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POSITION SUMMARY

MARKET	CYCLE	MEDIUM-TERM *Up to 3 months*
S&P	Bearish	Bearish
30y Long Bond (price)	Constructive	Constructive
Brent Oil	Neutral	Neutral
Gold	Bullish*	Bullish*
EUR/USD	Neutral	Neutral*
USD/JPY	Neutral	Neutral
USD/CNH	Bullish	Bullish

* Indicates a new position or change in view

- Global economies will not collapse as they did in 2008, but will continue to erode.
- The corporate sector continues to suffer from weak pricing power, which will lead to disappointing earnings.
- The global equity bear market remains intact. Recovery attempts are countertrend moves and present an opportunity to lighten exposure and liquidate positions.
- Gold is in a new cyclical bull market. Corrections are opportunities to increase positions in gold and gold mining shares.
- Forex markets are calming down for a while, as the US dollar is correcting its recent run against other currencies. The structural US dollar bull run, however, is not over.
- Perceived quality bond yields are near the end of a secular decline. However, there is still more downside for long dated US treasury yields after a short-term bounce.

A Deflationary Process at Work

In our last report, we called for a temporary short-term bounce within a bear market decline and expected it to be front loaded. The bounce lasted only eight trading sessions, and markets resumed the bear trend quickly again thereafter.

During December/January, we had discussed the current investment landscape with many experts around the world and found only a minority of bears. In fact, we were surprised how much push- back we received regarding our bearish investment outlook. It is probably because the current mechanism at work is so different from the past, at least in the industrialized economies, and therefore more difficult to understand.

Actually, we were surprised how many still believed this was only a correction. We noticed, however, that the self-confidence among the bulls had eroded somewhat, but the vast majority was still not accepting our case that mounting economic problems are leading to declining earnings and a cyclical bear market. In contrast, they still saw this as a buying opportunity because in their view there is no recession on the horizon and as a result this decline ran against intact bullish fundamentals.

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We believe our case is very simple and easy to understand, but it involves a structural deflationary process, which is what many are rejecting because they have never seen it before. While our world faces major structural hurdles, we have written many times (demography, debt, regulation, productivity, etc.) about our view that the biggest problem in this cycle is weak pricing and eroding product prices. Actually, most still don't understand how it affects the bottom line of the corporate sector. We recall discussions in the fall of last year when some fund managers said there is a manufacturing recession. But most could not see a broad-based recession and therefore were confused and had difficulties coping with this market.

Our case for the last few quarters was that global pricing power was weakening and spreading from the weakest to the strongest industries in a step-by-step fashion.

If one takes two companies with same unchanged revenues for several years but company A has steadily rising prices and declining volumes every year and company B has just the opposite, namely steadily rising volumes and declining prices, it follows that company A may increase its earnings while company B (declining prices and rising volume) may suffer declining earnings. This is primarily due to fixed costs. Our case for the last few quarters was that global pricing power was weakening and spreading from the weakest to the strongest industries in a step-by-step fashion. Moreover, those with high profit margins are getting affected later, while those with low profit margins get hit earlier in the process. So far, that process has hit many energy, basic resource, material and industrial companies. But in our view, the process keeps spreading, although slowly.

Why is it so? Well, the boom in the current cycle took place primarily in the emerging world, and China in particular. The expansion of capacities of all sorts went far beyond what the world needs. As the boom ended those excess capacities were hitting the world, as many producers are simply trying to make up for weaker prices by higher volume. And devaluing currencies helps staying competitive. Hence, the race of competitive devaluation continues, and the process is deflationary in nature for the global economic system.

At present, inventory/sales ratios are still very high in the US and in Asia. While they may be distorted somewhat on the upside due to lower prices and therefore weaker sales, the fact remains that Asia and the US must adjust their production to lower sales levels. In addition, lower energy costs are hurting producers and related businesses and those regions including financial institutions active in lending in those industries and regions. We should also keep in mind that many sovereign wealth funds have been forced into ongoing selling of assets due to lower energy costs. Moreover, lower oil prices equal lower petrodollars and therefore lower global liquidity by those who previously bought all sorts of assets from fixed-income to equities and real estate. Moreover, forex reserves, a decent proxy for global liquidity, have been declining since the second half of 2014.

Cutting costs means cutting somebody else's income.

