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MACROCOSM

2016: Two Charts, Six Words, One Man

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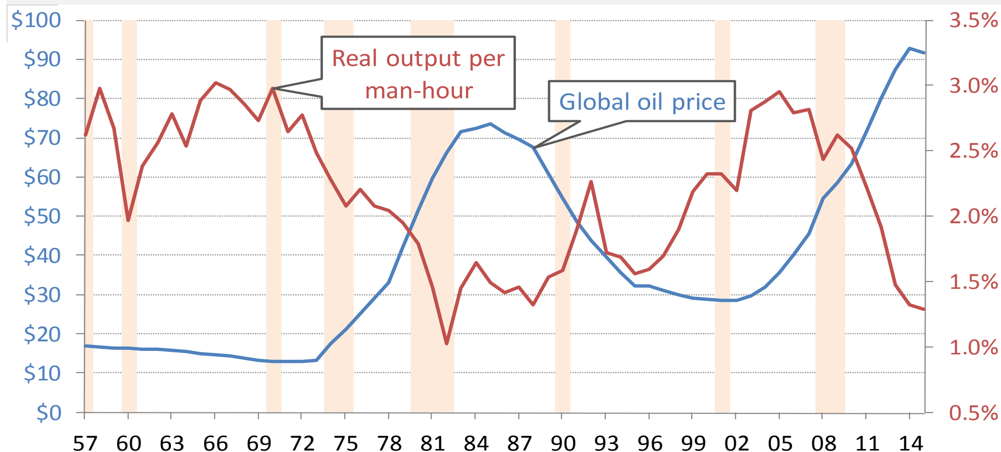
The New Year is going to start out rough. And then there's Donald Trump.

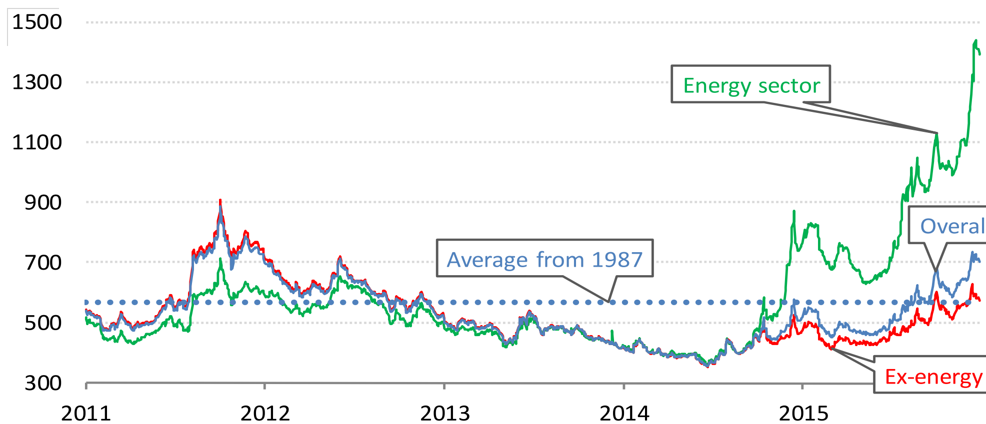
We'll save our 2016 market outlook for the end. First, a strategic overview of what we see as the three big drivers in 2016.

TWO CHARTS: THE OIL PARADOX When in June 2014 we called the top in oil and predicted a crash (see "The Stench of CrISIS" June 25, 2014), we highlighted how the shale revolution would usher in a new secular period of faster global growth. The first chart below is drop-dead

US productivity growth versus oil price 10-year moving average **Recession**



US non-investment grade bonds Spread to Treasuries



Source: BP, BEA, BAML, NBER, TrendMacro calculations

Update to strategic view

We're in the first-ever global recession caused by too-low oil prices, driving tightening financial conditions, falling earnings, rising inventories, and soggy labor market internals. The Fed is a non-issue – as the economy visibly weakens, there won't be any more rate hikes, and very possibly a reversal. 2016 will start rough, as the economy weakens. But this unique recession will likely be mild, supported by a resilient consumer. Global equities will likely test the August lows, probably successfully. Low long-term yields are the key to preserving the equity risk premia that put a net under stock prices, and we expect they'll stay low with no inflation risk and no Fed risk. Assuming oil prices don't fall so low as to trigger financial contagion or outright geopolitical instability, we can get the rough-patch out of the way in the first half, and then on to recovery. But the wild-card is Trump – a double-risk the markets aren't currently seeing: one risk if he wins, another if he loses.

