A World Upside Down

Who would have thought that in today's world, ¼ of all government bonds have negative yields? This represents assets of over US$ 5.5 Trillion. Even some High-grade Corporate Bonds from companies like Nestle and Royal Dutch penalize investors for being long their credits.

In this Thinking Man's Apprach, we identify 10 main investment issues that show a world turned upside down.

1. No peloton in the Tour de Global Economy;
2. Monetary Policies:
   a) QE world and the expansion of Central Banks Balance Sheets;
   b) Terrible communication policies by Central Banks;
   c) A new tool: Negative Interest Rate Policy
3. A world with a lot of Money but low Liquidity – problems in the pipes;
4. A world with great deflationary pressures and a bearish commodities cycle;
5. A world with "currency wars"
6. A world with great geo-political risk, while oil prices are low;
7. US Politics: Anger rules; outsiders dominate both parties (Trump and Sanders);
8. S&P500 companies: Negative revenue growth and negative earnings growth – Can the market have multiple expansion in this environment?
9. US households are saving!
10. "US Millennials" and the Japanese "Deflation Generation" are extremely conservative and risk averse – much more than baby boomers and older people are!

1. No peloton in the Tour de Global Economy

We like the comparison Deutsche Bank made at the end of last year in describing the global economy to the "Tour de France." They relate the current environment to a race without a peloton, or main group/pack of riders. The absence of peloton translates into a lack of synchronization among the world economies, who are all moving at different speeds, and leaving the world in a state of disarray and uncertainty.

The Thinking Man's Approach

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2016 is off to a rocky start, filled with wild daily crashes and upswings. There has been no rhythm to the markets, no real sense of direction. There have been brief respites of calm, but there is no feeling of stabilization, as these periods have been extremely short lived and followed by days of intense volatility. This may be a reflection of a world upside down – the theme of this month's Thinking Man. We discuss 10 different ways across the spectrum that this is happening in today's world, and again encourage our clients to stay with the positioning we've championed for the last few years.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

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The breakdown of the "riders" in the race is as follow. While the US may be considered the leader, it's not a strong one, as it's moving forward at a sluggish pace (GDP growth expected to be between 2-2.5% for 2016). Europe is waiting for a breakout, but is stuck in a neutral zone, expected to grow around 1 or 1.5% this year. Then there's Japan, which is really "spinning its wheels," putting in all its efforts to move ahead, but really getting nowhere. In 2016, Japan is expected to grow around 1%, and its economy today at the same size as it was in 1995, 2001, 2003 and 2008. Finally, we have the BRICs – which are a mixed cycle on their own, with Brazil and Russia in a serious struggle and with China and India downshifting.[1]

2. Monetary Policies

a) QE world and the expansion of Central Banks Balance Sheets;

While the Fed has expanded its balance sheet 4 times in the last 8 years, the ECB President does "whatever it takes" and the BOJ has already bought ¼ of all the JGBs in the marketplace. As Kuroda mentioned a few days ago, they still have ¾ more to buy (on top of the newly introduced tool of NIRP). Great investors, including bond manager Jeff Gundlach of DoubleLine Capital and Ray Dalio, the head of the world's biggest hedge fund, Bridgewater Associates, have renewed criticism of the Fed, urging it to abandon the notion of raising rates any time soon. The Minneapolis Fed President, Mr Kocherlakota, is calling for a "hard U-turn" in monetary policy. He thinks the central bank is underestimating the risks of sinking inflation expectations and says the credibility of its target is under threat. That steep drop in inflation expectations is being watched by Fed policymakers, as is the effect of market volatility on corporate borrowing costs. The volatility that followed the Fed's rate rise led to criticism from investors, who say it was wrong to tighten policy in the face of a global slowdown. Few believe it will stick to its plan for more increases this year.

b) Terrible communication policies and no humility (high profile) from Central Banks;

Central bankers have had a high profile posture, that is not congruent with the role and low profile a central banker should have. They're the new stars! Monetary policy is being hampered by poor communication. The latest central bank to spring a surprise is the Bank of Japan, which on Friday went back on previous statements and cut interest rates to negative. In recent weeks, however, most criticism has been reserved for the People's Bank of China. The PBoC has been attacked for botching its communication and worsening the slide in the renminbi, the falls in stock prices and continued capital flight from China. The Chinese authorities are worried about the risk of capital flight, as many consumers attempt to move money offshore.

