February 1st, 2016

Another bite at the apple…
Asset prices of all kinds accomplished a rare feat to close out January with stocks, bonds, gold, and the dollar all registering gains on the week – the first time this has happened since November of 2014. It was the second consecutive weekly gain for the S&P 500 (+1.7%) which cut its monthly decline to -5.1% after being down more than 11% at its January lows. The opening salvo for 2016 was a tough month for risk assets with nearly $6 trillion of paper wealth evaporating across the globe as virtually all major equity indices finished in the red:

- Dow Jones Industrial Average -5.5%
- Nasdaq Composite -7.85%
- Russell 2000 (small caps) -8.85%
- Transports -8.01%
- German DAX -8.8%
- France CAC -5.56%
- Italy -12.15%
- Hang Seng -10.18%
- Shanghai Composite -24.03%
- Japan's Nikkei 225 -7.96%
- MSCI All Cap World Index -5.3%
- Emerging Markets -5%

However it wasn't all bad as investors who have been proactively preparing for risk before it happens found refuge in segments of the capital markets that have historically acted as safe havens when risk aversion rises:

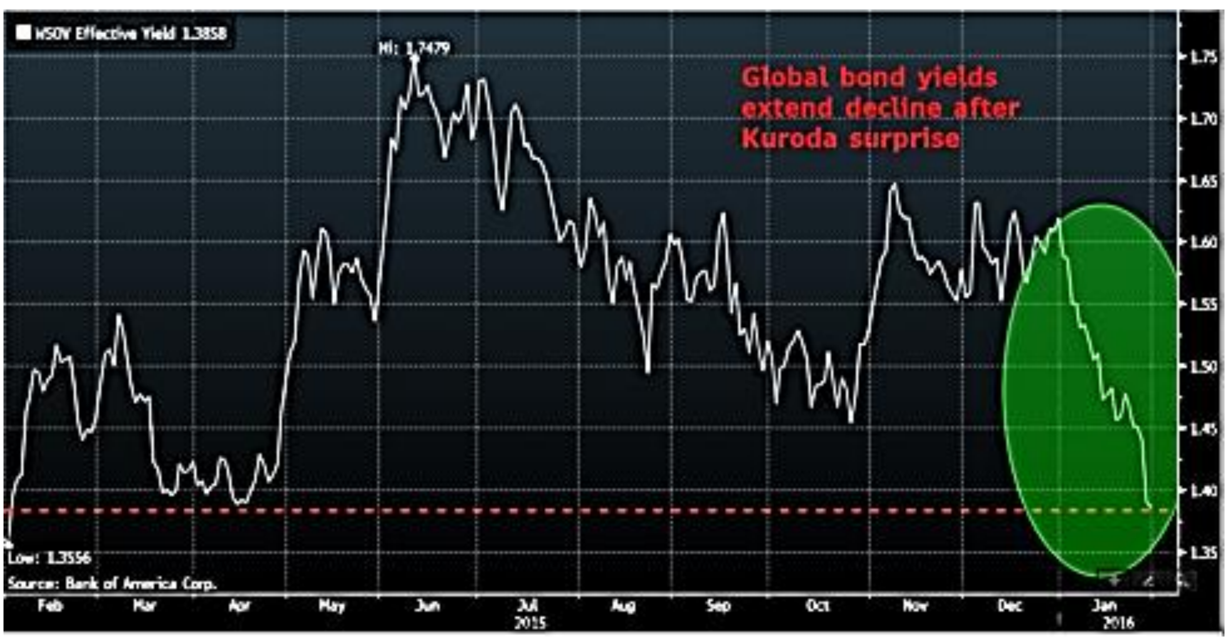
- Utilities +5.8%
- Consumer Staples +0.53%
- Intermediate Term Treasuries (IEF) +3.33%
- Long-Term Treasuries (TLT) +5.57%
- Municipal Bonds (MUB) +0.77%
- Gold (GLD) +5.4%

At a time when the incoming data continues to highlight the increasing probability of a recession, the bulls can still hang their hat on central banks pulling out all the stops in an effort to stave off economic gravity. The latest example came from the Bank of Japan last week as they served up a major surprise when it added negative policy rates to its long standing QE program (¥80 trillion or $666 billion annually). BOJ Governor Kuroda emerged victorious in unveiling this bazooka in what was a close vote on the BOJ board (five to four), sending the yield on the 10-year Japanese Government bond to a record low 9bps (down 13bps on Friday). To say this took many investors by surprise is a gross understatement as Kuroda stated publicly as recently as two weeks ago that he was not thinking of adopting a negative interest rate policy.

