
STRAY REFLECTIONS
Stray Reflections
WRITTEN BY JAWAD MIAN
Stray Reflections is a global macro research and trading advisory with a focus on major investment themes and actionable trade ideas. Now in its third year, Stray Reflections has a diverse global following—from individual readers to some of the world's largest hedge funds, family offices, and institutional investors. Jawad's writing is prized for its staunch independence, distinct poise, clarity of thought, and courage to push readers outside of the manacles of conventional thinking.
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STRAY REFLECTIONS

Special Issue: The Bull Case for Real Vision viewers

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Milton, Why So Bearish?

Judging by our conversations with market participants, global investors are *short* conviction and *long* fear. For every bullish interpretation of market developments, there exists an equal and opposite bearish one.

Confidence remains fragile and investors are extremely wary of embracing risk assets. Citi strategists claim the world economy is trapped in a "death spiral." RBS has recommended that investors "sell everything" in what will prove to be a "cataclysmic year."

In this special issue for Real Vision viewers, we attempt to separate the signal, or the underlying economic and market trend, from the noise.

Betting On Apocalypse Now

Three fears seem to be influencing market psychology: 1) the prospect of a sizeable devaluation in China's currency, 2) contagion from the oil price collapse, and 3) the threat of a US or global recession. Taken together, these risks have the potential to cause a cascading decline across various risk assets.

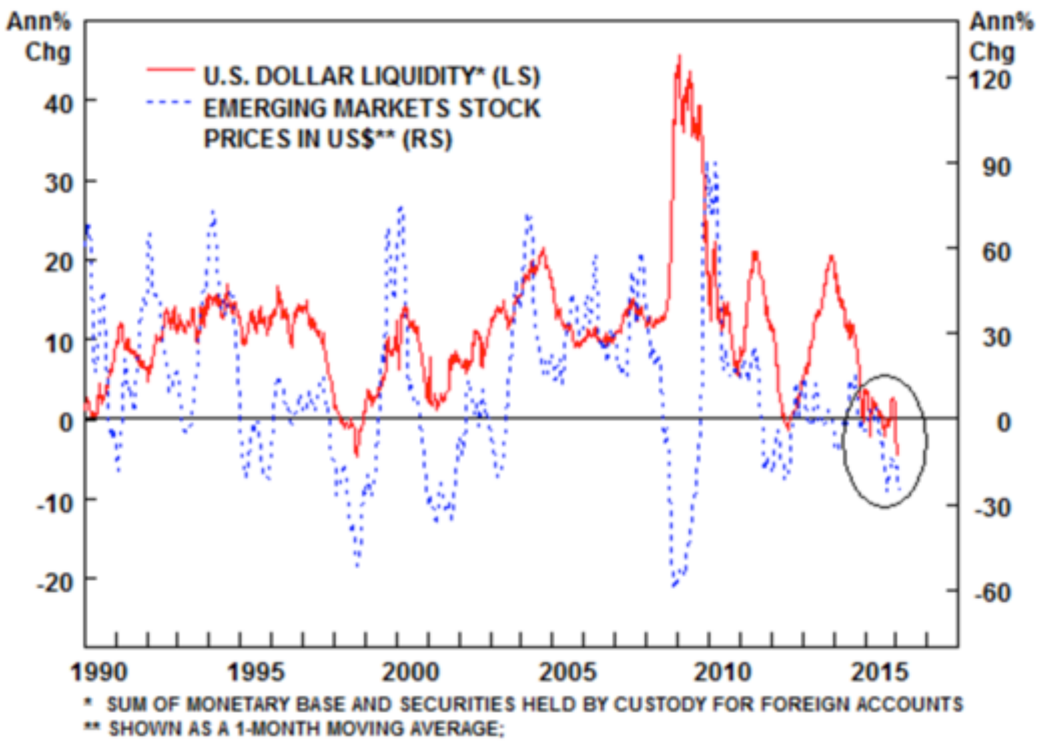
As it is, markets are trading as if something bad is about to happen.

Source: Aksel Kibar (Tech Charts)

To appreciate the complex investment landscape, we must begin with the single most important macro variable: the US dollar.

The duration and magnitude of the dollar advance has not been seen for several decades. This is sending a signal of tightening dollar liquidity, which is generally bearish for asset prices.

Emerging markets (EM) are more vulnerable to tighter global funding conditions than developed markets and are suffering as a result, especially given the rise in debt levels and falling returns on capital. EM stocks have fallen 43% in US dollar terms since 2011.



Source: BCA Research

China is the biggest elephant in the room.

After juvenile attempts to rescue the bull market and botched efforts to redesign their currency policy, investors have lost faith in "managed capitalism." The weak-growth narrative from last summer has given way to the possibility of a banking crisis. According to George Soros, a hard landing is "practically unavoidable."

The $800 billion decline in China's FX reserves is seen as proof that authorities no longer have control of the economic situation. The prevailing wisdom is that China must now devalue its currency to boost growth. Hedge funds have declared "war on the renminbi" and are betting on a 30-50% decline.

In 2015, the renminbi fell 5.8% against the dollar, although it rose 0.9% against the RMB index, a trade-weighted basket of 13 currencies.

