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**POSITION SUMMARY**

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

\* Indicates a new position or change in view

**BEAR CASE REMAINS INTACT**

- The world is waking up in steps to the scenario we predicted, although we still get much more push-back than acceptance to the bearish perspective.
- The world economy remains soft, and deflationary pressure has spread from China/Asian EMs to the developed economies.
- China is fighting the devaluation pressure on its currency by intervening, which is counterproductive and will not prevent continued capital outflows.
- EM and natural resource currencies have not yet reached bottom against the USD.
- EUR/USD is eroding but not plunging, and USD/JPY remains in its sideways range.
- Global equity markets have bottomed short-term. Recovery attempts are front-loaded and are expected to give way to renewed selling after a few weeks.

- Commodities are deeply oversold and beginning to bounce, although there is not a fundamental reason for a trend change yet.
- US treasury bonds remain a good safe haven despite already lowered yields and despite foreign central banks selling. Yields may rise during the equity bounces.
- Gold is showing positive divergences, with mining stocks breaking to new lows but bullion refusing to follow, which is a positive.

**What US Housing was in 2008 is China Today**

We doubt the investment world has already fully understood and embraced the process at work in the current cycle with the global economy and financial system, although more voices are joining our bearish view. Our debates with colleagues around the world reveal divergent views, and we believe investors may not recognize what is going on in the investment world because the process at work differs from how previous cycles have played out. A friend in the US told us that he had checked the US data back to WW II and could at present not find any signs pointing to a recession. Our answer is that he is looking in the wrong place.

The major problem this time is the end of China's boom, and its ensuing downswing that is not visible at the surface or in most frequently published official statistics. The 6.8% GDP growth statistic doesn't show the problem, of course. But the decisive decline of the last few years in base metal prices, declining wholesale prices, and sharply rising accounts payable in the Chinese corporate sector are hardly signs of a healthy economy but rather of a recessionary economy wrestling with mounting problems. The PBOC's currency interventions are also a reflection of large capital outflows the Chinese authorities want to prevent.

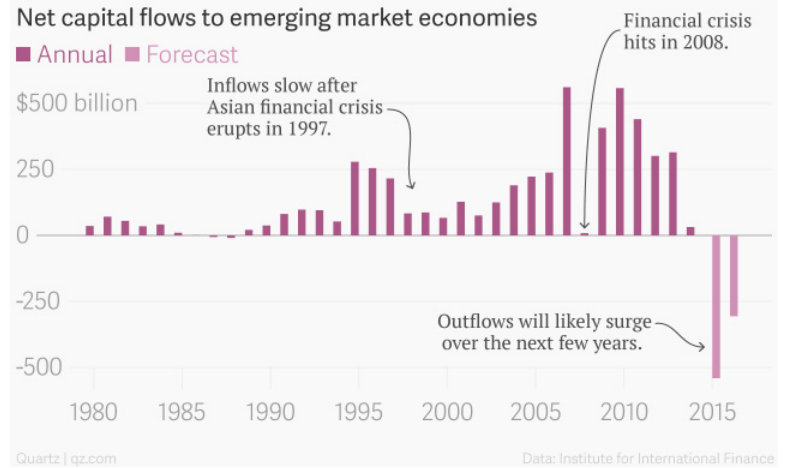
Our view is widely unaccepted, because Western economists and strategists rely on official numbers and so do international organizations. Moreover, a bear market cycle shows changing sentiment from complacency at the top and in the early stages of decline when fundamentals are not clearly detectable. In the second stage, fundamentals begin to deteriorate and sentiment reflects concern as equity markets continue declining. We are now in between those two stages, but not yet fully at a level of concern. When weaker fundamental numbers are released, we will arrive at lower prices and people will get concerned. The third stage will eventually become capitulation, when fundamentals are really bad. Investors will suffer deep losses and finally accept the scenario and fear that it will not get any better anymore. That is why the biggest damage is often done in the final six months of a bear market.

## China is now to the rest of the world what US housing was in the last downcycle.

Our most important case has never been a hard landing in China (although we had already seen signs of it in

CHART 1

### Net Capital Flows to Emerging Market Economies



Source: Institute for International Finance

part), but rather an economic downswing that forces wealthy Chinese for the first time ever to diversify internationally. Before the wealthy were locked in by capital controls. In addition, there was an economic boom with sharply rising real estate prices and booming businesses. Hence, diversification outside the country was not necessary. Now, in the current environment the outflows keep running. On top of this, 1 trillion of USD denominated debt in China (according to BIS) must be changed back into yuan - or suffer more losses - leading to capital outflow. In contrast to the BIS statistics that showed capital inflows to the emerging economies of \$6 trillion, half of it to China, unofficial guestimates are as high as \$15 trillion of which approximately half is China. Chart 1 shows the gigantic inflows over the years that has now reversed and will keep going. As China is the driving force in this respect, China is now to the rest of the world what US housing was in the last downcycle.