On the other hand, lower energy costs and lower costs of selected goods may support consumers to some degree. We have made the case for over a year that lower energy costs will not lead to rising expenditures for other goods, as most economists have been saying, because private households have lost the compounding of interests on their financial investments due to zero and negative interest rate policies. Nevertheless, lower costs of some important expenditure items are supporting the economy. That support will be removed once cost-cutting by the corporate sector begins to spread, as seems now likely on a broader scale. Cutting costs

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means cutting somebody else's income. It is therefore our view that the very important global auto sales cycle is peaking and will weaken in the future, not the least after all the tricks of lengthening lease times have been used by car manufacturers to squeeze as much from the current cycle as possible. In addition, the wealthy and big spenders are now also getting affected as stock prices decline around the world and even real estate markets in formerly hot regions turn softer. As their balance sheets get hit, their appetite to spend will decrease. Hence, it is our view that the world economy will continue to soften, but unlike 2008 it will hardly be a slump but more a continued erosion. Whether that will turn out to be a recession according to economists' definition is not important, and if it does, it will only be recognized as such very late and deep into the bear market for equities.

From Complacency to Concern

Bearish sentiment has grown in synch with declining stock prices. In the US, AAII individual investor sentiment (AAII: American Association of Individual Investors) shows bulls fell from 27.6% to 19.2%, a reading close to the levels reached in the 2009 lows. Bears rose from 34.7% to 48.7%, still far away from the 70.3% seen in the 2009 lows. And Investor Intelligence shows just 24.7% bulls versus 39.2% bears, a more extreme reading than during the 2011 correction. In the evolution of sentiment during a bear market from complacency around the top to concern and finally capitulation, we think sentiment has moved to the early stage of concern. We mention this because there could be some countertrend moves in the next few weeks, and they are often short but violent. Even if such violent countertrend moves were seen in coming weeks, we don't think this medium-term decline is already complete and would use any bounce to get more – or in fact most – defensive.

In our view, extreme sentiment can be read in two different ways. First, as a contrary indicator of a temporary extreme – this is certainly the case for the very short-term – but second, as a trend confirmation indicator. Sentiment, we believe, is far from a bear-market cycle bottom. At a true bottom, nobody wants to buy, while at present all the talk is about the bottom the first day of a bounce. Moreover, the fundamental background has softened, but there is no real damage yet, no major company has gone bankrupt and there has been no fraud, as is usually seen near bottoms. We have not seen any major financial accident, yet. Moreover, valuations are in our view still way too high in a stagnating world economy and eroding earnings. We noticed that real money is beginning to get concerned, particularly in view of the damaged bank stocks in Europe, and is beginning to lower equity exposure slightly. That is closer to the beginning but not near the end of the bear cycle.

Central Banks Are Out of Ammunition

Bear markets often relate to the monetary excesses of the previous bull market. And there is no question that the last bull cycle saw the biggest monetary excesses ever. Central banks have tried any trick from cutting rates to zero and even negative to money printing in huge amounts. It inflated asset prices around the world but did rather little for the real economy (except for extending and intensifying the China and EM boom and the shale oil boom). Even central bankers must admit their strategy has failed. The dumbest thing ever done was introducing negative interest rates in the belief they would weaken the currency and increase lending. Since the Bank of Japan introduced negative rates, the yen has strengthened and quite decisively so against all other currencies! And since the ECB introduced negative rates, the euro has stopped falling but European bank stocks started a serious decline because negative rates are simply an additional tax on banks. And if the banks passed it on to their clients, the banks risk suffering large deposit outflows, jeopardizing the whole banking system. When the central bank world is left to former professors and investment bankers who have no clue about the real economy, the result is horrible.

Investors thought that central banks would support equity markets, and therefore risks in equities were limited. Nothing could be further from the truth. After hiking rates for the first time and indicating four hikes by the FOMC, the Fed cannot turn around by 180 degrees or lose what little of its former credibility is left. Moreover, having an expert economist focused on employment in the driver's seat is like guaranteeing a policy of looking in the rear-view mirror, as employment is the most lagging of all indicators

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in an economy! And what will the ECB do from here, as the euro is firming? The Swedish Riksbank just cut its repo rate from -0.35% to -0.50%. Interestingly, stocks immediately sold off after the announcement. If central banks want to completely destroy their banks they should simply drive their negative rates into even deeper territory. In addition to hurting the already weak European banking system, this also hurts in a broad sense the pension and provision industry and a whole generation of savers as the compounding of interest has turned into a compounding confiscation of savings. In our view, today's central bankers collectively reflect desperate people who don't know any longer what they should do.

