Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

MACROCOSM

Is This 2016, or 2008?

Friday, January 15, 2016

Donald Luskin

As we test the August lows, capitulation is in the air, from Soros to Summers to Bullard.

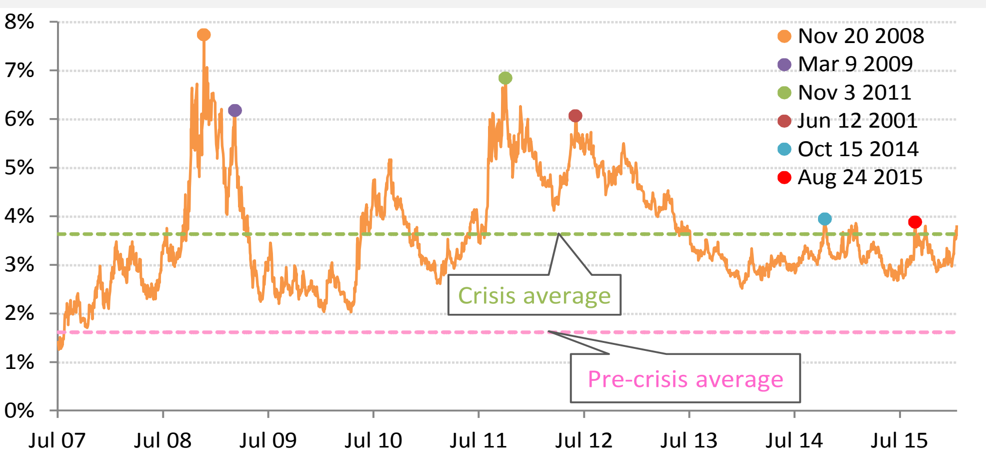
In our year-end report looking ahead to 2016 (see "2016: Two Charts, Six Words, One Man" December 31, 2015), we said that for global equities "2016 will start rough, as the economy weakens." *Check.* We also said, "Global equities will likely test the August lows…" *Check.* Then we went on, *"…probably successfully." Barely. At best. Many markets are below the August lows now – US small-cap and mid-cap indices, and some emerging markets, by a lot. At this point the "test" may well be to see what happens when the lows are breached and stops are triggered.*

- *As of this writing shortly after the US opening today, the S&P 500 is still barely hanging in there above the August lows. Within the S&P 500, all but three sectors – energy, materials and financials – have held the August line.*
- *Perversely, perhaps, but Chinese stocks have held the line, too, as has China-sensitive Japan.*

One encouraging sign is that there is so much evidence of capitulation.

- *The equity risk premium has risen back to slightly above the crisis-era mean* (please see the chart below). *But as of this writing this morning it has yet to quite match the peaks seen at the panic lows*

S&P 500 equity risk premium Forward earnings yield minus 30-year Treasury



Source: Various, TrendMacro calculations

Update to strategic view

US STOCKS, ASIA STOCKS, US BONDS, US FED, OIL, FX: As we expected, it's been a rough start to 2016. So far key equity markets have successfully tested the August bottom – small-cap and mid-cap stocks have not. The equity risk premium hasn't quite reached the panic levels of October 2014 or August 2015, so perhaps we haven't quite seen the ultimate selling climax. But signs of capitulation are all around, including panic mongering by Soros and Summers. Fickle Bullard has started to fret about falling inflation expectations, perhaps signaling capitulation by the Fed in the face of a horrible reaction to "liftoff." The yuan devaluation that has panicked markets is a positive development, but with some externalities for emerging markets, yet not likely a systemic risk. Fundamentals in oil markets are in flux with Iran sanctions set to end shortly, and Saudi talking about taking Aramco public. But we continue to think oil is putting in a "sloppy bottom," which points to an end to growing credit stresses.

of October 2014 and August 2015. This is our favorite indicator of risk-preference, and it suggest to us the possibility that we have to have one more test – one in which the August lows are breached slightly, to establish a truly compelling valuation argument for stocks.