A year ago, we had concerns about how the dollar bull market may end. In our February 2015 issue, we wrote:

> In our current experience, the dollar bull-market has followed a rotational pattern. The first up-leg was primarily driven by a falling Japanese yen in 2012, followed by a decline in EM FX in 2013 after the taper announcement, a crash in commodity FX in 2014 with the oil market rout, and recently the fallout in the euro in 2015. Could the Chinese renminbi be the final shoe to drop?

If China devalues, all hell will break loose. The global economy will fall of a cliff, stock prices will slice in half, and oil will trade in the teens.

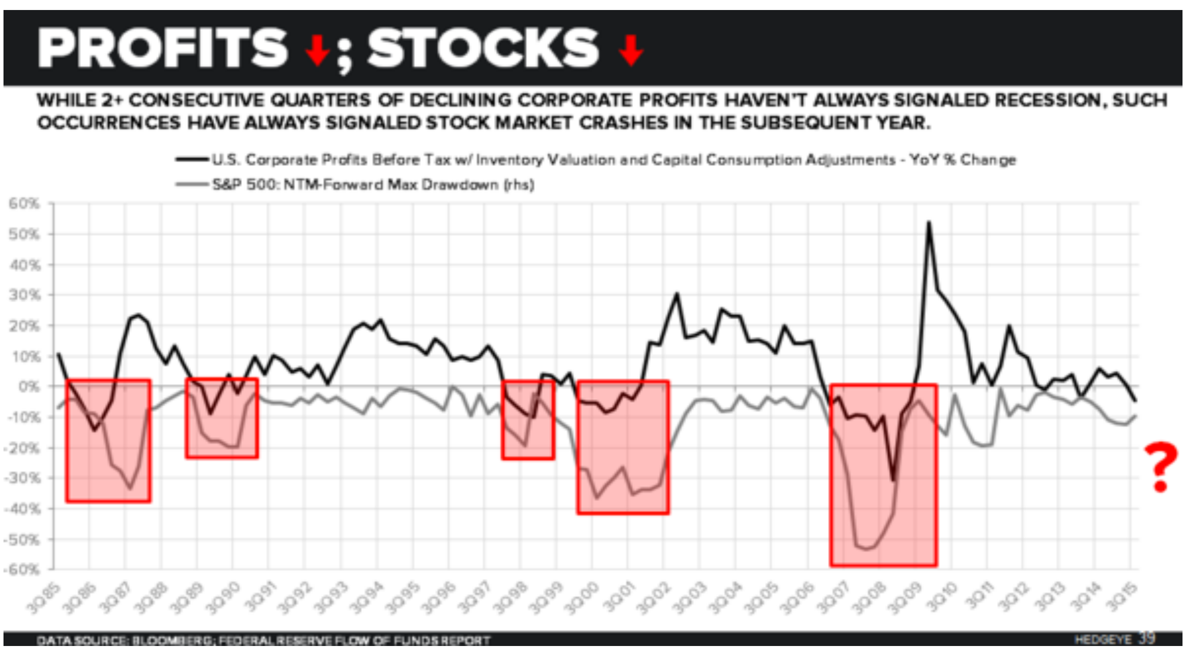
Source: Cagle

It is no coincidence that oil prices peaked in June 2014, just as the dollar began its incredible bull run. Over the past eighteen-months, the dollar and oil have been joined at the hip.

If oil falls any lower from here, the contagion can prove destabilizing, as it will threaten credit markets and dramatically deteriorate the outlook for commodity-based economies, which represent 21% of global GDP. There are already concerns about loan defaults and bankruptcies in the US shale oil patch. The widening of credit spreads is a warning shot for the credit cycle.

The strong dollar and commodity fallout is hurting global manufacturing activity. Investment, orders, shipments, and output are all in recession territory, seeing as energy and mining account for 40% of global capex.

The impact of the dollar bull market is also apparent at the corporate level with US profits struggling in the past year. We have already had three consecutive quarters of year over year earnings decline. According to Hedgeye CEO Keith McCullough, stocks have always crashed when US corporate profits go negative for *two* consecutive quarters.



Source: Hedgeye Risk Management

Lastly, to make matters worse, who the hell hikes interest rates with the dollar at a 13-year high and in the midst of a manufacturing and profits recession?

The Fed usually begins to normalize monetary policy when the unemployment rate is higher and there is ample room for a recovery in earnings. In contrast, the Fed has begun the tightening process much later compared to past cycles, and while global risks are clearly on the rise.

Consequently, markets seem intent on humiliating the Fed. The S&P 500 fell 15% from the record high in May.

Mix it all together, and these macro forces, set in motion by the unrelenting rise in the US dollar, are pushing the world closer to a tipping point.

Sell everything?

Source: Real Vision

China: WTF?

For as long as we can recall, there has been a parade of endless calls for a China hard landing. While it is possible that 2016 is the year it happens, our analysis suggests otherwise. **We find evidence of stabilization in the Chinese economy, which is being overwhelmed by negative investor sentiment. Most economic data looked worse last summer, than it does now.**

The weakest parts of the economy are concentrated in the "rust belt," where heavy industries related to construction and resource extraction are based. In those five northeastern provinces, GDP growth is less than 4%, and unemployment is likely higher than the national average.

But the fast development and strength of the services sector has to a large extent offset the impact of the downturn in manufacturing. Last year, services and consumption accounted for more than half of China's GDP. A bet on a hard landing is a bet that all of the trends listed below will turn negative.

