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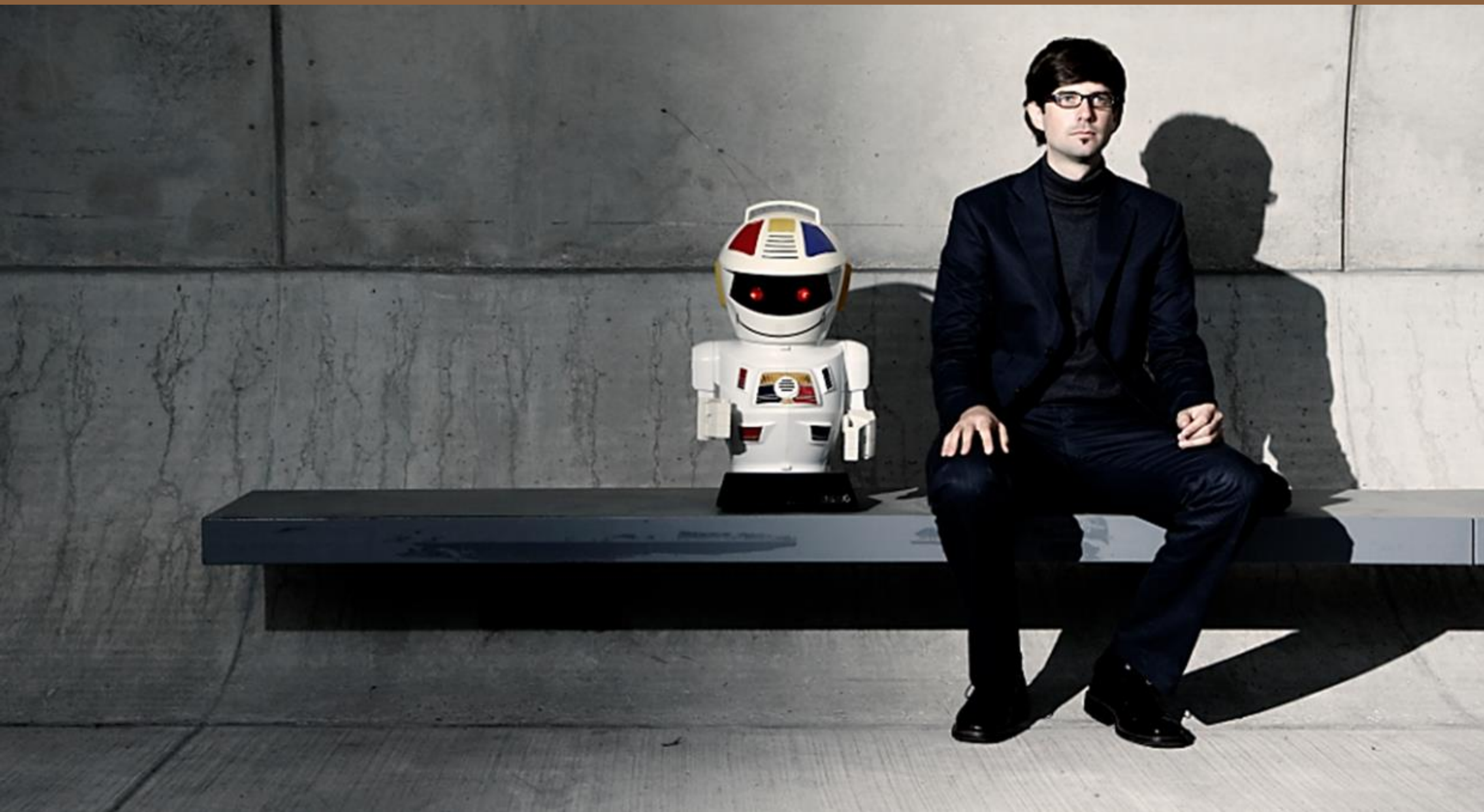

Friday 16 February 2018

For the past few weeks we have been mulling the unusual behaviour of markets. From the US Dollar, which has continued to melt-down against our "rational" expectations of a carry-driven rise, to the sudden dislike of the bond markets with the resulting rise in yields, all culminated in a sharp reversal of trend in equity markets. And all this on the back of a broadly wonderful 2017 and exuberated January.

Yes, economic data was good, financial results have been coming in ahead of expectations, Kim Jung has become nice as the Winter Olympics beckon at his doorstep, the Tax code has been changed, (arguably for the better), we have seen good snowfall in the Alps - the world is behaving nicely. Yet, sentiment has soured. Why? We are not psychologists so we are at pains to explain. Except, perhaps, when we just revisit the oldest explanations for market behaviour - markets are driven by two emotions and nothing else: Fear and Greed! When the latter prevails, markets rise, and when fear outweighs greed, they fall. Suddenly, as January roared to a close, fear came in to roost. The VIX, commonly known as the

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"fear index", roared up from historic lows to much higher levels - actually, to really high ones. Why? Freud may have had an explanation had he still been amongst us.

The plunge in stocks that greeted February was the type of event that should have scared the bejeebers out of investors and, for a nanosecond, it did - the S&P 500 Index fell into a correction for the first time in two years. But if there's anything this bull market has proven after surviving five Federal Reserve interest-rate increases, Brexit, the U.S. elections, North Korean missile tests and various other threats, is that it's resilient. The S&P 500 index continued its rebound on Thursday, climbing for the fifth straight day. It has risen 5.82% in the period, its biggest five-day gain since December 2011. The latest weekly poll of clients by the American Association of Individual Investors shows that 48.52% of investors are bullish - above the average of 36.74% since the start of the bull market in 2009. At 27.11%, the spread between the bulls and the bears has only been wider four times going back to early 2015. Investors seem convinced that even though borrowing costs are on the rise, they are not yet at levels that would hinder equities, especially with the economy gathering pace.