- But the stench of panic necessary for a bottom is in the air.
- It's very constructive that George Soros – a very successful investor but also the man who sold everything *the morning after* the crash of 1987 – says that in "financial markets there is a serious challenge which reminds me of the crisis we had in 2008."
- Larry Summers says "the global risk to domestic economic performance in the US, Europe and many emerging markets is as great as at any time I can remember."
- And some strategist at RBS got headlines out of all proportion to his wisdom or reputation by saying "sell everything" because it "all looks similar to 2008."
- Perhaps the most important sign of capitulation so far came yesterday from St. Louis Fed President James Bullard, a fickle weathervane for fashionable policy fads, who – after being a cheerleader for the misguided December "liftoff" – has suddenly decided to get concerned that "the decline in market-based inflation expectations measures is becoming worrisome."
- Yeah, "worrisome" indeed – they are the lowest in the history of the data, as we have been pointing out for quite a while, and as the Fed knew at "liftoff" (see, among many, "One Small Step -- In the Wrong Direction" November 23, 2015). But if Bullard's "worry" is emblematic that the market action so far this year has begun to force the Fed to see that which it had willfully ignored, then that's all to the good.
- That willful ignorance is a deliberate strategy, according to the minutes of the December FOMC "liftoff" meeting. It cited the "importance" in the future of "confirming that inflation would rise as projected and of maintaining the credibility of the Committee's inflation objective." We fail to see how credibility is maintained by deciding in advance what to say, whether or not it is true.
- Markets have always known that the Fed would have to back off this silliness, now more than ever. The swaps markets are now calling for a funds rate of only 1.24% three years out. So much for Vice-Chair Stanley Fischer's notion that four hikes in 2016 are "in the ballpark."
- *Here it is in a nutshell – to the extent that his stock market correction is a reaction to the Fed's error, then to the extent that the Fed will respond to it, then that reaction can subside. As a base case, it seems plausible to think that is what is happening.*
- *On this point, we said at year-end that the key metric to watch would be long-term Treasury yields* (again, see "2016: Two Charts, Six Words, One Man"). *We need them right in a sweet-spot where they are now.*
- We need yields not to rise – which they may well if the Fed were right that inflation will automagically come back to 2% anytime soon, or if the Fed were committed to a hiking regime that lifted the whole platform of the curve. Rising long-term Treasury yields would

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

Recommended Reading

The Neglected Dimension of Global Security: A Framework to Counter Infectious Disease Crises
Commission on a Global Health Risk Framework for the Future
January 13, 2016

Who Will Rule the World Oil Market Over the Next Decade?
Heather Saucier
American Association of Petroleum Geologists
Explorer
January 2016

[Reading home]

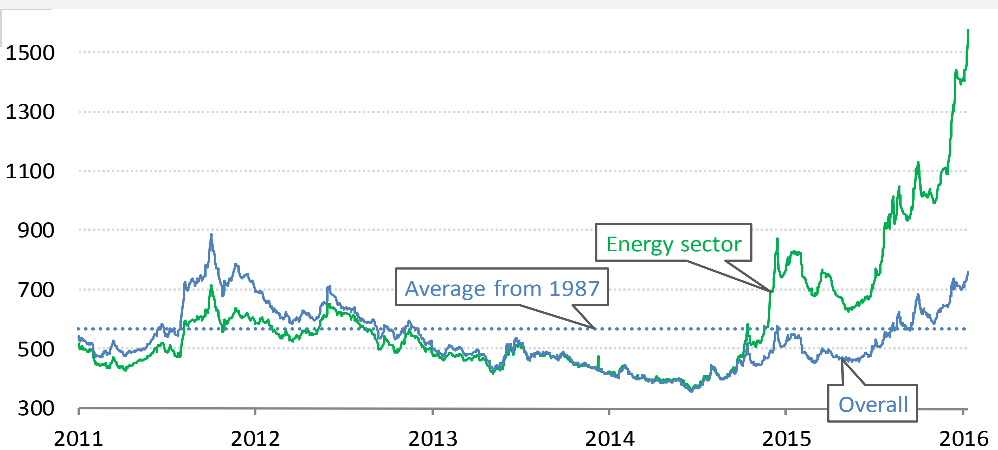
undermine the equity risk premium, which forms the value case supporting stock prices (please see the chart below) – and indeed was, arguably, the one credible case underlying years of quantitative easing (see "Is the Fed Moving the Stock Market?" March 11, 2013).
- We need them not to fall too much either, as they would if we really faced the systemic threat that Soros and Summers are seeing.