Figure 2. **THE WORLD'S BEST CONSUMPTION STORY**

Year-on-Year Change		
109%	Chinese visitor arrivals in Japan	January–November
99%	Apple's greater China revenue	3 months ending September
52%	SUV sales	2015
49%	Movie box office revenue	2015
48%	Express parcel deliveries	2015
33%	Chinese tax-free shopping in France	October
30%	Nike shoe sales in Greater China	3 months ending November
16%	Furniture sales	2015
11%	Inflation-adjusted retail sales	2015
11%	Household appliance and electronics sales	2015
8%	Gasoline consumption	January–November
7%	New home sales	2015
7%	Passenger car sales	2015

Sources: Japan National Tourist Office; Company Data; Global Blue; CEIC; CNBC; National Bureau of Statistics of China
As of December 31, 2015, no accounts managed by Matthews Asia held positions in Apple and Nike.

Source: Matthews Asia

China faces a structural slowdown due to a peak in the investment rate, changes in demographics, and the base effect. That's important. **But economic rebalancing, driven by healthy consumer fundamentals, will ensure the deceleration is gradual.** Income growth is more than 6% in real terms and consumption equals roughly two-thirds of GDP growth.

We believe China's trend growth rate will be about 5% through 2020. Old China (manufacturing and construction) will grow at 2-3%, as state-owned enterprises retrench and slowly shutter overcapacity, while New China (services and consumption) will grow at 6-7%.

Private firms will increasingly drive growth as they become the backbone of China's economy. Already, Matthews Asia estimates more than 80% of employment and all new job creation comes from private firms.

This brings us to why a renminbi devaluation does not make economic sense for China:

1) A cheaper currency is of no benefit as the Chinese economy is no longer reliant on exports. Exports haven't contributed to GDP growth for the past seven years. Exports as a share of GDP peaked in 2006 at 35% and stand at 22% today.

2) **China is not uncompetitive.** Given productivity gains, there is no evidence of currency overvaluation. Even as the renminbi appreciated 58% in the last decade, China's market share of global exports kept rising.

3) A big drop in the value of the renminbi would act as a tax on consumption, and reverse much of the progress policymakers have made in rebalancing thus far.

4) The purchasing price index for industrial inputs, or PPI, has been stuck in deflation for almost four years. But this reflects lower commodity prices rather than domestic issues. The core consumer price index (CPI) was up 1.6% last year, on par with the historical average. A large-scale devaluation would extend the commodity bear market and worsen goods price deflation.

5) **A one-off devaluation would not suddenly cure China's main problem of excess capacity (and associated debt) in a number of sunset industries.**

We are dumbfounded by the notion that China must devalue to escape a hard landing. From our vantage point, the only way China experiences a hard landing is if they surprise with a large-scale devaluation.

There is, of course, a third argument. Even if China does not want to devalue, they will be forced to regardless because of massive capital outflows.

Let's first consider this in the shadow of the last major EM crisis.

By 1997, Asian countries had built up large foreign debts. Currency devaluation was sparked by "hot money" outflows driven by foreigners. In contrast, China maintains a very low relative level of external debt (estimated at $1 trillion), and foreign investment flows into China are still positive (new FDI grew 5.5% in 2015). Basically, China 2016 is different than Asia 1997/98.

It is surprising how little attention is being paid to understanding the nature of capital outflows. Based on our review, no single factor comes close to explaining how money is "vanishing" out of China.

We make some observations about the outflows and try to dissect the $800 billion fall in China's FX reserves to dispel some of the myths:

1) Looking at the consumer spending data (on page 6), we do not get the impression that the people of China feel pessimistic about the trajectory of their economy. We doubt Chinese money decided to vote with its feet.

2) Capital controls limit Chinese citizens to taking out $50,000 a year out of China. Considering average household wealth is $60,000, and that out of the 50 million active brokerage accounts, 73% hold less than $15,000, while fewer than 1% have more than $1 million, we find it hard to imagine this as the source of capital outflows.

3) Mis-invoicing is surely partly to blame. Firms can spirit funds out of the country by understating their exports and over reporting their imports. But with China's trade surplus at a record high, up 55% to $595 billion in 2015, this leaves us scratching our heads.

