December 14th, 2015

When does a ripple become a wave?…

There is no way to sugarcoat the action in the capital markets last week as investors shunned any asset class remotely associated with risk attributes. On the week the Dow lost 3.3%, the S&P -3.8%, the Nasdaq -4.0%, and the Russell 2000 gave back almost 5%. The S&P 500 was down in four of five trading days last week and has now declined in 18 of the last 27 trading days (the S&P 500 has gone 27 straight days without back to back gains – the second longest streak since 1970).

What’s more is that the S&P has now sliced below its 200, 100, and 50-day moving averages, setting up a very tough technical picture as we move into year-end with only 13 trading days left for the Santa Claus rally to work its magic. Furthermore the ‘distribution’ in the market (volumes rising on price declines and volumes declining on bounces) are worsening with Friday’s large sell-off on high volume a case in point.

The action in international markets was just as dire with Emerging Market equities falling almost 7% to their lowest levels since 2009 and having declined for eight consecutive days. European equities as measured by the EuroStoxx 600 declined 4.6% on the week and are now down more than 6% on the month. Japan’s Nikkei 225 Index gave back nearly 500 points (-2.4%) since last Tuesday as the Yen stopped falling. Perhaps the heads of the ECB and BOJ may want to take note that when your entire monetary policy strategy is predicated on debasing your currency, you better make sure it keeps going down!

The lone port in the storm last week, as is often the case in times of capital market stress, was in Treasury bonds with intermediate term T-notes rallying by a little more than 1.0% and long-term Treasuries surged more than 2.5% as yields fell across the curve.

The real story last week emanated from the commodities (namely oil) and junk bond market. WTI oil prices finally broke below the $36 dollar level en route to an 11% plunge on the week and taking out lows set in March. The commodity once dawning the name 'black gold' has cratered by more than 40% on the year. For investors with a contrarian spirit you may take some solace in the fact that bearish positioning as measured by short interest is at its most negative state in history. Only time will tell, but this is an indication that a whole lot of bad news is priced in to the price of oil at the moment and any surprise to the consensus group think out there could set off one heck of a short-term reversal.

What has become obvious over the last several weeks is that OPEC has all but abandoned its production targets and has no desire to rectify an oversupplied market – can you say every man for themselves? Adding insult to injury for oil was a report from the International Energy Agency stating that they anticipate the global oil supply glut to remain intact into the second-half of 2016. In the report they cited estimates that worldwide demand would weaken to 1.2million barrels per day next year from the five-year high of 1.8million barrels per day in 2015.

The carnage in the commodities markets is widespread and this pain was on full display last week with a litany of announcements by companies taking action to recalibrate to the current reality:

- Kinder Morgan (KMI), the poster child for yield-starved investors attracted to the Master Limited Partnership (MLP) asset class over the last several years, cut its dividend by 75% from $0.50 to $0.125.

- Anglo American (AAL.UK), the British based mining conglomerate, announced that it will be shedding some 60% of its mining assets and cutting 85,000 employees.

- Freeport-McMoRan (FCX), the world's largest copper producer, whose stock has fallen almost 90% from its highs said it will undertake cost cutting measures including a significant reduction to capex and a suspension of its common stock dividend.

- Oil majors Chevron (CVX) and ConocoPhillips (COP) both maintained the view that their respective dividends are of the highest priority to them as they each announced a further reduction to their capex budgets going into next year.

In my opinion the actions we are seeing take place in the C-suites of these organizations is more consistent with a cycle nearing its trough than its peak. You usually don't see this type or level of activity at the top of a market because these executives are not shouldered with the burden of predicting the future and trying to time when to start pulling back production, shoring up their balance sheet, and reducing capex in anticipation of the next downturn. No, they shoulder the burden of maximizing shareholder return and when you are in the business of exploration and production, if you are not producing you are not generating cash flow. Investors need to be on the watch for additional signs of capitulation in this space that will help make the lows stick, but my guess is that we are closer than many expect.

However, when we inevitably find the bottom in the resource and commodity sector is, at this time (in my opinion), somewhat of a moot point relative to assessing the damage it has already inflicted upon the global economy. When you throw a pebble into a pond the initial ripples are rather muted, but then grow larger as it expands. I hear and read commentary every day arguing that if one excludes the weakness in the energy and materials sector from – name the market statistic – that all is well in the world. Yes, some of this analysis is on point, thoughtful, and insightful – for example, since oil rolled over from its peak in the summer of 2014, the U.S. economy has managed to generate four million net new jobs and 3.8 million have been full-time positions.