Is there a systemic threat?

- Though the test of the August lows we are facing now actually began in the last weeks of 2015, the neck-snapping cascade-phase that began in the New Year has been attached to systemic risk stories connected with China. We are less worried about that than the consensus seems to be.
- The gyrations of the Shanghai stock market are regarded as a bellwether for global risk, but it seems to us that it has performed pretty much like most of the other markets around the world, albeit with higher volatility. But again, so far it has held above its August lows.
- As to the continuing devaluation of the yuan, we reiterate what we have said often since the first overt devaluation which triggered the global panic that produced the August lows in the first place (see "On the RMB Devaluation" August 11, 2015). Because of the super-strong dollar – triggered by the collapse in oil prices (see "Dollar Strength: A Crude Connection" April 23, 2015) – the yuan has become terribly overvalued, and for China to let it weaken is a move in the direction of goodness, whether or not it creates various stresses and uncertainties in global supply chains.

But how might all this go wrong? As always lately, it's all about oil. This morning's negative retail sales and industrial production numbers ought to add heft to our idea that we are entering the first-ever recession caused by too-low oil prices (see "The Recession Caused by Low Oil Prices" January 8, 2016). For us the only question is how much damage gets done.

Non-investment grade bonds, spread to Treasuries



Source: BAML, TrendMacro calculations

- It is alarming to see oil below $30, driving credit-risk higher and tightening financial conditions overall (please see the chart on the previous page). If the oil price falls to $20 – a narrative that more and more investment banks are piling on to – then this tightening could produce serious stresses.
- *We just don't think $20 oil is going to happen. Indeed, the growing consensus for it is a form of capitulation.*
- But as we said at year-end, at this point in this savage bear market for oil, "we are in the hands of the gods" (again, see "2016: Two Charts, Six Words, One Man"). And also again, having been among the very few to have perfectly called the top in oil (see "The Stench of CrISIS" June 25, 2014), it's frustrating to have so imperfectly called the bottom.
- There are many very complex and indeterminate issues pressuring oil at this point.
- "Implementation day" for the end of sanctions against Iran could be coming within days, much sooner than we expected. No one really has any idea how much oil Iran can put into global markets – although our view anchors the pessimistic case for their production ability (see "Iran: The New New World Oil Order, Volume I" July 20, 2015).
- Saudi Arabia's announced intention to take Saudi Aramco public sends very complex and confusing signals about the Kingdom's outlook on oil, and on its strategy as the world's single largest producer.
- We'll be writing on these matters in great detail next week. *For now, we continue to think that oil has found a supply-destroying price without any visible demand-destruction so far* (please see "Data Insights: Oil" January 12, 2016)*. Until further notice, we're still going to say that oil is working out a "sloppy bottom."*
- *If that's right, then we've seen the worst from the single factor that we think has been the epicenter of the stresses that have been driving weakness in global equity markets since last spring.*

Bottom line

As we expected, it's been a rough start to 2016. So far key equity markets have successfully tested the August bottom – small-cap and mid-cap stocks have not. The equity risk premium hasn't quite reached the panic levels of October 2014 or August 2015, so perhaps we haven't quite seen the ultimate selling climax. But signs of capitulation are all around, including panic mongering by Soros and Summers. Fickle Bullard has started to fret about falling inflation expectations, perhaps signaling capitulation by the Fed in the face of a horrible reaction to "liftoff." The yuan devaluation that has panicked markets is a positive development, but with some externalities for emerging markets, yet not likely a systemic risk. Fundamentals in oil markets are in flux with Iran sanctions set to end shortly, and Saudi talking about taking Aramco public. But we continue to think oil is putting in a "sloppy bottom," which points to an end to growing credit stresses.