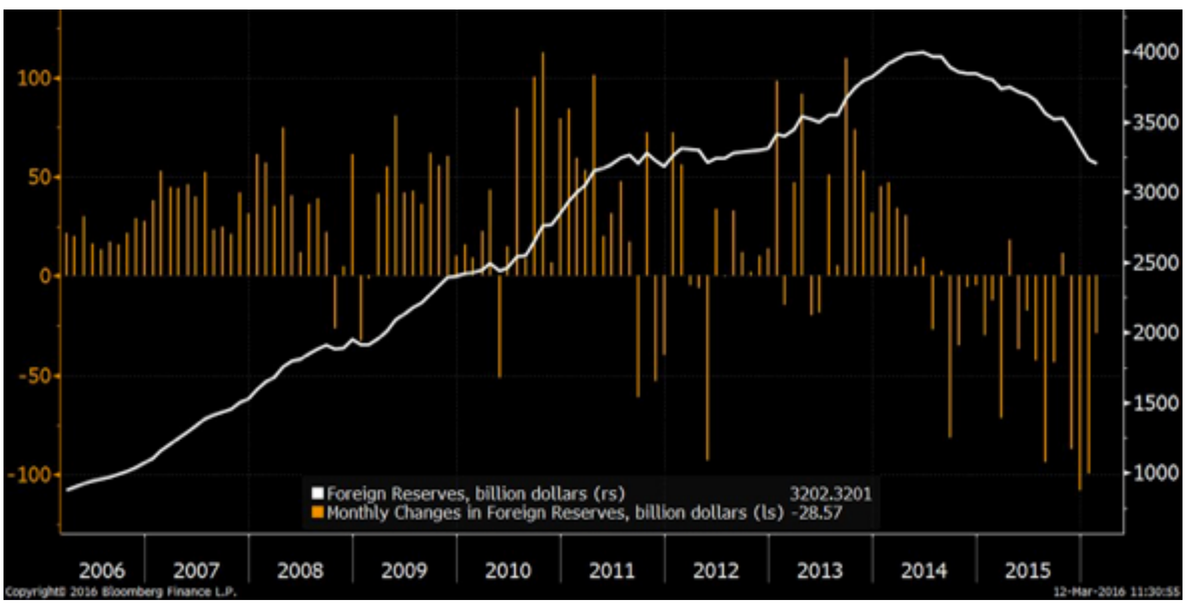
4) At least $150 billion reflects a net repayment of foreign debt by China's corporate sector. This is actually prudent debt management.

5) Valuation adjustments due to exchange rate changes account for $200 billion. China's FX reserves peaked in June 2014 at $4 trillion, just as the dollar began to rally against other major currencies.

6) Using the current account surplus ($270 billion) versus the merchandise trade balance ($600 billion) to compute outflows is more rigorous as China runs a service deficit. Most analysts don't do this, and thereby overstate capital outflows.

The remaining drop in FX is likely due to Beijing's intervention in the offshore renminbi market, and an adjustment of the mismatch that builds up in the foreign exchange market due to "termaillage" (leads and lags in trade settlements which created a "float" that artificially boosted China's FX reserves). Contrary to what the headlines insist, this is not all bad news, and certainly does not suggest a loss of confidence in policymakers.

China is not on the verge of a major financial reckoning. We believe the market is exaggerating the extent of capital flight out of the country. **An assessment of the factors driving the decline in China's FX reserves implies that the depletion will gradually wane.** The corollary is worries about China's economy and its currency are set to dissipate.



Source: Bloomberg

The best indicator to gauge that China's liquidity situation is under control is the 7-day Shibor interbank lending rate. It is 2.4% today, down from 4.6% at the end of 2014.

It is a mistake to think that China is following in the footsteps of the Fed, the ECB or the BoJ to devalue its currency. China is more concerned about stability, rather than promoting exports or growth. **We believe a relatively stable exchange rate is an essential element to maintaining financial stability.**

Finally, China assumed the rotating leadership of the G20 for the coming year. Among the priorities on the agenda is making the global financial system more resilient to shocks. We would wager that even if Beijing desires to devalue the renminbi, they won't be doing it in 2016.

Whispers in Hong Kong are that Beijing wants the renminbi to weaken 5% a year. Given the 6% decline in the last eight months, we think the exchange rate will be relatively stable going forward. Modest depreciation may resume in 2017, but an overnight devaluation is not in the cards.

In due course, with clearer motives and improved policy communication coming from Beijing, financial markets will adapt to greater volatility in the USD/CNY cross rate.

For now, the country's latest five-year plan, looser monetary conditions, extensive fiscal stimulus, and ambitious structural reforms aimed at reducing excess capacity should help build a floor under Chinese growth expectations over our investment horizon, which is 6 to 18 months. This could lead to a period of outperformance by beaten up emerging market (EM) risk assets.

On an encouraging technical note, EM stocks now sit at a critical support level, and did not confirm February's new lows in global equity markets, setting up a positive divergence.

Source: Short Side Of Long

Party In The USA

Since the 2008 crisis, anxiety about the US economy slipping into recession soars whenever financial market volatility intensifies. **Today, however, a sober reading of the data does not support a recession call.**

For example, retail sales were up 2.1% in 2015, below the 3.9% in 2014 and the weakest since 2009. While this looks worrying at first glance, the data is misleading as it fails to account for lower nominal gasoline prices. In real and volume terms, the data is actually pretty good.

Real consumer spending is growing at 3% and the personal saving rate is 5.5%. This is healthy and reflects healed household balance sheets. We expect spending to be supported by ongoing employment growth, solid wage gains, and much lower energy costs.

From a labor market perspective, if the US economy is recession bound, firms should be laying off temporary workers or at least be pulling back on the pace of hiring. We do not see that yet. The job openings rate is near its highest level since 2001. And temporary employment rolled over twelve months ahead of the last two recessions.

The recent pickup in initial jobless claims is not worrisome amid tightening labor market conditions. The four-week average is about 285,000. If claims rise above 330,000, then the probability of recession would rise sharply.

Arguably the biggest risk to the expansion is the lower proportion of working age adults who elect to participate in the labor force. That said, there is still some unutilized slack in the economy. The broader U-6 underemployment rate, which includes discouraged job seekers and involuntary part-time workers, stands at 9.9%, which suggests some spare capacity remains in the labor market.

The positive readings from the non-manufacturing ISM survey, the Conference Board's Leading Economic Indicator and hiring plans support a non-recessionary outcome. **The latest congressional budget agreement should also provide the strongest fiscal stimulus since the financial crisis.**

While everyone talks about the unprecedented easy monetary policy, no one talks about the fact that we have also seen unprecedented *tight* fiscal policy.

The US economy has faced five consecutive years of contractionary fiscal policy since 2010. This is extremely unusual. Consider that in the 50-year period from 1955 to 2005, fiscal policy made a negative contribution to GDP growth in only five years (1970 to 1973 and 1993). The scale of this unbroken 5-year run of fiscal tightening (about 8% of GDP) is unparalleled.

With fiscal policy and monetary policy no longer pulling in opposite directions, there is plenty of scope for economic improvement.

The high-profile ISM manufacturing index rose back above 50 in February, ending a five-month streak of declining factory activity. Moreover, rising consumer prices dim deflation concerns. The core PCE index, the Fed's preferred gauge of price pressures, increased more than expected to an annual rate of 1.7% despite the firm dollar and low oil prices. Consumer sentiment is also remarkably steady given the bearish market headlines and negative political tone.

The Fed hiked rates in December and there are no compelling reasons to suggest the new tightening cycle is having an adverse impact on the US economy. The Fed Beige Book noted: "Across the nation, business contacts were generally optimistic about future economic growth."

As the damaging effect of the dollar surge wears off on a rate-of-change basis, we expect positive economic surprises to continue. Consequently, the Fed will be emboldened to maintain its relatively hawkish policy stance.

Since 1990, during periods when the ISM manufacturing index was declining, the median retreat in global stocks was 14%, which includes both recessions and mid-cycle slowdowns. The current cycle is in-line with past norms, with global stocks down 17%. **Now that the manufacturing sector may be poised for recovery, we expect stocks to follow suit as growth expectations stabilize.**

There's Something About Oil

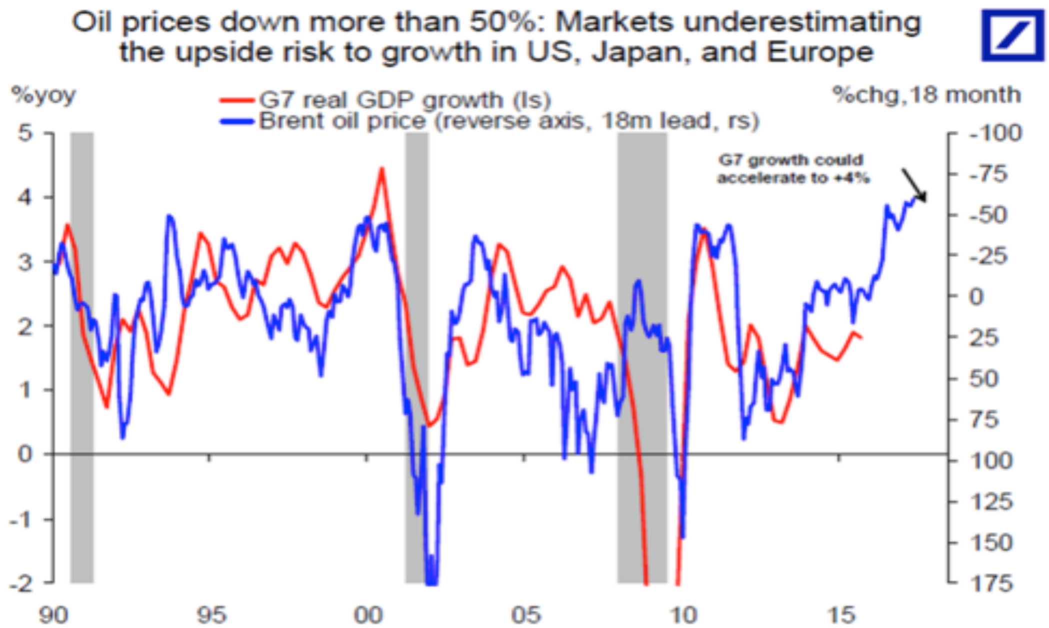
Contrary to received wisdom, investors appear to have anchored higher oil prices as a barometer for stronger global growth. Now that oil has fallen 75%, the reverse must hold true, so economic fears are rampant.

Investors have largely ignored the supply-driven nature of the oil price decline. **For the first time in our lifetime, we are witnessing a truly "free market" for oil pricing.** Lower oil prices do not reflect economic weakness.

The fact is that sharply *rising* oil prices, not falling prices, have historically been a leading indicator of economic trouble.

Every global recession in the past fifty years was preceded by a big increase in oil prices. Meanwhile, every recent period when the oil price was cut in half (1982-1983, 1985-1986, 1992-1993, 1997-1998, and 2001-2002), global growth was better in the following year.

The maximum reflationary impact for the global economy from the collapse in oil prices is yet to be felt. IMF estimates suggest that the level of global real GDP rises by about 0.4-0.8% for every 20% decline in oil prices. This implies we could see at least 1% added to global growth in each of the next two years.



