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Market Commentary

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WHAT THE WORLD NEEDS NOW

I know you think it's love, sweet love (and that is probably true) but, at least when it comes to financial markets, what the world really needs now is a weaker dollar. And, no, not just for some, but for everyone.

The trade weighted dollar is up a staggering 25% since July 2014 and while some economies have benefited from this trend through improved export competitiveness (Japan and Europe in particular), even a Belgian strategist can recognize the importance of the mighty greenback and US liquidity conditions for the global economy and financial markets.

I am convinced that by now, policy divergence has become part of your financial vocabulary. This very real divergence between a Federal Reserve hoping and willing to normalize monetary conditions and other major central banks doing the exact opposite (quantitative easing and negative deposit rates) has been the primary factor behind the dollar's rapid ascent in the past 18 months. It is true that, back in July 2014, the dollar was particularly cheap from a fundamental perspective (purchasing power parity). A stronger dollar was also justified by the relative health of the US economy compared to Europe and Japan (as well as more pronounced deflationary pressures in these economies). Positioning portfolios for a sharp rally in the USD became a major consensus and it did work beyond many investors' wildest hopes.

However, many of the current issues plaguing financial markets can be traced back to when the dollar started this powerful rebound.

One of the first casualties of a strong dollar was the emerging market asset class. EM currencies had started to weaken already one year before (at the time of the now infamous "taper tantrum") but the trend intensified after July 2014. The weakness in emerging markets was at first mostly focused on those economies running a negative capital account as a surging dollar and (at that time) rising bond yields in the US resulted in a significant shift in international capital flows away from these markets (and back to the US). EM economies were forced to raise interest rates to stabilize their currency and fight off inflationary pressures and, as a result, domestic growth weakened considerably. The other negative impact of a strong dollar for developing countries is related to the significant increase seen in dollar denominated debt (mostly corporate) in these economies. Servicing this debt became more expensive, leading to widespread concerns over a potential EM debt crisis, fueling renewed capital outflows and further currency weakness. Very quickly, contagion spread to the entire EM region with sharp declines in currencies seen across the board.

This leads us to the second casualty of a strong dollar, China. Until last August, the Chinese currency was moving up in tandem with the dollar due to the existence of a loose peg. But being stable against the dollar meant that the Yuan was allowed to strengthen considerably against most other currencies (and important trading partners). The Yuan had become grossly overvalued on a trade weighted basis and given the softness in global trade and a developing recession in the Chinese manufacturing sector, the Chinese authorities surprised the markets with a mini devaluation of their currency last August. This trend was reinforced earlier this year with renewed currency weakness. Other EM currencies fell in sympathy given the close trade linkages with China. As investors position for further Yuan weakness and capital is flowing out of the Chinese economy, the Chinese have spent the past few weeks trying to prevent a too rapid (and unwelcome) decline in the Yuan by selling part of their huge USD reserves. This is an important development (and we will come back to this in a moment) as this results in tighter USD financial conditions.

Obviously, oil is the other major big story in global markets today. The plunge in oil prices is primarily the consequence of the significant increase in oil supply over the past few years (and particularly US supply). But a strong dollar is reinforcing this trend given the strong inverse relationship between commodities (priced in dollar) and the greenback. There is another important feedback loop of weak oil prices and this is related to the recycling of petrodollars. Oil rich countries such as Saudi Arabia tend to recycle their oil revenues in US financial markets. With oil prices plummeting (partly as a result of the weak dollar), the amount of petrodollars being recycled have fallen off a cliff, resulting in a further tightening of US financial conditions. This, together with the Chinese selling USD assets in their effort to prevent a disorderly decline in the Yuan, is a powerful cocktail leading to tighter financial conditions in the US.

But the impact from plunging oil prices goes beyond the direct consequences for oil exporting nations. Given the unprecedented speed and magnitude of the current decline, credit markets have also come under significant selling pressure. Today, the average yield in the energy high yield market stands at 19%, up from less than 5% only 18 months ago. The longer oil prices remain depressed, the bigger the damage will be in terms of companies defaulting on their debt obligations. As investors shied away from high yield, credit spreads have widened significantly across the entire spectrum, spreading over to sectors either not impacted or seen as beneficiaries of lower oil prices, such as healthcare, consumer cyclicals or technology. The current earnings reporting season saw banks disclosing their direct impact to the oil sector and implementing write downs accordingly. Once again, wider credit spreads result in a further tightening of credit and financial conditions for the US economy. But the damage from a strong USD does not stop here.

While the US economy is predominantly driven by domestic growth with exports accounting for only 13% of GDP, a strong dollar is much more damaging for corporate profits as close to 50% of S&P 500 sales are sourced outside the US. As a consequence, corporate profits for US companies actually fell in 2015 (a so-called earnings recession), something that usually happen only during economic recessions. A strong dollar, weak global growth and plunging commodity prices also resulted in growing signs that the US manufacturing sector is entering a mild recession.

With corporate profits under pressure and corporate leverage moving higher in recent years (courtesy of extremely low interest rates and greater reliance on financial engineering - such as debt financed share buybacks), corporate credit spreads have been widening since July 2014, even for investment grade and companies outside the commodity complex) and have now doubled over the past 18 months.

