CROSSBRIDGE CAPITAL

Market Viewpoints

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> **When we remember that we are all mad, the mysteries disappear and life stands explained.**
>
> - Mark Twain

We have just witnessed a period of intense market volatility. This time around, its effect is compounded by equity markets finding it hard to break off the link to plunging oil prices. In 2008, over-leveraged banks and over-leveraged households, combined with feckless supervision and regulation led to the market crash and the great recession which followed. Today, banks are healthier, households have greatly deleveraged and there are no real signs of a systemic bubble or malcontent on the scale of the 2008 mortgage-backed securities (MBS) crisis. If there is one thing which is of concern to me, it's the lack of liquidity, as regulations have forced banks to move out of various businesses and placed restrictions on the use of their balance sheets. The developed world has a growth problem, a productivity problem, a disinflation (if not deflation) problem and a middle class income problem. As I wrote in my December newsletter, the fiscal response from governments to address these is missing and monetary policy is near exhaustion. This will lead to market volatility but, to be clear, this is not 2008 all over again.

Is it 2008 all over again?

Earlier this month, billionaire financier George Soros, speaking at an investor conference in Sri Lanka said - "when I look at the financial markets there is a serious challenge, which reminds me of the crisis we had in 2008." So is it 2008 all over again?

I am not one who often disagrees with Mr Soros, but in this case I feel I must. This is most definitely not 2008 and the current economic and financial conditions are far better than the prevailing ones that led to the global meltdown in 2008.

In 2008, over-leveraged banks, over-leveraged households, feckless regulation & supervision led to the market crash and the great recession which followed. Today, banks are healthier, households have greatly deleveraged and there are no real signs of a systemic bubble or malcontent on the scale of the 2008 crisis.

- **Healthier banks**: In Q2'15, domestic deposits at US banks hit $10.59 trillion, up 38% from five years earlier. Loans outstanding at US banks as a share of total deposits tumbled to 71%, significantly down from 92% pre-financial crisis. The leverage on banks' balance sheet has been reduced by more than half from the region of 30x to low double digits

- **Healthier households**: the US Household debt service ratio (i.e. debt payments as a percentage of disposable personal income) which was as high as 13.2% in 2007 is now at 10% i.e. 25% healthier. In 2007/08 before the crash, household credit growth in the US and the Eurozone was surging at an annual rate of +9.5% and +8% respectively. Today, it is less than a quarter of that. This, after the household credit growth in the US was negative for 4 years in a row following the 2008 crisis

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The European Central Bank (ECB) meeting last week delivered a dovish message and a return to "forward guidance" in some ways to highlight that the Governing Council expects interest rates to remain at present "or lower" levels for an extended period of time. Increased downside risks due to heightened global uncertainty, the tightening of financial conditions and significant deterioration in the inflation expectations, were the key concerns outlined. The ECB Governing Council unanimously agreed it would be "necessary to review and possibly reconsider our monetary policy stance at our next meeting in early March". ECB President Mario Draghi noted that there were not many reasons to be optimistic about core and wage inflation. Inflation is likely to turn negative again in February while the ECB is likely to revise its 2016 inflation forecast down to perhaps 0.0% from +1.0% in December.

I now expect the ECB to cut the deposit rate by at least 10bps to -0.4% (potentially by even more depending on market conditions and sequencing of other central banks) in the run-up to the next meeting on March 10. While I don't expect the ECB to announce an extension of its QE program beyond its March 2017 expiry date, I do expect an increase in the monthly pace of purchases - either via additional purchases or front-loading (accelerated purchases now and slower purchases later). This will spur a European bond market rally i.e. yields will fall, EUR/USD will weaken and financial conditions will ease, further helping the Eurozone economy and underpinning inflation expectations.

The developed world generally has a growth problem, a productivity problem, disinflation (if not deflation) problem and a middle class income problem. As I wrote in my last newsletter; the fiscal response from governments to address these problems is missing and monetary policy is near exhaustion. This will lead to market volatility but, to be clear, this is not 2008 all over again.

Xi Jinping, a supply-sider?

China's importance to the world is significant. It is the world's largest exporter ($2.2 trillion) and its second largest importer ($1.7 trillion) behind the US. China is a $10 trillion economy, which is expected to grow at +6.5%. As with any developing economy, there are periods of capital misallocation and China has been guilty of it. According to an estimate, State Owned Enterprises (SOEs) suck up 80% of the country's bank loans, while delivering a return that's a third below that of private Chinese firms and half that of foreign companies. The misallocation of capital crowds out the innovators and entrepreneurs that China is counting on to reboot growth. The excesses in business cycles are nothing new and many other countries have had to go through big cycle swings and economic restructurings. The US has experienced four significant debt restructurings: in 1971, in 1982 during the Latin American debt crisis, the 1986 savings and loan crisis, and the 2008 debt crisis.

The tragedy would be if China doesn't realise the misallocation has happened. Signs are that the current leadership not only realise this but are actively working to correct it. Reports in the *Wall Street Journal* indicate that President Xi Jinping of China may be a "supply side" reformer in the mould of US President Ronald Reagan and Britsh Prime Minister Margaret Thatcher. "Supply-side" came to describe President Reagan's program to revive the US economy in the 1980s. It comprised deregulation, tax cuts, restrained government spending and sound money.