In any case, China has continued to intervene heavily in January and we estimate they have already spent over \$100 Billion so far to keep the yuan stable against the US dollar. At the World Economic Forum in Davos, China's vice president and member of the Communist party's politburo Li Yuanhao declared that China has no interest in devaluing its currency. For whatever politicians' words are worth and given current economic circumstances, we believe the only alternative to devaluation (which would happen without PBOC intervention) are tighter capital controls. If implemented, it would make wealthy Chinese even more aware of the problem

and their desire to diversify out of the country would even increase more. However, the currency would remain relatively stable but domestic asset inflation would pick up (due to excessively easy monetary policy). Domestic capital would in this case be buying all sorts of real assets seeking protection against future currency devaluation, due to monetary easing. It is the classic triangle of currency, interest rates and liquidity. Authorities cannot control all of them and historically, whenever the problems get bigger, they favor liquidity (to support the domestic banking system) and interest rates (to support the economy). They tend to let the currency go. China will hardly be an exception, as too much stake is on the table domestically.

Another asset bubble on top of the one that has not been fully deflated yet would be the last thing China needs, and would make the situation for them even worse a few quarters later. Hence, we expect China to eventually let the currency find its new equilibrium that we estimate at \$7.50 or higher. However, we suspect they will keep trying for a while longer to control the forex ratios.

### Temporary and Front Loaded Bounces

The Chinese New Year celebrations will last from February 7-13, 2016. And it is clear to us that China will try everything to stabilize the currency until that period has passed. Hence, we have a brief window until mid-February where global financial markets have some breathing room to bounce after the deep dives since late December 2015.

There are a few short-term positives of notice. First, USD money market futures have improved to the extent that only one more future rate hike is priced in against more than two in late December 2015, and four as signaled by the FOMC dots. Second, Draghi hinted that he would become more aggressive if economic and market performance undershoots expectations, a

classic verbal intervention to prevent the euro from firming. And finally, there were rumors out of Japan that the Abe government was encouraging the BoJ to ease further. While we doubt that central banks will become very active any time soon, markets may take this noise and development as a positive. In the medium-term, any easing outside the US would be counterproductive as it would strengthen the USD and reinforce capital flows toward the USD, which would intensify current problems.

In addition to what the market may consider short-term positives, crude oil had at least a mini-climax on the downside with sharp declines on increasing volume and has set an important short-term low while our own technical indicators have just given a short-term buy signal for crude oil WTI as well as Brent. In addition, we have noticed that most base metals did not go to new lows on the latest commodity weakness but are holding at levels reached in November 2015. Copper and tin were the only two exceptions making lower lows, while all others did not – a major positive divergence in a deeply oversold market.

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## Bounces could last at most 3-6 weeks and most likely it will be front loaded and extremely volatile.

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And the Chinese currency has stabilized and with it other Asian, EM and natural resource currencies. Most of them have a short-term technical set-up allowing some recovery although we think it will be modest for Asian EM currencies and more likely lead to a sideways ranging pattern than powerful bounces. Natural resource based currencies like Aussie and Canadian dollar may have somewhat better bounces but we would not play them as we cannot confirm a medium-term low has already been reached in our work.

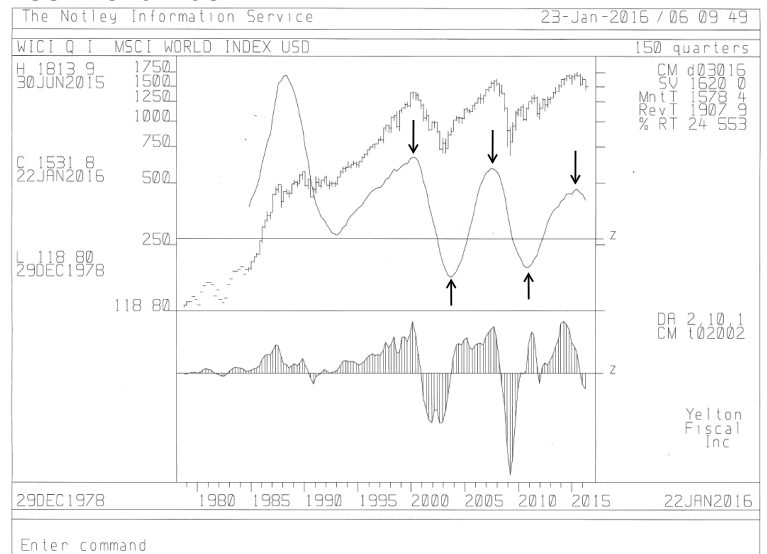
In the equity arena, we noticed some pick-up of short-term concern and sentiment according to survey, put/call ratios and anecdotal evidence - and media coverage became bearish. But as mentioned above, the vast majority is pushing back on our bearish scenario, and many investors do not believe it will play out this way. We suspect this attitude reflects pretty fully invested positions because if they were not, the hurdle to accept it

would be much lower. In our view, last Wednesday's low is a short-term low and should hold several weeks. It coincided with a 20-year trading cycle low that was due in the time window around late January according to our colleague Walter Murphy at WMInsights. We expect bounces to the mid-1900s or at maximum back to the breakdown levels, which for the cash S&P 500 is the upper 1900s. Broader indices like the Russell 2000, