Unknown Fears Dominating Market Sentiment

The oldest and strongest emotion of mankind is fear, and the oldest and strongest kind of fear is fear of the unknown"

The famous economist Paul Samuelson once joked that the stock market had predicted nine of the last five recessions. Analysis shows us that while equity and bond markets are poor predictors of recessions, the yield curve[1], in "normal" times, has an excellent record of forecasting them. Before every single US economic downturn since World War II, the yield curve has been flat or "inverted" — in other words longer term borrowing costs have fallen close to or below shorter term ones.[1]

Unfortunately for us, we are not living in "normal" times – and instead we are living in a distorted world thanks to the expansive global monetary policy executed by central banks over the last several years. This expansive policy has led to the artificial anchoring of the short end of the curve. Thus, it is difficult to say how valid the yield curve is as a predictor of the recession in today's world. Even so, when we analyze what the yield curve is telling us today, the chances of a recession are slim, as the yield curve is far from inverting. The New York Fed's calculations (which uses the difference between three-month Treasury bills and the 10-year yield) indicated last month that there is less than a 5% chance of a recession over the next 12 months.[1]

BigSur clearly sees 3 areas of fundamental weakness. These are the recession in the Manufacturing Sector (8% of GDP), a crisis in the Energy sector (10% of GDP) and a profits recession. Earnings per share (EPS) of S&P 500 companies are on pace to decline 3.9% versus a year ago, and this quarter alone is shaping up to see a 4.8% contraction from the previous year. The situation is no better in Europe, where Eurozone EPS growth forecasts for 2016 are down 7.3% year-to-date. However, these are not new news! The market has been digesting these realities for at least 6 months.

So, then why the massive beginning of year sell-off? It's hard to show that company or economic fundamentals are weak enough to justify this scale of sell off as direct measures of economic health such as retail sales, auto sales, home sales, construction, employment and wages have been sending largely upbeat signals.

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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- Employment: the Labor Department said wages increased 2.5% in January from a year earlier as employment continued to rise to a near full-employment economy, with a 4.9% jobless rate.
- Retail sales: economists' calculations suggest that real consumption growth will rebound to 3.0% annualized in the first quarter, from a more muted 2.2% in the previous quarter. The modest gain in retail sales value in January was primarily a reflection of the 3.1% month to month (m/m) price-related fall in gasoline sales. Otherwise, motor vehicle unit sales rebounded a little last month and remain very strong. Furthermore, the very encouraging 0.6% m/m rebound in control group sales, which feeds into the GDP calculation, more than reversed the 0.3% m/m dip in December. Finally, the weather-related rebound in utilities output points to a massive 5.5% m/m increase in households' utilities spending.
- More generally, against a backdrop of healthy labor market conditions and falling gasoline prices, consumer confidence remains elevated, despite the current financial market turmoil, and should support a pick-up in real consumption growth in the first half of the year. Through our bottom-up approach we are seeing a strong pick-up in restaurant sales. Despite fears of a "zero-sum" game thesis in fast food, results suggest category growth, aided by an improving low-end consumer, increased ad spending and a focus on price point promotions. Home improvement companies like Home Depot (which just posted an impressive +8.9% same-store-sales) are seeing a strong pick-up in traffic.
- Construction: Goldman Sachs points out that the housing recovery has at least several more years of upside. Investors are unlikely to differentiate between slowing growth in certain sectors of the industrial economy and continued measured growth in homebuilding volume, thus preemptively discounting the cycle peak for homebuilders. BCA Research points out that building permits remain close to the highest level in eight years, suggesting that the housing recovery has not run out of steam. As Ed Leamer famously argued in his paper "Housing IS The Business Cycle," a deterioration in the housing market has been the single best predictor of U.S. recessions. At least by that standard, the U.S. economy still looks reasonably healthy.

This is all still quite good – and the fact is that the big drop in oil prices has yet to really filter through the system in terms of its benefits to the consumer. There is a disconnect between market action and fundamentals. This really relates to the market pricing in fears of a large global macro or credit shock that we cannot yet see or fully describe – or unknown unknowns that are looming in the back of investors' minds. We at BigSur identify three such unknown unknowns which are weighing on markets:

1) Central bank credibility is causing a big drop in market confidence and market sentiment

The overarching concern amongst global investors is that Central Banks are running out of firepower. Investors all over the world are concerned about the ability of global central banks to continue to play such a large part with financial markets. As a whole they are losing credibility with investors – and that credibility is key to market confidence.

The Fed's decision to raise rates in December, and Janet Yellen saying they have yet to study or research negative rates has investors wondering if the Fed understands the workings of the real economy. Investors have not forgotten that one of the Fed's key goals of expansive policy was to pump money back into the economy – and encourage business to investor more. However, most used their cash for share buybacks, and corporate cash hoards remain a big contributor to global savings excess that continues to unbalance the world economy.

In Japan meanwhile, the deflationary mentality is so deep-seated that policies seem to have less and less of impact. The Bank of Japan moved into negative rates earlier this year. When this happened, the Yen surged and tightened financial conditions instead of having any expansionary impact.

In 2012, Mario Draghi, president of the ECB committed to "whatever it takes" to preserve the Eurozone. Four years later, his words no longer have an effect as ECB leaders are constantly in disagreement and there has been limited material progress.

The market and investors are still weary of the People's Bank of China. The financial system is still immature and central bankers are still navigating how to both execute and communicate policy moves effectively. However, authorities still have the fiscal capacity to stabilize the banking system, and their rhetoric still has influence over China's currency market.