At least one governor of the European Central Bank appears to regard outright deflation as a necessary condition to expand the bank's campaign of quantitative easing (QE) — a very elastic interpretation of the bank's target of keeping inflation below but close to 2 per cent. And the US Federal Reserve has some credibility problems. This week its open market committee, though

[1] Adams, Larry, "2016 Ten Themes: Crawling, not Leaping, into the New Year," *Deutsche Bank Wealth Management.* December 2015

acknowledging recent volatility in financial markets, continued to argue that the US labor market was tightening and that inflationary pressures were building up. Last month, when it raised interest rates, the average of Fed officials' forecasts suggested another four quarter-point rises this year. The problem is that investors clearly do not believe them and are currently pricing in one at most .

c) As QE failed, a new tool for the tool-kit: Negative Interest Rate Policy

Negative yields now account for ¼ of JP Morgan's index of government bonds! Almost all 2 year government yields in Europe are negative, most 5 year government yields in Europe are negative (including Germany, France, Netherlands, Switzerland and Sweden). Swiss 10 year government yield is negative, while the 10 year Bund trades at 0.35% per annum. In Japan, the 10 year JGB trades at 0.04% per annum! The BOJ's bond purchases have expanded its balance sheet to 75% of GDP from 35% in 2013, compared to the U.S. Federal Reserve's 25% of GDP. Yet growth in Japanese bank lending, now 2.2% per year, has barely budged. Companies are sitting on about $2 trillion in cash, and real wages have declined. Japan's share of total exports by developed countries fell to 6.5% in 2013-15 from 8% in 2005-07, despite the yen losing 30% of its value.

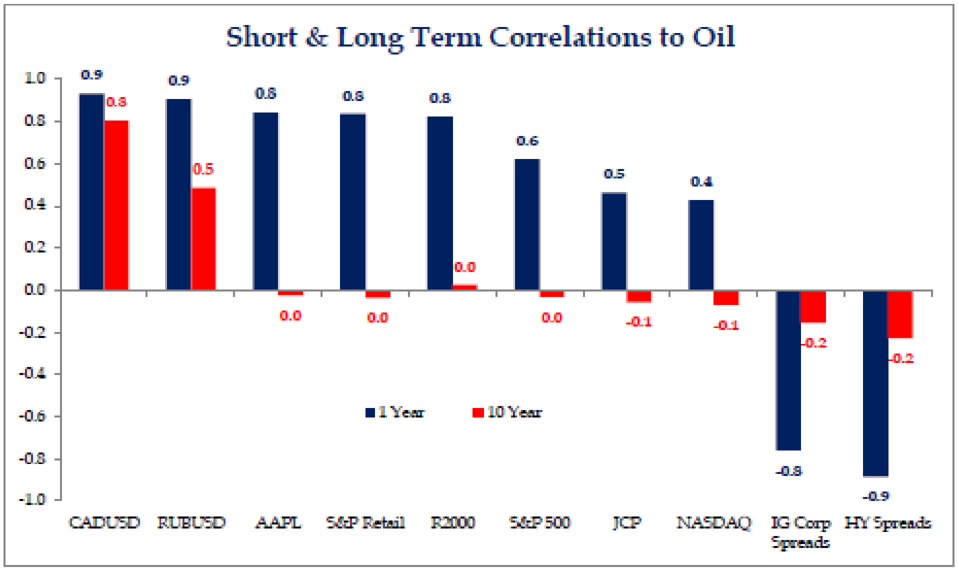
The failure of unconventional monetary policy in Japan and Europe is proof that central banks can't conjure growth in economies that need major reforms to let resources find more productive uses. If companies can't find promising investments, credit creation will remain stalled no matter how cheap capital is.

The contrast with South Korea is striking. After the Asian financial crisis in the late 1990s, Seoul opened its economy to greater competition, and today Korean companies are outpacing their Japanese peers. Korean President Park Geun-hye is pushing reform of restrictive labor laws, while Japanese Prime Minister Shinzo Abe postponed labor legislation to pass national security laws.

3. A world with a lot of Money but low Liquidity – problems in the pipes

There's a huge stockpile of money in the world, created by the past few years of unorthodox global accommodative monetary policies; the stock of liquidity is abundant, as corporations and households are sitting on unprecedented levels of cash. What is more relevant, however, is the flow, or the degree to which assets can be traded. For cash to translate into liquidity, the mechanisms or "pipelines" for cash to flow through to the markets must be wide open and free flowing. Thanks to structural risks and regulatory changes created as a consequence of the 2008 crisis, these pipelines have become narrow and bottlenecked, creating illiquidity and large gaps down (or up) in prices. Furthermore, we are seeing crowded trades in this "risk on, risk off" environment, where niche and risky markets are suffering because of a lack of liquidity. When there are wild price gyrations in these markets, there is a "contamination" effect in other markets for a short window of time-creating a fast spikes of volatility. We wrote about this theme in our Thinking Man #24.

The last few weeks of volatile markets have showed that low liquidity has created new paths of "contamination" in different asset classes.