Last May, China cut taxes on small businesses and Premier Li Keqiang, long known for free-market views, announced a deregulation push and reform of the Sate SOEs. China suffers not from America's 1970s stagflation, but from an equally damaging mismatch of supply and demand. Senior Chinese officials attending the World Economic Forum conference in Davos last week reiterated this view. It essentially boils down to:

- Chinese consumers "demand" more services such as education and health care and high-quality branded products, which are not being met by local "supply" and therefore they have to pay high prices and buy from abroad

- On the other hand for products such as steel, ships and cement, local China "supplies" outstrip the "demand" i.e. resources, capital and jobs are tied up in unproductive sectors

It's understandable then that China's growth has slowed as the new government has clamped down on many of the past activities that lead to poor allocation of capital. The previous regime of Hu Jintao and Wen Jiabao (2003-2013), in my view, was one of status quo. Their obsession with stability led to a missed opportunity for China. In managing China as "not rocking the boat", they inadvertently steered toward a choppier, more perilous future, as capital misallocation and crony capitalism thrived. In doing so, they damaged the great work done by the previous regime of Jiang Jemin (1993-2003).

President Xi is now focussing on targeting SOEs and political corruption, which are prime drivers for the capital misallocation. State firms are influential within the Chinese Communist Party, so targeting them is gutsy, but it has been done before. In the early 2000s Premier Zhu Rongji closed 60,000 firms and laid off 40 million workers. That set the stage for years of double-digit economic growth. China needs similar bold reforms this time around and President Xi could be the one to deliver them. His anti-corruption zeal has already been noted.

In his recent newsletter, Ray Dalio of Bridgewater Associates, the largest hedge fund manager in the world, went so far as to say that he is more confident in how China's economy is managed than those of the US and Europe. He further added that there is far less risk of ignorant people choosing incompetent leaders in China than there is in most democracies, especially those in the US and Europe. That's some endorsement coming from world's largest hedge fund manager with $160 billion asset under management and, looking at Donald Trump's poll ratings, you do get a glimpse of the risk Dalio is talking about.

Where to invest?

In my December newsletter, I wrote that I do not expect the S&P 500 (SPX) to reach a new high this year and to expect plenty of volatility. I wasn't expecting the volatility to arrive so early in the New Year. The SPX is now -13% from its all-time high and -8% YTD.

Talking of market sell-offs and looking at the US market, in the last 100 years there have been 123 corrections (declines of more than 10%) and 32 official bear markets (20%+ declines). This data translates into an official bear market occurring once every 3 years or so and corrections occurring more than once a year.

What we are seeing today is a period of market volatility, which based on the data presented above, happens quite regularly. This time around, the effect is compounded by the equity markets finding it hard to break off the link to plunging oil prices. If we move from correction to bear market territory, then I would view it as a gift for investors who have the tolerance to buy stocks at oversold levels, when everyone else is panicking.

The weekly sentiment survey from the American Association of Individual Investors (AAII), is an indicator that is crying "oversold market":

- Last week the AAII Bullish sentiment dropped from 22.2% to 17.9%
- Not only is that the 45th week in the last 46 weeks where sentiment has been below 40%, but this week's level of bullish sentiment is the lowest weekly reading in more than ten years

So what happens to the SPX following the slide of the AAII bullish sentiment to below 20%?

Since 1987 there have been 28 occurrences when the weekly AAII bullish sentiment has dropped below 20%. Numbers crunched by *Bespoke Invest* indicate

- Looking at all periods, the SPX averages a gain of +2.05% over the next month, +6.5% over the next three months, and +13.4% over the next six months
- What's even more impressive is that the SPX was up six months after in all but one of the 28 occurrences. That one instance was 2008

In my view, this sell-off is exaggerated relative to the fundamentals. Equity markets in the US, Europe, Japan, and India all look oversold.

It is important to note that at least for the SPX, China is not as big a deal as investors think. Over the first three quarters of 2015, exports to China made up less than 1% of US GDP. Therefore, a slowdown in China affects commodity exporters (Brazil, Russia, Australia etc.) yes, but not the US as much.

I suspect equity selling has been exacerbated as sovereign wealth funds of oil exporting nations selling positions to raise liquidity and meet their budgetary requirements. There was news of sovereign wealth fund withdrawals back in December. Oil was at $40 then and it's a third lower now. No doubt this has caused some of these same funds to liquidate more of their equity holdings.

Whatever the reason, as an investor, it is best to focus on the medium term and the economic outlook and not just short-term market volatility. If the short term presents an opportunity to pick good assets at "cheaper" prices, then jump right in.

Some of the stocks I hold/recommend holding – Starbucks (SBUX US), Citi (C US), JP Morgan (JPM US), Bank of America (BAC US), Gilead Sciences (GILD US), Allergen (AGN UN), General Electric (GE), General Dynamics (GD US), Apple (AAPL US), Google (GOOG US), Amazon (AMZN US), Schlumberger (SLB US), Anheuser Busch (ABI BB), Pepsi (PEP US), UBS (UBSN VX), Richemont (CFR VX), Daimler (DAI GY), Airbus (AIR FP), Roche (ROG VX), Rio Tinto (RIO LN), Halliburton (HAL US), Walgreen Boots (WBA US), Home Depot (HD UN), CBS Corp (CBS US), Alibaba (BABA US).

Best wishes,

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