

Global Strategy: Bulletin

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Surprise, Stumble, Fall, Not “Doomsday” Revisited

- A confluence of realized and feared risks has hit world financial markets at a quite unusual time (the very start of the calendar year). Fundamental challenges such as the energy glut and China’s economic transition seem to have interacted with investor memories of 2008’s brush with catastrophe. Yet as always, market fears have to be confirmed for bearish expectations and asset price declines to be maintained.
- World policymakers now seem overconfident in taking the chances they did in the final month of 2015. This has left markets to ponder both fundamental unknowns (commodities, FX and related credit problems) and the seeming unwillingness of central bankers to ward off budding threats to the economic expansion (deflation risk).
- Investor risk tolerance has now been shown to be highly fragile in this present episode. Confidence itself is an important fundamental for recovery to persist. We doubt, however, that policymakers are immediately ready to acknowledge this and take action. Simple risk hedges have soared in value in early 2016, but still have significant value over the near-term in our view.
- At the same time, investors should not equate today’s fundamentals with 2008’s, 1997’s or other crisis episodes. Weak EM growth and an oil glut (one of historic proportions) won’t lead to the same outcomes as systemic banking sector capital risks in the US and Eurozone eight years ago.
- Immediately ahead, petroleum and currency uncertainties suggest that downside risk remains in most other asset classes. However, a lasting downturn in markets requires a lasting downturn in economic drivers of markets. Akin to August 2015, we ask fundamental bears to prove that such a turning point has occurred and that cheap petroleum has no benefits for anyone.

For more than two decades and three business cycles, the U.S. Federal Reserve has avoided the month of December when announcing the start of a new monetary policy tightening cycle. While long heralded, the consequences of moving from years of QE to gradual rate hikes has always held some unknown risks. Meanwhile, with inflation near zero in the Eurozone before the latest sharp drop in petroleum, the European Central Bank saw a need for stepped up stimulus last month. But so unsure it was of the long-term inflation consequences, it felt it better to surprise markets with disappointing steps that fell short of the action expected.

We suspect policymakers will argue to justify their recent decisions rather than reverse them. It’s the human response. However, as discussed in our last Quadrant report ([China Risks Reloaded](#)), new fundamental deflationary challenges are unfolding.

OPEC’s December decision to scrap production ceilings rather than cut production to accommodate Iran’s return to world markets means greater oil price declines and financial distress for producers. With most of the world’s oil producers running “all out” to sell petroleum and limit losses, a deflationary psychology in petroleum has set in. We see this as likely to both speed along the timing of a bottom in the oil price and also make the decline deeper.

In isolation, the credit distress of oil producers need not be a systemic financial event. But it is important for the rest of the world economy and other’s balance sheets to be healthy while this unfolds. At present, we do indeed see

this health (See [Quadrant Figure 13: EBIT Margin Ex-Energy, page 10](#)). Notably, however, there can be “second round” impacts of falling inflation expectations from oil’s drop. This has certainly impacted financial markets, if not yet the world’s consumers.

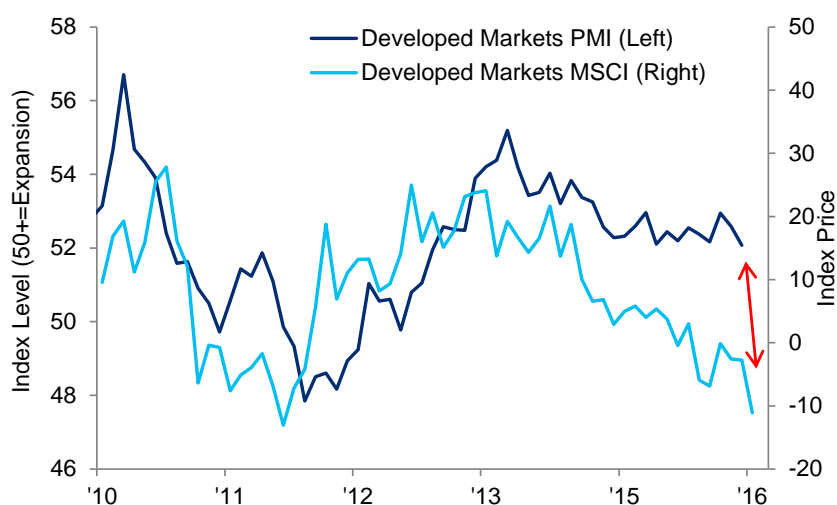
Open Ended Petroleum and CNY Uncertainty