As the chart on the right shows, the short term correlations of oil and many different assets has sky rocketed. The correlation between the oil price and Chinese stocks has almost reached 1, when historical correlations between them is only 0.01. What has caused this? One explanation is the recent selling behavior of Sovereign Wealth Funds (SWFs) from energy rich countries like Norway, Finland, Qatar, Dubai and Saudi Arabia. Oil and gas related SWFs represent nearly 56% of the total assets of SWFs globally and are among the largest investors in private equity and other illiquid asset classes. [1] They have high commitments to fund these types of investments, but with the loss of expected income (due to the sudden and sharp drop in oil prices), they have been forced to sell their liquid assets to raise funds. Two such liquid assets to fall victim: Japanese equities (the best performing equity market of 2015, where the SWFs can take profits) and Chinese equities. These historically uncorrelated markets to oil have now fallen victim to contamination in today's markets.

4. A world with great deflationary pressures

The benefits from lower commodity prices have been hard to discern while the negative impacts have been fully felt. Generally speaking such declines would be a net positive for consumer spending oriented economies. Without some stabilization in the price however, it appears that investors will have little confidence in the ability of policymakers to stop the ravages of deflation. Most countries from the USA to India suffer from DISINFLATION. In the US, inflation has been lower than the Fed target for more than three years, and the pressures on the oil price and surge in the dollar could force the Fed to again push back its unrealistic 2% target when we're running at 0.7% CPI year-over-year. Other countries, from Japan to Zimbabwe, suffer DEFLATION. We are arguably in a moment where few countries have INFLATION like Brazil, which ended last year with a budget deficit equal to 10.34% of gross domestic product and the country's debt is also expanding at a rapid pace (the ratio of debt to gross domestic product was 66.2% in 2015, up from 57.2% the year before).

[1] Trennert, Jason and Ryan Grabinski, "Strategas' 'Shareholders' Equity' Negative; First Time Since Mid-2013," *Strategas Market Balance Sheet.* January 25, 2016

5. A world with "currency wars"

The moves from the ECB, from the Popular Bank of China, and most recently from the Bank of Japan, highlight their common concerns in generating inflation. Every central bank has a 2% inflation target that seems unrealistic! And this seems to spark fears of a "currency war". Everyone wants to ease monetary policy using orthodox and unorthodox tools, generating weakness in their currency that helps boost their exports (and puts a hurdle on imports). As one bank makes a move, another seems to follow. As China suffers from capital flight as it liberalizes the capital account of the balance of payments, Japan's negative interest rate on excess reserves is a reaction to the natural Yen appreciation from the China effect. This behavior is "passive aggressive," as most countries don't admit there are currency wars happening.

6. A world with great geo-political risk, while oil prices are low

Geopolitical tensions are growing and there is widespread fear that today's geopolitical events could undermine financial stability. Lower commodity prices are causing upheaval in commodity producing countries, particularly in the Middle East. Supply of oil has far exceeded demand, and this imbalance is being primarily driven by an increase in world production and not a decline in consumption growth. The battle for market share represents a "geopolitical struggle" in the Middle East, contributing to the region's increasing instability as it battles the Islamic State, problems in Syria, and tensions between Saudi Arabia and Iran.

The lack of economic growth is prompting some countries to look for expansion in neighboring territories, further fueling geopolitical tensions around the world. Russia's aggressive behavior with Ukraine had the world on edge. China is another example. Its move to reclaim land and build artificial islands in the South China Sea has raised tensions with neighboring countries and the US – especially because China plans to use these strategic locations for military installations, and because that land has already been claimed by Malaysia, the Philippines, Vietnam and Taiwan.

Furthermore, we're seeing sanctions being imposed which further lowers global growth, and heightened tensions could lead to greater protectionism after decades of expanding trade. What remains to be seen is if these tensions and conflicts are more structural in nature, of if the pressure will subside if more "normal" levels of growth resume. For now, the "rhythm" to the latest geopolitical events has changed over the past few years, and it is likely that the longer growth is below "normal" levels, the more these pressures will build.

7. US Politics: Anger rules; outsiders dominate both parties

In this year's US Presidential Election, outsiders are taking the lead of both the Democratic and Republican parties. Donald Trump has dominated headlines and polls of the Republican primaries, although his second place finish in Iowa on February 1st was a blow to his campaign. On the Democrats side, Hillary Clinton's large lead over outsider Bernie Sanders has narrowed quickly in the last few weeks. The results in Iowa were the closest in the history of the primaries (Clinton

49.8% to Sanders 49.6%), and so close that several of the precincts were decided by a coin flip. Sanders got 84% of the Millennials vote in the Iowa caucus! This 74 year old self-proclaimed Socialist is proposing a marginal tax rate of 65%. The rise of these anti-establishment outsiders shows the anger and disappointment Americans feel with the current state of politics in the US.