But I have a difficult time being so readily dismissive of the notion that all is fine in the world if you exclude the bad stuff. All the reviews I do with clients would be very easy if I was able to remove all the bad performing investments from their portfolio. I'm sorry, but the clients we have are a little too sophisticated for this charade. Oil is the most extensively and broadly used commodity in the world where entire countries fiscal solvency is predicated on the profits they accrue from its production. Furthermore, just think about all the industries that have been built upon supporting the oil market. I just think it is a little naive to believe that the carnage in what is a very extensive industry can be put in a box and isolated from the rest of the pack.

It reminds me of the commentary that was so pervasive at the peak of the tech bubble when it didn't matter that a company didn't have any revenues, it only mattered how many clicks they got on their website. Or that the subprime loan market was contained leading up to the credit crisis in '08-'09, and yes similar arguments were being made during the early stages of that downturn for investors to exclude the decline in the financial sector and everything else was hunky dory. Give me a giant break! There is enough data and evidence in the capital markets today that suggests that not all is well in the world and the potential for some real problems is escalating.

This doesn't mean that one should panic as that is never a good strategy, but don't just sit on your laurels and accept the consensus view. Speaking of the consensus view, Barron's just published its year ahead outlook from Wall Street's top Strategists where they see the stock market rising 10% and profit growth rising 5%. This same outlook predicted that the S&P 500 would be up 10% this year (currently down 2.3% YTD) and EPS growth would come in around 8% (it looks like EPS will moderately decline for 2015). My point isn't to embarrass these highly intelligent and respected individuals for being wrong, more so it's to showcase how difficult it is to predict the future with any level of accuracy. To be right on one of these predications is as much about luck as it is about skill.

The destruction in the commodity markets has been one of the leading forces triggering the bloodbath that has and continues to take shape in the high-yield bond market. Year-to-date the high yield bond market is down a little more than 13% and the relentless weakness in the space shifted to a whole new level last week with the announcement that the Third Avenue Focused Credit Fund was refusing to grant any further redemptions to avoid fire-sale prices for fund holdings. The fund manager will attempt to execute a more orderly liquidation while returning the proceeds of the sales to shareholders.

This further perpetuated the redemptions that have been coming into this asset class for some time now as investors redeemed $3.5

billion in the past week with outflows registered in four of the last five weeks. The weakness in the junk bond market is something that I've been keenly monitoring for a while now given its history of being a tell for risk assets. The yield on the Merrill Lynch High Yield Bond Index has risen to 8.1% as of last week and is up considerably from the cycle low of 5.5% reached eighteen months ago.

However the junkiest of the junk bond market is where the real pain is being felt, as can be viewed from the below chart where the yield on CCC & lower rated date has risen above 17% (levels not seen since the depths of credit crisis). For sure much of this is being driven by the rising default risk in the energy and materials sector where Standard and Poor's estimates that 50% of energy junk bonds and

72% of metals and mining junk bonds are at risk of default.

So we have oil below $35 per barrel, the Chinese Yuan at 4.5 year lows, the S&P 500 coming off its worst week in four months, small cap stocks down 12% from their all-time highs, emerging markets at 2009 lows, junk bonds bleeding, a flattening yield curve, headline inflation at zero percent, ISM manufacturing index sub 50 – not exactly the backdrop the Fed would like going into what is widely expected to be the first rate hike in almost nine years.

What is important for investors going forward is not so much what the Fed decides to do at the conclusion of its meeting this Wednesday (the futures market is pricing in a greater than 3 in 4 chance that they raise rates 25bps), but the pace and timing of future rate hikes. It's my opinion that the Fed remains between a rock and a hard place as this economic cycle has already started to decelerate. The latest Flow of Funds report released last week for Q3 remained strong on the household net worth front even though net worth declined $1.2 trillion from the record high of $86.4 trillion in Q2. This decline was very much concentrated in the weakness we saw in corporate equities in Q3 which has already reversed so far in Q4 (outside of this, net worth was up by $558 billion in the three months to September).

What stuck out to me was that profits of non-financial corporations were down 5% versus Q3 2014, and their debt was up 7% versus Q3 of 2014. This 1200bps gap between debt growth and profit growth is the widest we have seen since 2007. The Fed data also showed a significant slowdown (75%) in Q3 net share buybacks which no doubt played a role in the stock market downdraft during Q3.

This is yet another indication that we are in the late stages of this cycle and if contracting corporate profits and much weaker cash flows persist into 2016, share buyback volumes will significantly decline relative to the last four years. This would be a rather large buyer of stocks not in the market to support prices which begs the question of who would or could replace this demand?

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