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proof: long-term, low oil prices are good for productivity and high oil prices are bad. But the second chart (on the previous page) symbolizes the high short-term costs of the oil crash: credit distress in domestic bond markets and among banks; economic malaise in oil-producing regions; fiscal stress in US states and oil-dependent nations in the Middle East and elsewhere; and political and military uncertainties emanating from oil-producing nations feeling the worst of the pinch.

This seeming paradox is a version of "creative destruction." It's always been a necessary dynamic of progress, but that doesn't make it pleasant. It's like Joe Louis said: "Everyone wants to go to heaven, but no one wants to die." All the more so in our age of exponential technology growth and rapid adoption. Creative destruction becomes "disruptive innovation," in which the losses experienced by obsolescent incumbents and their communities are commensurately accelerated. The new abundances created by shale technologies are "disrupting" the largest and most powerful class of incumbents in the world – huge multinational corporations, and entire nations, with correspondingly large consequences.

- *A year ago when the consensus was still clinging to the idea that oil would quickly snap back to $100, we were among the first to say that it would instead mean-revert to ''a range between $15 and $40 in today's dollars"* (see "Oilmageddon" December 16, 2014).
- *But it's happened sooner and harder than we expected. We had expected a fairly orderly process of creative destruction, but now it appears we are in for a more disorderly form of disruptive innovation.*
- *So we think we are already entering the first-ever recession caused by too-low oil prices* (see, first among many, "Houston, You're the Problem" March 9, 2015).
- We see the causes of it and the evidence for it in the tightening of credit conditions in bond markets and in bank lending standards; in the rollover in corporate earnings world-wide (whether or not energy sectors are excluded); in the strength of the US dollar; in the continuing buildup in US business inventories; and in the deteriorating internals of the US labor market – and then, in the face of all this, the Fed has hiked interest rates.
- The good news – of sorts – is that oil seems to have found prices low enough to destroy supply. US production – now the steady-state swing factor – peaked in April, and has now fallen more than 4%. OPEC production has been flat for a quarter.
- The only major upside uncertainty for supply is Iran – which out of one side of its mouth brags that it will do anything to grab market-share, and out of the other side promises it will get good prices.
- *Our call is that US production will continue to fall, that OPEC production ex-Iran has peaked, and the Iran production will be both late and disappointingly small.*
- *At the same time, though we see recession, we don't expect the kind of demand-destruction normally seen in a recession. This time, the oil price is so low – after a decade of being brutally high -- we think consumer budgets will mostly make cuts elsewhere.*

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How North Korea Became the World's Worst Economy
Nicholas Eberstadt
Wall Street Journal
December 29, 2015

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- *So once again, we're prepared to call the bottom for oil. We still think the core range for 2015 will be $45 to $60* (see "Oil's Hard Road Forward" October 5, 2015).
- It's hard enough to have predicted a great bear market like the one oil is experiencing – which we did. But it's much harder – once you've predicted it – to predict its exact end. We called the bottom in oil several times in 2015, and were early – that is, wrong – every time. But this is the way great bear markets are. As they reach their inevitable end, prices go random – with alarmingly large moves seemingly having no correspondence to objective factors of supply and demand. So at this point, it's in the hands of the gods. At least that means it's almost over.

SIX WORDS: THE FED MAKES A LITTLE MISTAKE Last year, we had expected the Fed to "liftoff" from the zero policy rate at the June FOMC meeting, against the backdrop of a smartly accelerating US economy. Because we made a mistake by underestimating the extent of the oil crash and its disruptive effects, we never got that acceleration – we acknowledged that mistake in April, and pushed out our "liftoff" expectations (see "On the March Jobs Report" April 3, 2015). But at the December FOMC the Fed made its own mistake – in the face of self-evidently deteriorating macro fundamentals, it nevertheless raised policy rates for the first time in a decade (see "On the December FOMC" December 16, 2015).