Source: Deutsche Bank

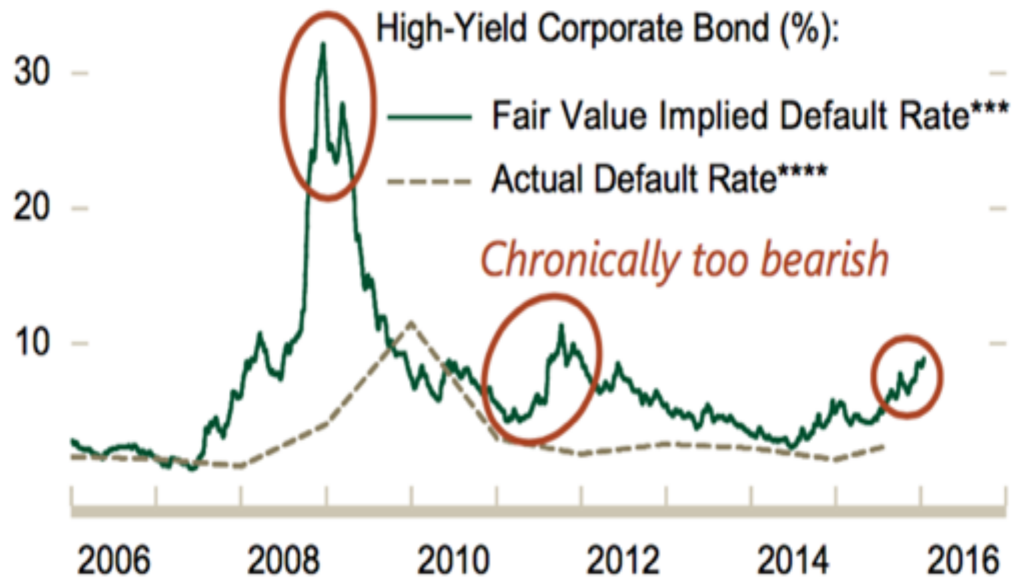
Eclectica founder Hugh Hendry expressed in a recent investor letter the irony in market perceptions, "It seems that we have shifted from fretting that oil mattered because there simply wasn't enough, to agonizing that there is just too much of the stuff!"

Widening credit spreads—driven by the blowout in energy spreads—present a notable risk, but what is currently negative for the energy sector is positive for the rest of the economy. **We believe it is premature to conclude that the end for the credit cycle is approaching.** There is no evidence tightening credit conditions is stifling growth. Actual lending remains robust.

At current high yield spreads, the market has priced in a 12% default rate. We suspect that the market has overestimated the prospective default rate, as it has consistently done since 2008. **There is no historical evidence of a material speculative-grade default cycle absent an outright economic contraction.** While we are likely entering a new default cycle, it will largely be limited to the energy and resources sector.

Credit losses from energy and mining industries are manageable and do not pose a systemic threat. Regulatory overhauls since the 2008 financial crisis ensure that bank balance sheets have the strength to cope with a slowdown in any particular sector of the economy.

On aggregate, banks have between 2-7% of their total loan book in the commodity sector. From a capital and liquidity standpoint, banks are much better prepared to deal with another wave of losses compared to previous years.



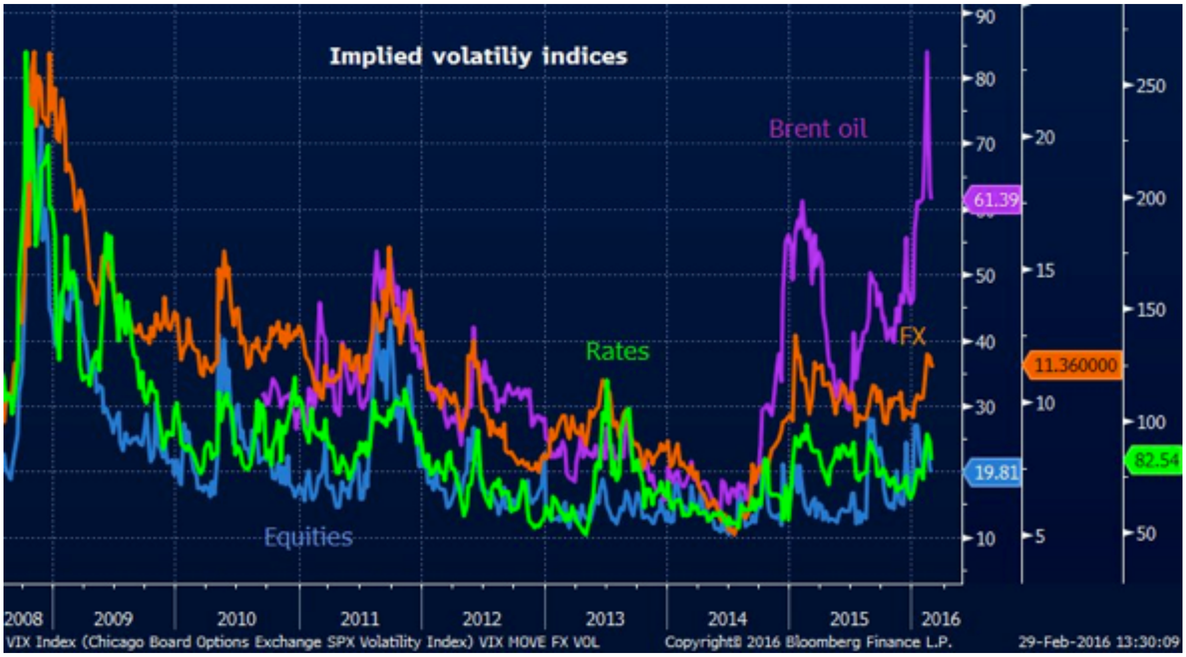
Source: MRB Partners

We think oil overshot to the downside and has found a bottom. The last drop in oil prices in February was not supported by supply or demand trends, and is likely a final capitulation by investors. With global oil production falling and consumption continuing to grow, oil markets should rebalance later this year.