The world's leading central banks still have their most difficult hurdle in managing the orderly decline in the price of assets that have been artificially inflated by their expansive policies. Investors worry that there is little scope or appetite for Fiscal Policy. Some economists suggest financing a fiscal stimulus with yet more debt, focusing on infrastructure assets and simpler tax codes. However, public debt in the US rose from 64% of GDP in 2008 to 104% by 2015; in Europe it rose from 66% to 93% and in Japan, from 176% to 237%. Central banks have done their bit, it is now time for governments to be bolder.

2) Health of the European Banks

Investor confidence in the European banking sector has hit crisis era lows. Banks across Europe are struggling from a lack of profitability thanks to low interest rates, sluggish economic growth and the legacy of around 1 trillion Euros of bad loans on their balance sheets. European banks have been a focal point of the recent market volatility, with the the Stoxx 600 banks sub index down 23% for the year.

The ECB, which once had a calming effect on volatility, now has a contributing effect, as investors are worried that interest rates staying lower for longer would reduce the profits of banks already constrained by the effects of post-crisis regulation. Additionally, the so called ECB "stress tests" used to test the financial system are seen by the market as quite "unstressful". On February 24th the European Banking authority outlined the continent-wide "health check," described as the Wall Street Journal as one which "can't be failed." Unlike in previous tests, to pass this test, banks will not need to meet a minimum capital requirement to pass. The macroeconomic scenario does not factor in the possibility of negative interest rates. Banks with less than 30 billion Euros of assets don't have to go through the process – which will keep many of the European Union's more troubled lenders from participating in the test. No banks from Portugal will be included and several small Italian banks will not have to face the test. Italy's banking sector has become a concern as the whole system seems to be weighed down by loans which have built up during recent years. Progress in shedding bad loans has been very slow across the European banking sector: in November, the European Banking Authority said that the ratio of bad loans to total loans in Europe is about double that of U.S. banks.[1]

This "slow motion approach" of the ECB to reforming the banking system has left investors nervous about the unresolved issues in the fragmented European banking system. A fundamental problem is that there are too many banks in Europe and that many are not profitable enough because they have clung to flawed business models. The investment banks in Europe don't have the deep domestic capital markets that give their American competitors an edge. Take Deutsche Bank for example, which has only just decided to scale back its investment bank in the face of a more intense regulatory environment following the financial crisis. Deutsche has been at the center of the recent storm around European banks – at some time during the last week, the equity was trading at 30 year lows and at one-third of its book value last week. Its contingent capital bonds have suffered as analysts have questioned whether they would have enough earnings to pay the interest for these bonds. The bank faces many hurdles – potential losses to loans to energy firms; pending regulatory infractions and costs of restructuring.

Problems with the banking sector in Europe can threaten the continent's growth, as European companies tend to depend on banks for funding, unlike US companies who more frequently tap investors directly. In 2015, European bank lending finally grew after years of contracting, providing more fuel for the European reflationary story. Now as banks worry about their own profitability many analysts are expecting them to retrench – which would be a huge roadblock to Europe's economic growth.

3) US politics: outsiders' success spooking markets?

The rise of Donald Trump and Bernie Sanders, two extreme candidates who represent the "anti-establishment" in both of their parties, has correlated closely with the decline in stocks the past eight months. Some analysts argue that while most explain the sell-off as linked with weakness in China, Europe and oil prices, market experts are overlooking investors' growing political worries in the US.

With Trump winning the Nevada caucus, which is now his third straight primary victory, he is now the most likely to win the Republican candidacy – no Republican nominee has lost the

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[1] Colchester, Max, "European Banks Face Test They Can't Fail," *The Wall Street Journal.* February 24, 2016

nomination after winning three of the first four races. For Ted Cruz or Marco Rubio to have any chance of pulling ahead and winning the nomination, they will need to win some states in the next week and one of the two will need to consolidate the "non -Trump" votes. While they are splitting votes, they don't have a chance and one will need to take a dominant stand. Even if that happens, could be "too little too late" and Trump may very well be the Republican Presidential candidate. Sanders, on the other hand, has only won one of the last four primaries. He is still producing stronger than expected results, however, and is closing the expected margin between himself and Hillary Clinton.

The market is nervous about a Trump presidency, especially as he has threatened to punish China and other trading partners with tariffs to "level the playing field." Many economists view these protectionist measures as harmful, and some even point to these types of measures as being the cause of the Great Depression. His views on deporting immigrants are seen as highly impractical and likely to cause "tremendous civil strife" by many in the Republican Party. And if Sanders were to win, there would be a professed socialist leading our country with the most expansive social and fiscal policy agenda in modern American history. His major policy proposals – single payer national health care, free tuition at public colleges, and a major federal bridge & highway construction effort - will be paid for with higher taxes and less economic growth.

Analysts argue that the success of these outsider candidates is creating reservations amongst investors who are nervous about the political instability that potentially lies ahead, weighing on current market sentiment.

Conclusion: What are the consequences? Investment action

- Use these relief rallies from this "rout of rationality" as we think it won't last too long; Sell into strength
- Clients should return to their comfortable position: if you happen to be "overstretched" in any of your risk assets, come back to where you are comfortable
- We doubt that this is the "big scare" of the year or that now markets are just on their way up with no volatility. We can see markets re-testing these lows in both the stock markets and lows in terms of spreads in the credit markets.

This is a market environment where there are important transitions happening around the world: the US monetary policy is diverging from global central banks; China is changing its economic model and reforming its financial system; Japan's central bank is going form a less proactive central bank to one that is super proactive; and the oil market is showing signs of stabilization with Saudi Arabia, Russia, Qatar, Venezuela agree to freeze oil output.

1. Clients should use rallies to lighten up and go to a portfolio that offers flexibility to be able to have a more adaptive portfolio to this market environment of huge transition.

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