As discussed in detail in Quadrant, the new risks don’t end with petroleum. World markets simply can’t know where China’s currency will be, and by extension, how much impact China will have on its trading partners. Currency and commodity uncertainty needs to be resolved for broader asset price stability.

While perhaps not at its summit, asset price correlations have spiked sharply. As an example, transportation companies who do their business consuming petroleum have fallen in price as much as oil producers in 2016. This is despite a highly dichotomous financial outlook for the two groups - unless a significant new economic contraction occurs.

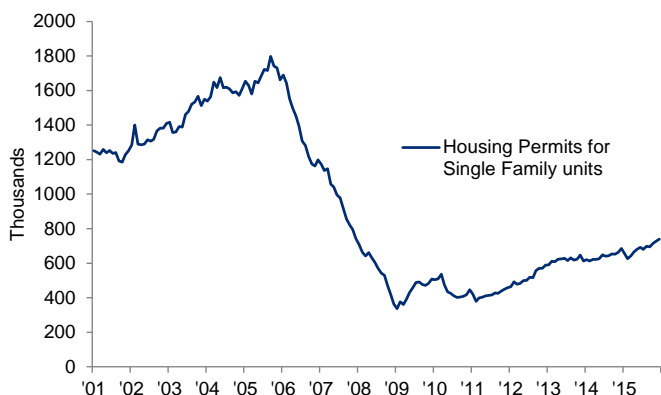
As figure 1 shows, a large “gap” has opened between the performance of developed market equities and purchasing managers indices. These are among the most timely readings on business activity. That gap needs to close. The turmoil we’ve mentioned can take its toll on economic activity, but share prices predict worse times already. The economy and fundamentals will end up coalescing.

Figure 1. Developed Market Equities vs Real Growth Tracking Surveys



Sources: MSCI, Markit and Haver Analytics as of January 20, 2016.

Recently, we’ve watched U.S. equities markets fall on strong data reports (+292,000 job gains in December), and weak data reports (-0.1% for December retail sales.) None of these readings, or yesterday’s housing construction report, suggested a pending economic contraction (see figures 2-3). We believe inventory excesses and weakening business confidence suggest a higher risk to the U.S. expansion than a year ago. **However, the onus is on economic data to show the collapse that financial markets now price.**

Figure 2: U.S. Single Family Building Permits


Source: CENSUS, Haver Analytics as of December 31, 2015.

Figure 3: Core U.S. Retail Sales

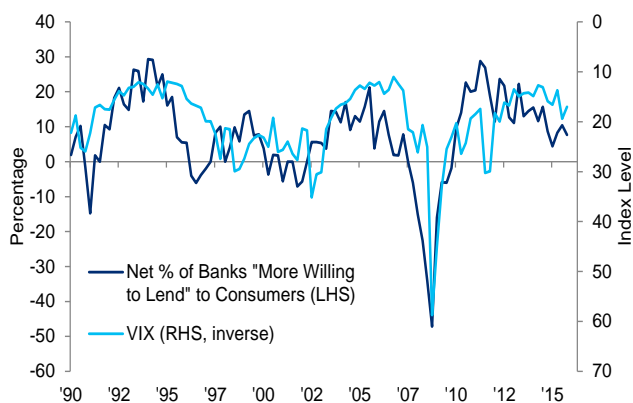

Source: Census Bureau, National Bureau of Economic Research, Haver Analytics as of December 31, 2015.