Non-OPEC oil production may fall by nearly 1.5 million barrels per day (mmbpd) in 2016. US shale output is already well below its mid-2015 peak of 5.5 mmbpd and will likely fall to 4.2 mmbpd by the end of this year as old wells dry up and are not replaced by new drilling activity.

With US crude inventories at the highest level since 1930, a decisive reversal in the inventory uptrend would thus lead to higher oil prices.

Considering how influential the oil crash has been on world markets, evidence of price stability will contribute to receding credit spreads and volatility globally. It will dampen growth fears and help stocks move up from oversold levels.



Source: Bloomberg via Aurelija Augulyte (Nordea Markets)

Occam's Razor

Sometimes, the simplest explanations are the best. So what explains the current financial market turmoil? **Financial markets are simply adjusting to a new rate hiking cycle—the first in eleven years.** That's it.

These transitions are always difficult, and this one is doubly so as the dollar rally has distorted growth *perspectives* and the overall macro picture.

At the onset of fresh Fed tightening cycles, two things happen: the forward P/E multiple compresses, and the yield curve flattens. We have observed the S&P 500 falls about 10%, and the curve flattens to a 50 bps spread between 10- and 2-year rates within the first year of the initial rate hike.

In our current experience, the S&P 500 fell 15% (which seems fair given the delayed tightening), and the spread between 10- and 2-year rates has dropped to 55 bps. In this context, we would argue the behavior of financial markets today aligns perfectly with past norms. There should be no surprise.

Earnings are initially unable to offset the P/E multiple compression so stocks fall. As the economic expansion proceeds, earnings recover and the forward P/E ratio rebounds. Similarly, worries that the Fed is making a policy mistake lead to curve flattening. As the market discovers that rate hikes are not derailing the recovery, the curve steepens again.

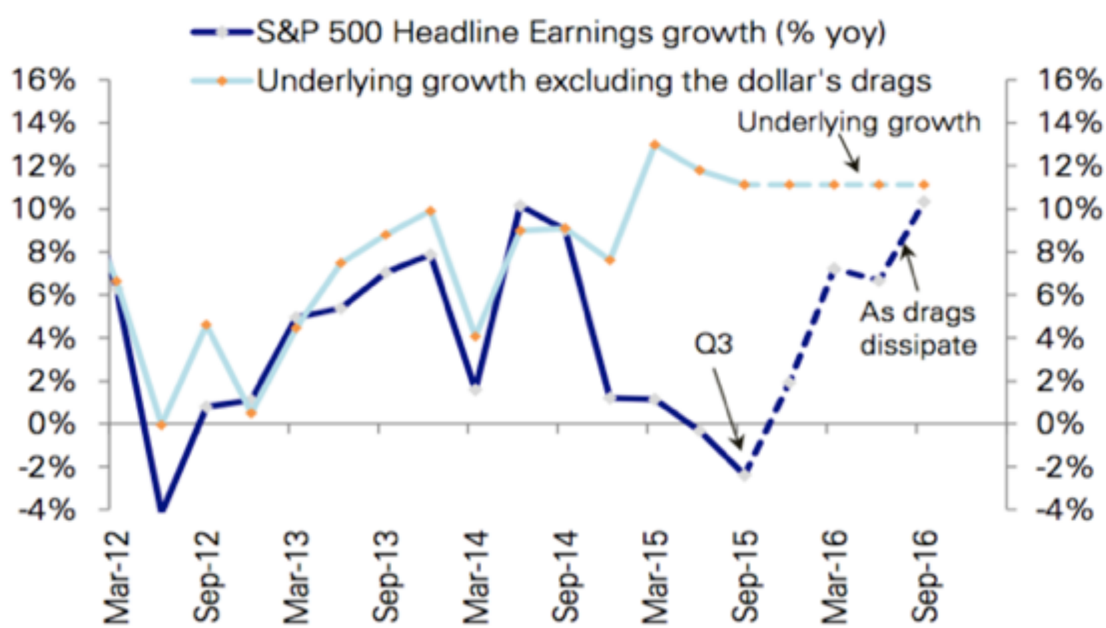
We see no reason why it will be different this time.

The earnings backdrop will improve markedly in 2016 as energy sector headwinds and the base effects from the strong dollar both fade. We expect corporate profits to grow 6% this year.

The last few times we saw a pause in earnings (like the one in 2015) was back in 1986 and 1998, for reasons that were very similar to today: dollar rally, oil crash, and an emerging markets crisis. What followed was a strong equity and earnings rebound.

The bull market is maturing, but valuations are not yet demanding. Stocks can become even more richly priced in this cycle. An unwinding of the growth scare will also allow the forward P/E ratio to climb higher, after falling to 15 in the recent correction.

