Infomail
February 9 2016

A Market with I.C.E. In Its Veins
Looking For a Turnaround

"It is possible to increase paper money to any amount by debasing the currency, but real income can only be increased by working harder or more efficiently, saving more, investing more and producing more"

Well-Known American Journalist Henry Hazlitt

Investors are seeking clues to the future direction of global equities, but they need not look any further than these three areas:

1) Interest Rates
2) China
3) Energy Prices

…Or I.C.E.

Let's break them down:

1) Interest Rates

The markets have been grinding sideways for most of 2015, but they have really gone sloppy since the US Federal Reserve raised interest rates in mid-December for the first time in almost a decade. They floated the concept for months, so I would guess it wasn't the 0.25% increase that makes markets nervous, as much as their rhetoric that it was the first of 3-4 rate increases they were planning.

Since the Fed increased rates, the data and market action has not supported their case, and famed bond manager Jeffrey Gundlach even openly stated a couple weeks ago, that if the Fed didn't back off of the harsh rhetoric, that the markets would embarrass them.

Now for those of you who actually read these, you will know that I've been mentioning for some time that the biggest thing government bureaucrats fear is being embarrassed, and Fed Chair Yellen doesn't want to be the one who dropped the ball after 7-8 years of the Fed trying to get things back on track. I think there's no way given current data the Fed can raise 3 more times in 2016.

Adding confusion to the situation is the fact that the US Fed is actually attempting to increase interest rates when the other major global economies (Japan/Europe/China) are actually still cutting and stimulating. It's almost unprecedented. In fact, Europe went with negative rates last fall, and Japan followed suit a couple weeks ago. Even Canada has been floating the concept.

Diverging monetary policy between the USA and China has been the major cause of the recent volatility in the markets.

Which takes us to…

2) China

The world's two largest economies – the USA and China – are on the opposite ends of the monetary spectrum and it's played havoc with the world's currency markets.

It's also created a strain on global liquidity as a result because as the US tightens while the rest of the world cuts rates, the by-product has been an incredibly strong US dollar and forced the Chinese to devalue the Yuan (which is loosely pegged to the US dollar), just when the Chinese economy shows signs of weakening.

Now the weakening Yuan is creating a capital flight from China, leaving China's central bank with the difficult task of trying to orchestrate an orderly and gradual devaluation of the Yuan. What started as an orderly depreciation of the Yuan in December has turned more disorderly in 2016. It's also hurt China's reserve balance which has gone from $4 trillion to about $3.3 trillion while trying to defend the Yuan.

And to add to the global worries, as the Yuan has depreciated so quickly, the fears increase that China is exporting deflation to the rest of the world as a result.

Which leads us to…

3. Energy Prices

A couple of weeks ago oil prices hit about $27.50 per barrel when the Dow Jones was down 566 points. It bounced to about $32, but now holding at $30 US per barrel.

The prognosticators seem evenly split. Some say $50+ sometime later in 2016, many still say low $20's, but isn't that what markets are made of?

I am still of the belief that this year's "the trade" will be in energy. I just don't know if it was two weeks ago at $27.50 or two months from now at a price a little lower than that, but we are in the range. The pain levels are too high, and the instability in the Middle East is rising as promises made by governments to their citizens become harder to keep.

So many pieces I am reading talk about a bear market coming. News alert, we've already been in a stealth bear market since last fall. The average stock in the Russell 2000 (The broad US index) is down over 20%, and it's pretty well the same on the TSX.

So putting it all together:

1) The March interest rate hike which was a sure thing in December, now seems clearly off the table
2) Once the Yuan stabilizes, expect a sharp snap back in markets
3) The lower US dollar will create a rally in the commodity sector (We are seeing this the last few days already)

Our friends at Fidelity believe the pattern in 2016 will be "V" shaped, with the first half of the year being the falling side of a "V" formation, and the back half of the year the rising side of the "V" pattern. The hard part is trying to figure out where the turn is.

I would guess commodity names, emerging markets, and high yield credit may have already bottomed, and explains how the TSX has outperformed the US markets so far in 2016.

We look like we are oversold in the near term, but the action has not been pretty. Almost like forced selling from Hedge Fund margin calls, or continued Sovereign bank selling trying to sell investments to cover budget deficit shortfalls. In either case, I think "weak hands" might be forced selling short term to long term "strong hands."

Panicking is never a good idea, and shopping for ideas will pay off.

Stay tuned,

Vito Finucci, B.COMM, CIM, FCSI
Vice President and Director, Investment Advisor
Associate Portfolio Manager