Whether you believe in the effectiveness of such a policy is a moot point at the current time – as an investor you must invest in the market you have, not the one you want or think should exist – as the common response among investors throughout the entirety of this global reflationary experiment has been to rally hard on each incremental dose of monetary policy accommodation. So the backdrop is one where the ECB is all in, the BOJ is all in, and the Fed is already on its heels after hiking rates a meager 25bps a little more than a month ago (a continuation of the proverbial central bank put).

However, the broadening view among investors is that it is looking more and more as if ultra-accommodative monetary policy has reached its practical limitations for eliciting any stimulative effect on the economy. As a result, the implications for investors are (in my opinion) a broadening of the shift in the pavlovian response by investors that started in late 2014 (the dogs are wising up to the experiment) – heightened volatility in asset prices, a continuation of deflationary forces overwhelming inflationary forces, the U.S. dollar remaining strong relative to most other currencies, and lower interest rates. In its most simplistic form – central bank credibility is coming under escalating scrutiny.

Following the BOJ announcement on Friday yields across Europe sunk between five and ten basis points, with German 10-year bund yields falling to 0.34% as the five-year note fell to -0.3% (yes, that is a negative sign). This filtered over into U.S. Treasury yields as the 10-year note fell to 1.91% and the 30-year Treasury Bond yield dropped below 2.75% – in the land of the blind, the one-eyed man is king, and on a relative basis you cannot find AAA-rated bonds at yields this high (even though in absolute and historical terms they are ultra-low). The below chart plots the pervasive downward trend in global sovereign bond yields that began last June and most recently picked up steam as we moved into 2016.



One constructive argument for falling yields is that it lowers the discount rate used in stock valuation models, therefore creating a modest tailwind for equity valuations. While in theory this is true, but most financial theories work off the premise of irrational assumptions, i.e. keeping all other variables constant. The reason yields are falling and central banks are taking the actions they are is because economic growth is decelerating and deflation is pervasive, not transitory, which reduces revenues and earnings – two pretty important variables in every valuation model and keeping these variables constant in the current environment is a very difficult argument for someone to make.

Another variable that has helped resurrect stock prices over the last two weeks has been the bounce in oil prices with WTI popping above $34/bbl in the wee hours of Friday morning's trading. The last leg of this pop from the sub $27/bbl level reached only a few short weeks ago is being driven by rumors that Russia and the Saudis are entertaining the possibility of output cuts – this is likely wishful thinking at the moment, but given the deafening silence as oil fell from $100/bbl to $30/bbl it is much more plausible to respect such rumors today.

There may be political reasons for the Saudis (i.e. stick it to Iran and fracture their cozy relationship with Russia) to continue to pump out oil at its maximum capacity (OPEC production is a full two million barrels per day above its old quota), but the more likely reason this verbiage is at least being bandied about is because of the outright implosion of these oil producing nation's economies. Both Russia and Saudi Arabia are seeing their budget and trade deficits spiral out of control and the war chest of foreign exchange reserves that once existed are experiencing significant stress. These regions may well have some of the lowest breakeven costs of production, but their fiscal budgets were set on the expectation of realizing a much higher selling price.

As a result, the sovereign wealth funds of these energy producing countries which have been huge beneficiaries of the run up in crude prices for years are being forced to liquidate large swaths of their holdings. Keep in mind these are some of the largest pools of money in the entire globe and they have been buying stocks, bonds, real estate, private equity, hedge funds, etc… for years – don't underestimate the pressure this potential source liquidations can inflict upon asset prices as this depression in oil prices persists.

As for the economic data and corporate earnings season – it continues to be a matter of your perception on whether you see the glass as half full or half empty. I have not been shy about sharing my 'glass is half empty' view and with each new piece of data being reported I believe this view to be the correct one.

