deciding whether one should be bullish or bearish on financial assets in 2016 and perhaps beyond. A stabilization would lead to a bounce in financial assets, but it is unlikely to be sufficient for a bull market.

To get really bullish requires either much lower equity prices or much more aggressive policy action that would extend well beyond monetary policy. This includes the BOJ's move to negative rates, which by weakening the yen may perversely lead to more dollar strength – the last thing the U.S. or the global economy needs. The Fed, in raising rates, and the BOJ, in moving to negative rates, are both doing what they believe is right for their domestic economies – the problem is the global nature of the supply-demand imbalance. The lack of discussion around a global, pro-growth policy mix at Davos further suggests that now is not the time to be bullish.

The bounce we are currently enjoying in many financial asset prices is to be expected, given the aggressive nature of the sell-off; the question is, what to do with it? The advice here remains to stress-test one's portfolio for recession and to prepare portfolios for further equity market weakness in the expectation that U.S. equities could reach 1,750-1,550 on the S&P, depending in large part on whether the U.S. enters a recession or not.

A more sustainable bounce could come about should there be a reversal in the negative feedback loops, driven perhaps by a reversal in Fed policy to an outright easing, as suggested in my outlook piece. The longer it takes for the Fed to reverse course, the greater the recession/stock-market-sell-off risk; the concern is that Fed chair Yellen will need some political cover in an election year and that this cover will come in the form of a lower S&P. This process could also lead investors to question their faith in central banks, the Big Fear scenario described here last fall (see [“The Big Fear,”](#) published on September 24, 2015).

A Fed reversal would almost certainly lead to a weaker dollar, which would have multiple beneficial effects for the U.S. and the world. A weaker dollar would support U.S. exports, and thus the manufacturing sector; it would help stabilize oil prices, and thus financial asset prices in general, given current correlations; it would allow China's FX to weaken naturally, given its peg to the dollar; and it would support inflation, thereby reducing the risk of deflation and a debt bust.

One thing that has become clear since the start of the year is that market repricing of the future path of Fed hikes will not be sufficient to reverse the dollar move. With markets now pricing in only one more rate hike this year, the dollar has basically been flat versus the majors and up versus the EM FX complex. The world needs a weaker dollar, not a stable dollar, and thus one could interpret the markets as telling the Fed that going on

hold is not enough to significantly weaken the dollar. The BOJ's decision to move to negative rates only reinforces this view.

Given that such a policy reversal remains far off and stabilization itself not yet visible, it would seem prudent to continue to hold significant amounts of cash and to remain underweight equities – especially U.S. equity, where it would seem that last year's leaders, the big-cap tech stocks, would need to catch up on the downside (the tone, and the focus on the lack of demand, on 4Q15 tech earnings calls is very worrisome) – while long equity positions in Europe and Japan should be unhedged and held in minimum-volatility vehicles. Credit acts very poorly, while long-duration sovereign bonds remain attractive. The commodity complex remains challenging, with the MLP “twofer” idea noted in my outlook piece proving to have been too early, to say the least. Positioning for a weak dollar would seem to be the way to participate in FX. Much depends on one's time horizon and mark-to-market risk. The longer the time frame and the lower the mark-to-market risk, the greater the opportunity to gradually put money to work.

Bottom line: Sell equity rallies and buy sovereign bond sell-offs. Prepare for a weak dollar and stress-test for recession. There is no reason to be aggressive. 2016 is shaping up to be a year where the chickens come home to roost and where capital preservation trumps the search for capital appreciation.

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