Duration of Market Corrections

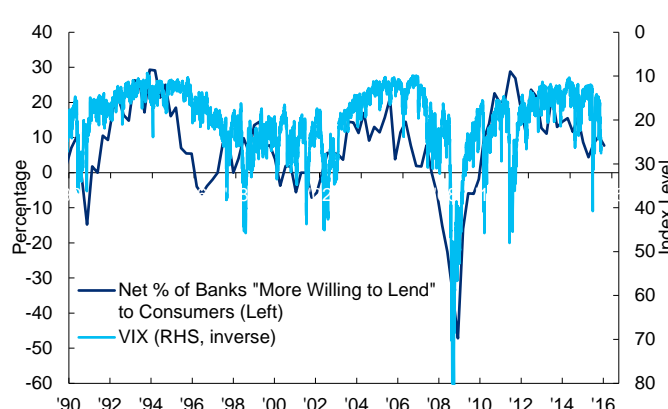
In the past, equities have fallen as much as 20% in a single day and *not* been a signal of a new economic turning point (October 1987). As figures 4-5 show, corrections can be as severe in expansions as in recessions. **The difference between the two is in the *duration* of the asset price declines.**

As noted, the timing of the financial stress, at the very start of the year, adds to the psychological impact. This does not mean fundamentals *haven't* changed from the times that investors fear most. For example, systemic risk to banks has declined dramatically with new capital requirements since the 2008 crisis (see figure 6). Developed markets' bank exposure to petroleum is of a much smaller scale than mortgages during the last crisis period.

In sum, for those fearing doom, the grim reaper must indeed deliver. We remain doubtful that the man himself will make an appearance.

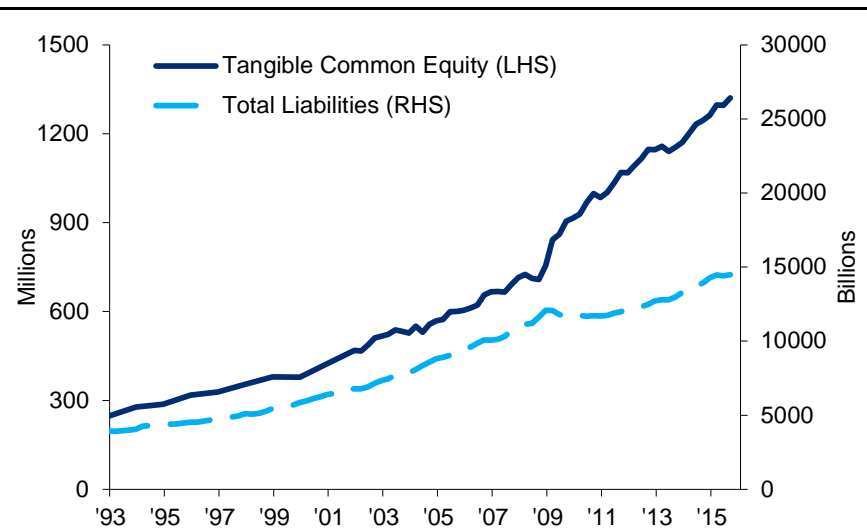
Figure 4: Corrections that Last...


Source: CENSUS, Haver Analytics as of December 31, 2015.

Figure 5. vs. Those (Many) that are Fleeting


Source: Census Bureau, National Bureau of Economic Research, Haver Analytics as of January 20, 2016.

Figure 6. Dramatic Rise in Bank Equity/Debt



Sources: FDIC, Haver Analytics as of 3Q'2015.

Steven Wieting
Global Chief Investment Strategist
 +1-212-559-0499
Steven.wieting@citi.com

Joseph Kaplan
Joseph.Kaplan@citi.com

Maya Issa
Maya.Issa@citi.com

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