Last week we got the December durable goods report which further confirmed that the manufacturing sector is in a recession. New orders sagged -5.1% (consensus was expecting a print of -0.7%) which was the fourth decline in the last five months with the absolute level lower today than it was in March 2006 (oy vey). Core capital goods orders (which excludes aircraft and defense and feeds into the capex outlook) fell -4.2% in December on top of a -1.1% slide in November, this sent the year-over-year decline to -7.5% which is the most negative it's been since November 2009.

As for the Q4 GDP report it was unequivocally bad as growth expanded by 0.7% quarter-over-quarter (down from 2.0% in Q3) with almost every metric contracting on both a quarter-over-quarter and year-over-year basis. The one variable that investors could take some solace from was consumption increasing 2.2% (which is a strong reading), but this is down from 3.0% in Q3. So once again, as with almost all incoming economic data over the last six months – growth is decelerating and unfortunately the pace of decline is picking up steam.

Central banks can continue to try and implement every stimulative monetary policy they can imagine (QE, forward guidance, negative interest rates…) but at the end of the day they can't stop economic gravity from occurring. It's undeniable at this point that global economic growth is under assault and frankly there may not be much that monetary policy can do at this point. This is what the bond markets are sniffing out and why Treasury yields are nearing their lowest levels in 11 months, financial conditions are tightening as both the cost of equity and the cost of debt have run-up, the yield curve is at its tightest level since the Great Recession, and credit spreads (especially in the high yield market) are spiking out to cycle highs.

Stock enthusiasts can try and argue the fact that earnings results are coming in above beaten down expectations, but I'm not buying it. According to Factset's Sr. Earnings Analyst John Butters, 40% of companies in the S&P 500 have reported Q4 results with 72% beating bottom line (earnings) estimates and 50% are beating top line (revenue) estimates. What this type of narrative doesn't tell you is that overall earnings are expected to decline -5.8% for Q4 as a whole and revenues are estimated to contract by -3.5%. Estimates for future quarters are also in the process of being ratcheted down with analysts expecting earnings and revenues to decline once again in Q1 2016 (if this turns out to be the case it will be the fourth consecutive quarterly decline in both EPS and revenue – according to S&P Capital IQ data).

It's no wonder why valuation multiples stopped expanding last year and are coming under assault this year. Even with the -5% year-to-date decline that dropped the S&P 500 by 103 points in January to 1,940, it is still trading at a P/E of almost 16 based upon analyst's estimates for the S&P 500 to earn $122/share for 2016.

S&P 500: Quarterly Earnings Growth

2015	Quarterly EPS Growth
Q4	-7.1%
Q3	-4.1%
Q2	-2.1%
Q1	1.1%
2014	
Q4	4.2%
Q3	7.8%
Q2	8.2%
Q1	5.1%

Source: Bloomberg

The accompanying table puts the trend in EPS growth (or lack thereof) into perspective. As an investor, is this the type of profile that you would look for in a company that you want to invest your money into: operating profit margins rolling over and declining from peak levels, falling revenue growth, and negative earnings growth? No thanks, I'll pass. This is what investors are wising up to and why the S&P 500 is trading back to levels it first reached in June of 2014.

From my perspective, the rally in the equity market over the last two weeks is a gift for those investors that were carrying a little more risk than they realized coming into the year. Without question it would be nice to see stocks levitate back to where they began the year and there is a chance that there is a little bit left in this rally, but please don't misconstrue the recent price action as anything more than a bear market rally. It's true that a lot of stocks have already discounted quite a bit of bad news with 77% of the stocks in the Russell 3000 trading below their 50 and 200 day moving averages (average stock is down -32% from its 52-week high), but I am far from comfortable believing that they have discounted all of it (particularly as the underlying fundamentals continue to deteriorate).

My advice to investors is to reflect back on how they felt and how their portfolio held up (or plummeted) when the S&P troughed at 1,812 on January 20th (-11.3% decline from where it began the year) and adjust accordingly if they were tempted to panic at that point. The 7% bounce in the S&P 500 since then gives you another bite at the apple to lower overall risk exposure at a more favorable price level. Because whether the worst is behind us or yet to come – panic has never been a profitable strategy for any investor.

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