This brings us back to the theme of policy divergence and the Federal Reserve. QE in the US is over since October 2014 (but we already knew this was going to be the case a few months ahead of time) and the Fed finally decided to raise rates this past December. Although a 25 basis points hike should be seen as insignificant, it was not for a few reasons. First, the starting point for the Fed funds rate was zero (and zero for many years), so this was clearly a major policy shift. Second, as discussed before, this took place in the context of everybody else expanding accommodative monetary policies. Third, for the first time in recent memory, the Fed initiated a rate hike at a time when (as highlighted previously) financial conditions in the US had already tightened significantly due to rapidly widening credit spreads, a strong USD, a significant reversal in capital flows from China, commodity exporting nations and other developing economies, a flatter yield curve and plunging equity prices. There are various estimations as to what the impact of these factors has been on US liquidity conditions, but most agree that they are equivalent to a Fed funds rate hike anywhere between 100 and 250 basis points. Hence, the markets had already done the tightening for the Fed. However, the Fed did not stop with a 25 basis points hike, they communicated to investors (on numerous occasions) that they expect to raise rates 4 times in 2016 (what happened to the Fed being "data dependent"?).

RELIEF MIGHT BE COMING

Last month, I made the point that we are already in a bear market for global equity markets and the same holds true for the US, even if the S&P 500 does not fit the definition of a bear market yet (a 20% decline from the most recent high). In bull markets, the best recommendation is to follow the primary trend (which is up) and use any weakness as a buying opportunity. In a bear market, the best recommendation is either to sit tight and stay the course or, for those who feel they need to be more active, follow the primary trend (which is down) and use any rebound as an opportunity to sell. Probably the easiest and most efficient way to understand the primary trend in a market is to look at the 200-day moving average (broadly equivalent to a calendar year). Despite some minor corrections over the past few years, the 200-day moving average for the S&P500 remained up until last September and each pullback proved to be a buying opportunity. Since then, the moving average has started to move lower, indicating that the primary trend has turned lower. I would suspect that the markets will experience several countertrend rallies in coming months but that the primary trend would remain on the bearish side. However, I reiterate my view that we are dealing with a non-recessionary (i.e. I don't expect a US economic recession in the medium term) cyclical bear market within the context of a secular (multi-year) bull market.

Getting back to the USD, I believe that a weaker dollar could be the trigger for a reversal of the primary trend, given all the headwinds associated with a strong dollar over the past few months. Over the last few days, we have started to see the signs of a potential dollar reversal, but it is still too early to proclaim victory. Despite the Bank of Japan surprise decision to follow the European example of negative deposit rates and despite comments from Mario Draghi that more easing is on its way in the Euro-area, the US dollar has moved lower against most currencies in recent days. Investors have sent a clear message to Janet Yellen and Co. by bringing down their collective expectations for rate hikes in 2016 to only one towards the end of the year. I think the Fed needs to acknowledge that the global economy is not healthy enough for additional tightening in the US. Unfortunately, we are not there yet and until the Fed sends a more specific message to the markets, volatility will remain elevated and the dollar could easily rally back up again. Let me reiterate my comment from last month - a weaker dollar and a stabilization in oil prices are needed for the markets to find a firm bottom and for the secular bull to reassert itself. A recovery in credit markets is also needed but will likely take place if these trends materialize. Right now, investors are on edge because they know that credit markets tend to get it right more often than not.

PORTFOLIO POSITIONING

What's an investor to do in the near term? The most important thing is to acknowledge the fact that this is a cyclical bear market and, as painful as it can be in the short term, I don't expect this bear market to last very long. But, I also believe this is not yet an environment for bottom-fishing as the technical picture still looks ugly and we need a trigger for a more sustainable rebound (the dollar, oil prices and credit spreads are the most obvious places to look at for any hint). I believe this is a time where it makes sense to look at ways to lower the overall volatility of the portfolio and make sure you have enough ammunition left to get back into the markets more aggressively when the time is right. Within equities, we recommend to look at minimum volatility strategies which tend to perform much better during broadly sideways markets. We also recommend to keep a decent exposure to core fixed income (treasury bonds, agencies, etc...) as they offer a good hedge during turbulent equity markets and bond yields are unlikely to move higher in the current environment of weaker growth, deflationary pressures, additional easing measures globally and negative deposit rates in several economies. If markets remain volatile and end up the year with minimal price gains and if bond yields remain depressed, then investors will continue to focus on relatively "safe" ways to earn a better yield - candidates in this space include utilities, telecommunications, REITS and preferred stocks. I also think that investment grade credit offers a good risk/reward trade off now as spreads have reached levels which are usually seen during recessions and the sector does not suffer from the same backdrop seen in the high yield space (in terms of energy exposure).

I expect 2016 to be another volatile and relatively trendless year. I also think that we are not on the verge of a US recession and a very painful equity bear market with earnings plunging and valuation ratios contracting significantly. Stay the course, don't try to be a hero in trying to catch the exact bottom, and make sure your portfolio is properly diversified in order to be in a good position once the trend turns back up again later this year.

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