Central banks cannot bail out financial markets at present.

Being already near zero or negative and going more negative makes the situation worse, not better. This implies that central banks cannot bail out financial markets at present. They have to enter equity markets and buy equities now to bail out the markets. In a bull cycle, markets would see such a move as positive, but in a bear cycle, markets would probably even see it as a desperate behavior by central banks that had lost their way. Our conclusion, therefore, is that central banks' safety net underneath global equity markets, which investors perceived to be at high levels, simply is not there. In plain English, this means the downside is considerably bigger than most can imagine. The monetary excess of previous years cannot be repeated without doing even more damage to markets. In other words, risk is still very high as economic fundamentals are soft and eroding. Nobody knows for certain how to value equities in a stagnating economy with soft product pricing and declining earnings. But to us, they are still too high. Hence, we still recommend remaining most defensive in equity allocation and for aggressive investors to remain short on a trend basis.

CHART 1

S&P 500

Source: Bloomberg Finance L.P.

CHART 2

Swiss Market Index

Source: Bloomberg Finance L.P.

CHART 3

MSCI World Index

Source: Bloomberg Finance L.P.

Have a look at charts 1-3. They show global equity markets around the world completing large tops, some stretching back for two years or

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even more. The S&P 500 is completing a large head & shoulder top with the neckline around current prices. The next decline will therefore be the big breakdown. The Swiss SMI has completed a large rounding top and has broken down at the breakpoint at 7,900 already. Any bounces will run into resistance at the breakdown point or even somewhat below. The MSCI World Index broke down from a large head & shoulder top, and bounces from here will run into heavy resistance underneath the neckline. One could go on and on and see similar distributional patterns, with many already broken down and some others dancing around the breakdown line. It is a very ugly picture.

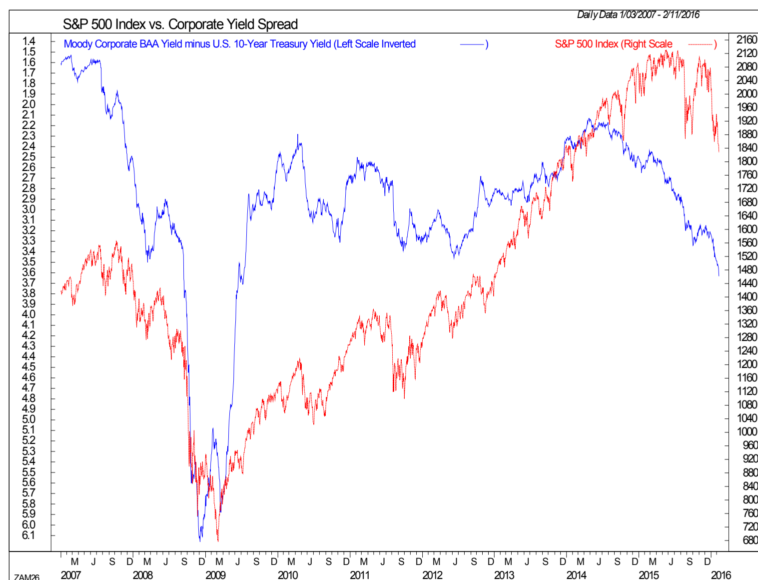
Bull Run in Gold Has Further to Go

One of the problems hurting equities is the bearish credit markets. They show how extended our system has become. Credit has been leading the equity bear markets by many months, and credit markets remain weak (chart 4). After the US oil shale industry, credit markets have now focused on the vulnerable European banking system. How could those banks raise equity capital at such depressed equity prices? The instrument introduced after the last crisis was CoCo bonds, or contingent convertible bonds. With equity prices declining, fixed-income investors all of a sudden become shareholders – but at much higher prices because the CoCo is converted into equities once a certain level is reached. That is hardly what investors intended when they were buying those bonds, attracted by high coupons. Worst of all, Sovereign Wealth Funds have 40% of their equity allocation in Europe, of which 40% is invested in financial institutions. This is a leftover from the bailouts in the last bear market. One wonders who could bail those institutions out in the current bear market.

Eventually, we expect the nationalization of selected banks in the current downcycle. However, governments are not cash-rich either and must issue money to pay the shareholders and recapitalize the banks. They will

CHART 4

S&P 500 Index vs. Corporate Yield Spread



Source: Ned Davis Research, Inc.

be forced to issue more debt, and perhaps central banks will underwrite it, although it is against the rules – but who cares. They have broken almost all other important rules already. Furthermore, Europe decided a while ago to introduce a bail-in clause, which means that banks can claim bondholders' and depositors' money in exchange for equity paper to recapitalize the bank. It has happened in Cyprus, Greece and Italy, and we don't see why it cannot happen in other EU countries.