- *If our recession call is right, or even half-right, then December's hike will be the last for a long time – with probably no further hikes in 2016. Indeed, the December hike may have to be reversed.*
- *Markets don't see it quite that bearishly, but almost.*
- Short-term markets are priced to expect no further hikes till June, and a funds rate of only 1.75% three years out -- which implies, on average, only one rate hike every four to five FOMC meetings.
- Long-term Treasuries have treated "liftoff" as a non-event, at most. 10-year and 30-year yields are almost exactly where they were a year ago, and notably lower than they were mid-year. *As we shall see at the end of this report, we think this is a critical indicator.*
- Combined with steady-state inflation expectations at or near all-time lows, markets seem to be thumbing their nose at the FOMC's belief it can be "confident that inflation will rise, over the medium term, to its 2 percent objective." Indeed, we would argue that markets see "liftoff" itself as at least a marginally deflationary event.

In the run-up to "liftoff" – indeed, in Janet Yellen's first FOMC statement as chair and in every one of her FOMC statements through October 2015 – the FOMC repeated verbatim a 38-word statement designed to reassure markets that the next hiking regime will be shallow, gradual and tentative. Here are those familiar 38 words, with the essence of the policy message called out in red.

- **The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels,**

economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.

[The "liftoff" FOMC meeting in December](#) added six words to strengthen the prior commitment – to include now the idea that the current hiking regime will be "gradual." We expect to see these 44 words in many FOMC meetings to come.

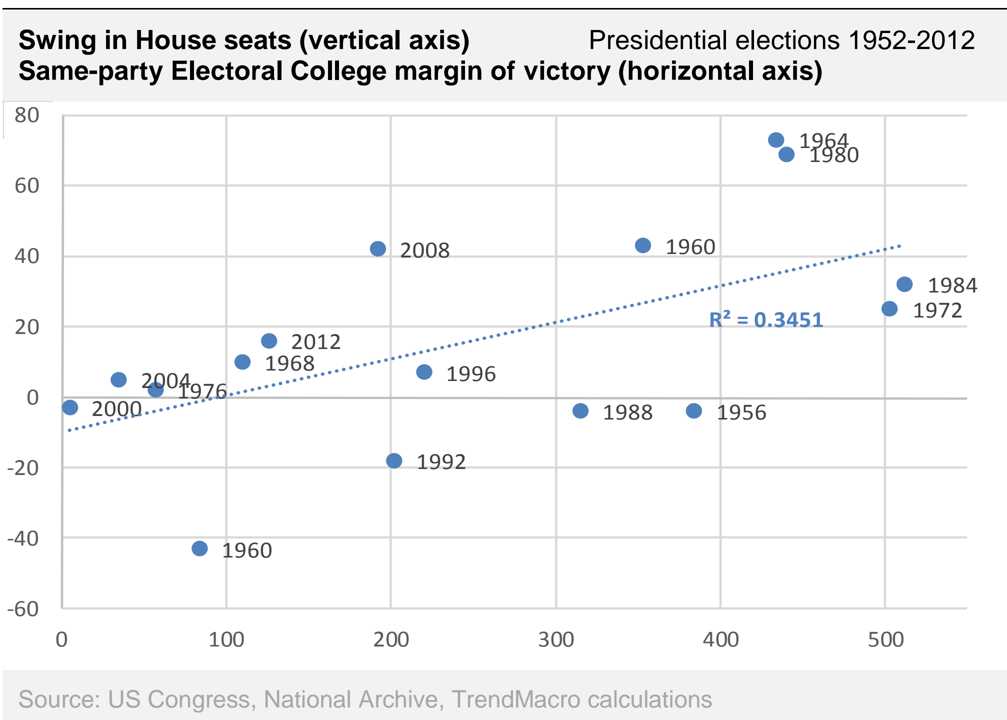
- **The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run.**

The six new words are primarily to reassure markets as to the "gradual" pace of hikes, in addition to the prior assurances on the low terminal level of the present hiking regime. But by speaking specifically of how "conditions will evolve" – a *dynamic* view of the future, in contrast to the *static* view in the 38-word version that treats recovery as a set of "levels" to be achieved – the Fed has bought itself significant wiggle-room.

- *Now, when things go wrong in the economy – as we expect they will – the Fed doesn't have to confess that its "levels," once achieved, didn't stick. Instead, they can say, well, things just didn't "evolve."*

ONE MAN: TRUMP Donald J. Trump continues to play the media like a violin, turning [gaffes that would ruin most candidates](#) into [brand-building victories](#). For markets in 2016, the reality is that he is not just going to

Swing in House seats (vertical axis) Presidential elections 1952-2012
Same-party Electoral College margin of victory (horizontal axis)



Source: US Congress, National Archive, TrendMacro calculations

automagically go away, as the conventional wisdom continues to expect.