Stepping back, investor confidence has taken a major hit, and evidence that the economic and earnings outlook is improving will be needed to spur greater risk taking in global markets. As mentioned, we believe this is coming.



Source: Deutsche Bank

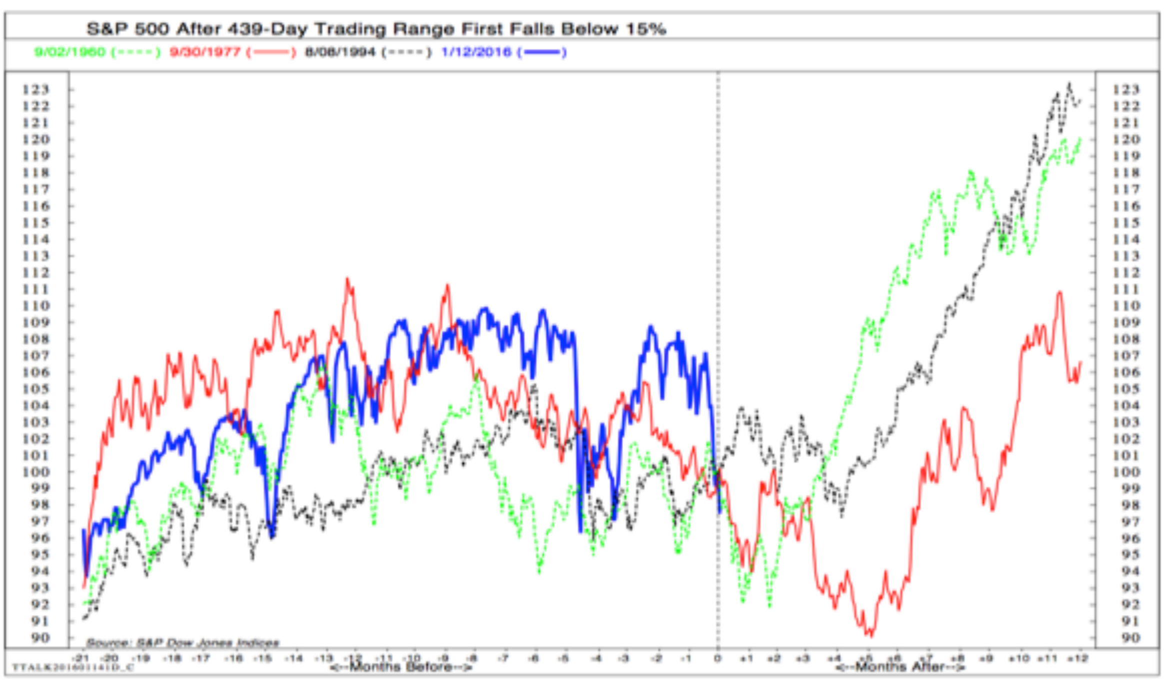
Putting It All Together

Although there has been significant technical damage, we continue to think that we are at the *end* of the correction, rather than just getting ready for another large downleg. The stock market's lower lows in February occurred against a backdrop of lower highs in volatility. This is a positive sign that suggests we may have passed the point of maximum fear.

According to Ned Davis Research, the average correction in global stocks, as measured by the MSCI All-Country World Index (ACWI), has been 12% when not associated with a global recession, 17% in a global recession that excluded the US, and 45% when the US has taken part. From the peak in April to the low in February, the ACWI was down 19%.

Given our view that the US and global expansions will remain intact, and that we are not in a bubble (such as tech in 2000 or housing in 2007), it's likely that most of the bad news has already been priced into the market.

Reviewing past analogs where stocks traded in a comparable 20-month narrow trading range (1960, 1977, and 1994), we may see a strong upside breakout in the coming months.



Source: Ned Davis Research

There's an old adage: when one door closes, another will open, but standing in the hallway can be hell.

In many ways, this sort of characterizes the current macro environment. The door to QE and liquidity has closed, and markets are standing in the hallway, waiting for a new door to open—let's call it durable growth.

So for now, we are stuck in this liquidation cycle, and we are seeing an unwind of QE and liquidity-driven trades: notably we have shifted from 1) weak dollar to strong dollar, 2) EM inflows to outflows, 3) commodity boom to bust, and 4) low volatility to high volatility.

All of this leads to a narrow trading range in US stocks, which to many appears like a menacing top pattern, with the risk of breaking down. We then have a challenging 2015, and 2016 kicks-off with the worst start in history, and you can appreciate when we say standing in the hallway can be hell!

And we have become so enamored with the *old* environment that we are banging on the door that has already closed, pleading for QE and more monetary stimulus. As our readers know, we believe the world doesn't need more stimulus. It needs leadership. We have been proponents of a Fed rate hike.

The bullish view is that this transition in the investment environment—from an excessive reliance on liquidity to one where it can depend on growth—will be successful. In many ways it already is, but we just can't see it.

This is because the US dollar, which is a key macro influence, has distorted our perception of reality. What people fail to realize, however, is that the dollar's economic and market impact is largely driven by the rate of change, not the level. The corollary is that the news at home and overseas is about to look a lot better.

Several key market mysteries will be unraveled in the coming year. The future is not always a reflection of the present. Through the gloom, we see opportunity.

With gratitude,

J.S. Mian

April 11th, 2016

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