8. S&P500 companies: Negative revenue growth and negative earnings growth – Can the market have multiple expansion in this environment?

Very unlikely! The picture emerging from the results of the latest 2 quarters of 2015 and the guidance for 1Q16 and full year 2016 is one of all around weakness, with growth hard to come by in the slowing global economy, the strong U.S. dollar, and weakness in the oil and other commodity sectors. This isn't a new problem, we have been discussing these headwinds the last few reporting cycles as well. In other words, the earnings recession continues with Q4 earnings for the S&P 500 index on track to be below the year-earlier level – the third quarter in a row of negative earnings growth for the index and the second quarter in a row of negative revenue growth.

Recent weakness in oil and other commodity prices has effectively guaranteed that this negative growth trend will continue into the current and following periods as well. In fact, all of the earnings growth for the S&P 500 index in 2016 is now entirely expected to come in the second half of the year, with growth in the first half of the year now expected to be negative.

9. US households are saving!

Gross domestic product grew at an inflation-adjusted 0.7% annual rate in the fourth quarter, dragged down by an expanding trade deficit as well as companies slowing down inventory investment and cutting capital spending. Consumer spending grew at a 2.2% rate, which is enough to keep the economy going, but isn't very inspiring considering the U.S. gained 851,000 jobs in the quarter, marking the fastest hiring pace of the year.

All those additional paychecks helped push Americans' overall after-tax income up by 3.2%, at an inflation-adjusted annual rate. However, they chose to bank rather than spend much of that gain, lifting the personal saving rate to 5.4%—its highest level since 2012. The good news here is that the high level of savings suggests further income gains will flow into better spending growth in the year ahead. Indeed, economists are forecasting spending will grow more quickly in the first quarter, helping raise the pace of GDP. That would be good news for companies, which have had profits hit by tepid domestic sales receipts and horrid conditions overseas. For this to happen, it is also crucial that companies, despite their poor results in the fourth quarter and a jittery stock market, keep hiring.

10. Despite their youth, "US Millennials" and the Japanese "Deflated Generation" are extremely conservative and risk averse – much more than baby boomers and older people are!

With time on their side, these younger generations are expected to be willing to take on risk, and thus, their investment portfolios should have significant allocations to equities. However, this is not the case! A UBS survey showed that affluent US millennials on average hold 52% of their liquid assets in cash (more than double their older counterparts, who have 23% in cash); and only 28% in stocks (significantly lower than the older generation's 46% in stocks).[1] Their experience with both job security issues and market volatility during the Financial Crisis of 2008 early on in their careers (or watching their parents experience with this) has likely shaped their behaviors as being risk averse. This coupled with the high student debts many of them have (almost 45% of 25 years olds have student debt, up from 25% ten years ago) has made the US Millennials among the most conservative of investors.[2]

This trend of being risk averse is not only happening in the US. Japan has been in deflation for nearly two decades, prompting the young "Deflated Generation" to be more conservative than their parents, and even their grandparents. A Financial Times article discusses how these 20-year olds see the world. One student in Tokyo describes his generation as "coldly practical" and says: "We need to save as much as we can and take as little risk as possible." This highlights a clear sense of insecurity, the desire to save every penny and also to always take the cheapest option. Deflation has created a sense of insecurity – and has taken away the incentive for young Japanese to leave home, buy cars, marry, have children or take risks in general.[3]

Conclusion

In a world of higher volatility, lower liquidity and economic uncertainty, investors can expect acute market swings to continue. This has been clearly illustrated this in the sharp reversal in stocks and oil during 2016. Our view, as we wrote about in our Thinking Man #36 is as follows:

1. As John Maynard Keynes said: "*A speculator is one who runs risks of which he is aware and an investor is one who runs risks of which he is unaware*."
2. Diversification is still KEY in this "laboratory world" – while asset correlations seem to be constantly shifting, it's still a MUST have for investors;
3. Traditional asset classes will produce low mid-single digit returns for the next 5-10 years (with high grade bonds having barely positive returns);
4. Maintain a healthy amount of CASH for portfolio flexibility and to be opportunistic/ tactical;
5. Increase the "illiquid" revenue producing allocation of the portfolio in niche markets like Private Debt, Commercial Real Estate and Mezzanine Debt; these assets types offer an illiquidity premium of around 5% to public markets' comparable and help shield portfolios from the market-to-market monthly volatility;

[1] Smialek, Jeanna. "Recession-Baby Millennials Shun Stocks After U.S. Slump: Economy," *Bloomberg Business.* May 14, 2014
[2] Smialek
[3] Lewis, Leo. "Japan: Deflated generation," *Financial Times.* January 13, 2016

6. Use volatility to your own advantage: both to protect portfolios (by buying protective puts) as well as for "yield enhancement" strategies (selling covered calls);

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