- We have nothing to add to our report several weeks ago (see "Trumped!" December 14, 2015). So let us repeat:
- *If Trump is the GOP candidate and he wins*, we really have no idea what his actual policy initiatives would be, and which of them could be implemented.
- He has a pro-growth side, to be sure: the way he frankly embraces his wealth and success is inspirational and aspirational, and could awaken "animal spirits" in a world trained by politicians for almost two decades to expect the worst.
- But his explicit policy prescriptions all have the stink of protectionism, isolationism and nativism. These are all ingredients of a toxic anti-growth policy mix, resulting in withdrawal from globalization.
- *If Trump is the GOP candidate and he loses*, there is the risk that he would lose by a landslide, demonized the way Barry Goldwater was in the 1964 election. If that happens, then the powerful "coat-tails effect" – in which House and Senate membership shifts toward the party that wins the White House -- could give us an all-Democratic government like we had in 2009 and 2010.
- The Senate is at risk anyway, thanks to the normal partisan churn pattern that favors Democrats in 2016. But even what seems to be a comfortably gerrymandered House could swing by the 30 seats necessary for Democrat control if Trump loses by a sufficiently large landslide. In the 1964 Goldwater debacle, Democrats picked up 73 seats (please see the chart on the following page).
- *We hope that clients of all political persuasions will understand that this concern of ours is not politically motivated – it is a cold-blooded economic calculation. The reality is that in our hyperpartisan world, if either party seizes exclusive control of government, knowing it only has such control for two years, it will force ill-considered large-scale legislation for which no real consensus has been established through that narrow time-window – the result will be anti-growth policy.*

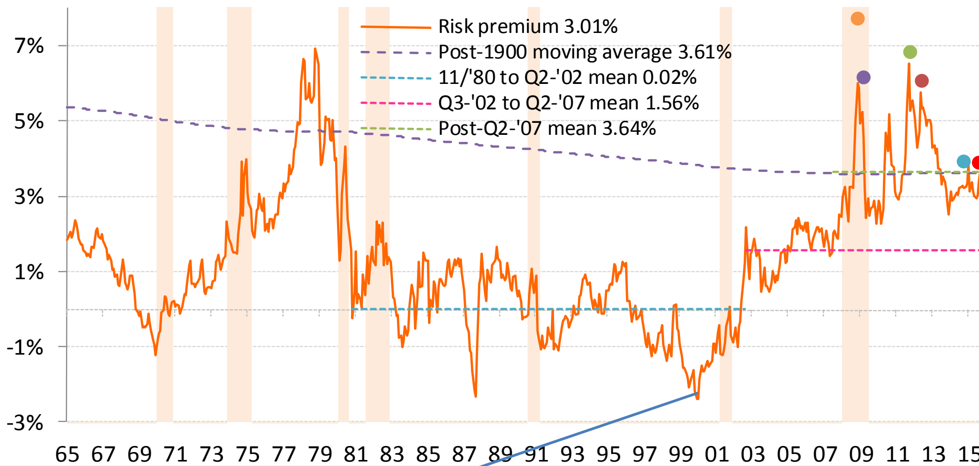
MARKET AND ECONOMIC OUTLOOK Our way of thinking about markets and the economy is to try to identify governing dynamics, and ride them as they change. And because they are not usually linear, it's not useful to guess where they will end up at arbitrary end-points. So it's not our style, at year-end, to say where we think things will be at *next* year end.