When counterparty risks are rising again, as is the case now, gold offers a safe place.

The latest discussion in Europe is about reducing cash payment limits again. In Italy it is €1,000 per transaction, as an example. Anything above that in a cash transaction is illegal. Now, the ECB is talking about eliminating the €500 banknote bill to eliminate a way for savers to store their savings in cash. All these steps – and we are sure we haven't heard all

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yet – will reduce or even destroy the credibility of the banking and legal systems in those countries. Again, it seems the elite have lost their heads and don't know any longer what is right or wrong.
When counterparty risks are rising again, as is the case now, gold offers a safe place, as it doesn't have a balance sheet, there is no fraud, there are no criminal managers and gold cannot go bust. As a result, capital is flowing into gold again. Within about a month, gold has gained roughly 15%, beating equities and bonds by far.

We showed the falling-wedge chart in our report dated October 15, 2015. In the last few weeks, gold broke the downtrend, driven by deteriorating systemic fundamentals. This breakout is valid, and the wedge pattern suggested a quick move back to where it started, which is approximately $1,400. Gold should offer investors not only protection against the equity bear market but also offer potential gains. The same goes for the gold mining complex, although that is even higher beta but contains the entrepreneurial risks. We recommend using any pullbacks in coming weeks to accumulate gold to full position.

Quality Bonds a Flirt, Not a Marriage

Bond yields of perceived quality borrowers declined to our medium-targets even more quickly than we expected. We thought 30-year US treasury yields could hit 2.50% or slightly below in this medium-term decline, and they did already in only a few weeks. This decline went too fast, and bullish sentiment here is reflecting an extreme. While we remain constructive long treasuries, we are not as bullish bonds as we are bearish stocks. This is simply due to our fear that governments must and will eventually step in, and risks will end up on the balance sheets of governments and central banks. Bond yields are in the terminal stage of a secular decline that may, however, draw out longer and consume more time. The zero-percent yield for 10-year JGBs is a clear case in how extreme markets can get toward the end of a secular move. For the time being, we would stick with those bonds and still buy some more on yield bounces in coming weeks, as the lows have not been seen, yet. We still consider this a trade and not an investment.

Currencies in Consolidation

We assumed the US dollar would correct once markets downgraded the US economy and the probability of future rate hikes disappeared. That process started from late January onwards. As a result, a certain repositioning has to work through the markets. Previous funding currencies strengthened the most, led by the Japanese yen and followed by the euro. As we approach fiscal year-end in Japan, we would be surprised if the BoJ did not try to push USD/JPY towards at least 120, which was last fiscal year's closing level.

But the problem is that Japan and particularly Europe will eventually have to move away from negative interest rates, although the ECB may lower negative rates a few basis points one more time in March. Once they realize, however, that they are destroying the banking and in fact the whole capitalist system, they must move away from negative rates. We wonder what that would then do to those currencies. In Japan's case, we assume the introduction of negative rates was more a preemptive signal to markets that if China devalued, capital would not be welcomed in Japan.

In our view, the current correction of the US dollar against major currencies is simply a correction in an ongoing cyclical bull market.

It is our assumption that the EUR/USD will remain in the sideways range it has been in for almost a year, namely 1.05-1.17. Any break to the upside, if it occurred, would be a temporary aberration and not be sustained.

In our view, the current correction of the US dollar against major currencies is simply a correction in an ongoing cyclical bull market. This bull market is based on a slowly deteriorating world economy, which strengthens the US unit because it is the currency in which most global debt is denominated. Moreover, the US economy is hurt the least in a contraction of world trade.

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We compare the current correction to what happened in the second half of 1998 due to the Asian crisis and a sudden strengthening of the Japanese yen as Asian borrowers were wrongly positioned and had to switch their loans back to domestic currencies, which in turn hurt the US dollar temporarily.

Our biggest conviction trade remains short the Chinese yuan. While China keeps fighting it, the fundamentals will eventually force China to decide between supporting its banking system and its economy or the currency. That choice is usually solved in favor of letting the currency go once the pain is great enough. We stick with our bearish stance on the yuan and related Asian EM currencies.

Felix W. Zulauf
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