"I think with the economy looking so good around the world, that we'll have an up year," Steve Schwarzman, the head of Blackstone Group, the world's largest private equity firm, said on Thursday in a Bloomberg Television interview. Equities won't be affected by higher long-term interest rates as long as 10-year Treasury yields stay below 4 percent, according to Gina Martin Adams and Peter Chung, equity strategists at Bloomberg Intelligence. The yields are at 2.90 percent as of Thursday. Yes, we have probably hit the inflection point in the cost-of-money. We have been on a multi-year run of a central-bank driven "cheapening of Money" diet, and suddenly, many fear that the change might be fast and furious. We doubt that. That said, we did see the somewhat "hotter" inflation numbers out of the States: CPI and PPI both up ahead of expectations, so yes, the Federal Reserve may find support here for its planned hikes in the next months ahead, especially as there is an increasing need for Federal funding. As such, get ready for a deluge of Treasury bills and the increase in short-term funding costs that's likely to result.

Investors are bracing for an onslaught of T-bill supply following last week's U.S. debt ceiling suspension, leading them to already demand higher rates from borrowers across money markets, according to Bloomberg News' Alexandra Harris. The aforementioned is just a result of the government replenishing its cash hoard to normal levels. The ballooning budget deficit means there's even more to come later, and that extra supply could further buoy funding costs down the line; making life more expensive both

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for the government and companies that borrow in the short-term market. Harris reports that concerns about the U.S. borrowing cap had forced the Treasury to trim the total amount of bills it had outstanding, but that's no longer a problem and the government is now ramping up issuance. Financing estimates from January show that the Treasury expects to issue $441 billion in net marketable debt in the current quarter and the bulk of that is likely to be in the short-term market. Yes, there may be further upwards pressure on benchmark US Government yields. This in turn will fuel rising rates down the credit quality ladder. But we doubt this will be a huge move, as in reality, the improving growth prospects for the global economies should absorb the future funding needs. There may also be somewhat higher inflation, but then, have we not hoped that this would happen? Ask Janet… Though Amazon is still out there keeping a lid on this brew.

On a somewhat lighter tone, savvy investors like to say that correlation isn't causation. That may be true, but here's one correlation they hope is causation. The Chinese New Year begins Friday, and this one is the Year of the Dog. LPL Research points out that the Year of the Dog has historically been strong for equities, with the S&P 500 Index gaining more than 15% on average. Of the 12 zodiac signs, none has a better average return for equities, according to LPL. The last Year of the Dog came in 2006, when the S&P 500 rose 12.4 percent. There was an aberration in 1994, however, as the S&P 500 fell 2.3%. Of course, that was the year that the Fed surprised markets with a series of unexpected rate increases. This anecdotal observation is illustrated by the American consumer: total household debt rose by $193 billion to an all-time high of $13.15 trillion at year-end 2017 from the previous quarter, according to the Federal Reserve Bank of New York's Centre for Microeconomic Data report released Tuesday. Mortgage debt balances rose the most in the December quarter, rising by $139 billion to $8.88 trillion from the previous quarter. Credit card debt had the second largest increase of $26 billion to a total of $834 billion. The report said it was the fifth consecutive year of annual household debt growth, with increases in the mortgage, student, auto and credit card categories. Clearly, the Consumer is confident… buying new cars in the face of a rising VIX… Then again, that is the reality away from financial screens…

Back in the times before grey hairs, the expression "Dead Cat Bounce" was popular and related to moments when prices rose somewhat after having fallen away. This past week the term has resurfaced…but it sure looks like a mighty dead cat, or was it just tasered? Every bear market starts as a correction, but fewer than half of all corrections deepen into bear markets. Now that the U.S. stock market has shed one-tenth of its value in two weeks in a sharp correction, the fate of this downward

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break in prices has investors in suspense. The answer is unknowable, but the weight of the evidence right now suggests we're in a nasty, anxious correction, rather than the kind of prolonged downturn of 20% or more that would place the bears in control. Stocks can likely work their way higher on sturdy corporate profitability and steady global expansion, perhaps after making their peace with somewhat higher interest rates and more elevated volatility. The market was likely overpaying for good fundamentals two weeks ago, and investors were giddily extrapolating the good news too far, encouraged by extraordinarily loose financial conditions. They are now figuring out the right price to place on profits juiced and front-loaded by tax cuts in a world where Main Street might take more of the rewards of a humming economy than Wall Street. A slightly less perfect setup, perhaps.

For now, it appears this bull market is not broken, just bent.

Where we are focussing our concerns is on the US Dollar. America's budget deficit swelled in the first four months of the fiscal year - increasing 11% to $176 billion between October and January from the same period a year earlier, according to a Treasury Department report released Monday. That's the largest fiscal gap since 2013 and it's expected to keep increasing as an aging population fuels entitlement outlays while tax cuts crimp government revenue. Data out of Washington last week showed the U.S. trade deficit excluding petroleum products widened to a record $50 billion in December as a jump in imports outpaced export gains. Furthermore, the U.S. Dollar Index has declined 3.8% in 2018 - its worst start to a year since 1987 - after a 9.9% plunge last year. Credit Suisse said it sees the dollar as overvalued and vulnerable to a drop of 10% in 2018. This suspense is terrible. We hope it will last… (Oscar Wilde).

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