- *We do think that 2016 will start out rough for equities, as we roll into the first-ever recession caused by too-low oil prices.*
- They aren't cheap anywhere in the world (if we had to pick needles out of haystack, they'd be Taiwan and Turkey).
- And forward earnings are in some form of rolling over virtually everywhere (Japan and Turkey are the closest things to being exceptions). This, we think, is a reflection of the general tightening

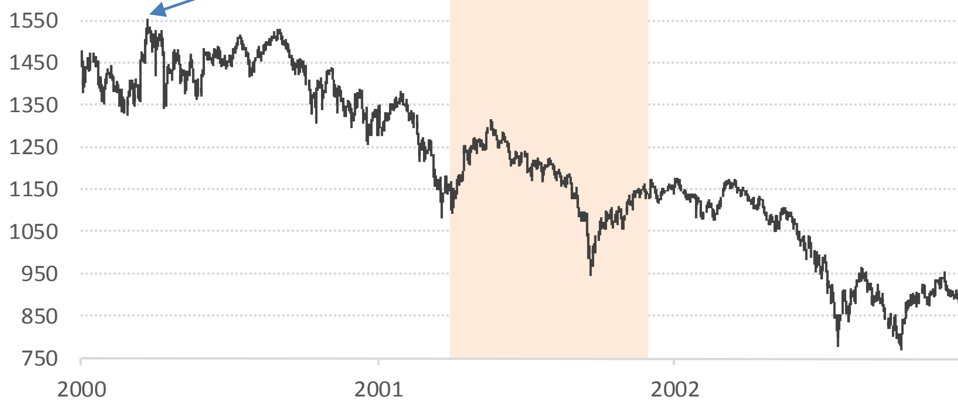
of financial conditions that has emanated from the crash in oil prices.

- All that said, equities are generally attractive versus bonds – that is to say, equity risk premia are generally high.
- So while stocks are not cheap heading into recession, the equity risk premium puts a floor under how low prices can go. We think this recession will be mild anyway – but we note that stocks don't typically experience bad bear markets during recessions unless they start out with narrow equity risk premia (please see the chart below), which is very much not the case now.

S&P 500 equity risk premium Month-end ● **Extreme days** **Recession**



S&P 500 **Recession**



Source: Various, NBER, TrendMacro calculations

- Obviously, then, the resiliency of equities depends critically on continued low long-term bond yields. Happily, that is something about which we can be quite confident. As this commodities-driven recession takes hold, there's certainly no reason to expect rising inflation to drive long-term yields higher. And other than the Fed, no major central bank is tightening – and for the Fed, we don't think it will tighten much more if at all, and may indeed even ease before long.

- How bad things get for stocks also depends on how bad the recession gets. That's a tough call – there's never been a recession caused by too-low oil prices before, so we don't have a playbook. But we do know that low oil prices impart great resiliency to the global consumer – which surely puts a safety net under how bad this recession can get. That resiliency was sorely lacking in 2008 with record-high oil prices when the Great Recession hit.
- The big risk is that oil prices crash from here to prices so low that there are contagious bank failures, sovereign defaults or even geopolitical chaos. We don't think that's likely. Again, at this point in oil's bear market, it's in the hands of the gods – but we do think we're in a sloppy bottoming process, and that the attention getting calls on Wall Street for $20 oil won't materialize in this move.
- *But if oil finds its footing before anything really systemic happens, then we can get a garden-variety recession out of our system in the first several months of the year, have a test of the August lows in global equities – which we expect would be generally successful – and then move on to recovery, a recovery energized by oil prices that are no longer too low, but are just plain low.*
- We said we didn't want to make year-end predictions, but if that version of events plays out, 2016 could be an up-year for equities – the eighth in a row (the S&P 500 was up in 2015, if dividends are included) – even after getting off to a terrible start.
- Politics – Trump! – is a wild-card. If the conventional wisdom is right and he just fades away, then that card doesn't get played.
- But if he's the nominee, markets are going to wake up one morning and all of a sudden stare a lot of uncertainty in the face – one risk if he wins, another if he loses.

Bottom line

We're in the first-ever global recession caused by too-low oil prices, driving tightening financial conditions, falling earnings, rising inventories, and soggy labor market internals. The Fed is a non-issue – as the economy visibly weakens, there won't be any more rate hikes, and very possibly a reversal. 2016 will start rough, as the economy weakens. But this unique recession will likely be mild, supported by a resilient consumer. Global equities will likely test the August lows, probably successfully. Low long-term yields are the key to preserving the equity risk premia that put a net under stock prices, and we expect they'll stay low with no inflation risk and no Fed risk. Assuming oil prices don't fall so low as to trigger financial contagion or outright geopolitical instability, we can get the rough-patch out of the way in the first half, and then on to recovery. But the wild-card is Trump – a double-risk the markets aren't currently seeing: one risk if he wins, another if he loses.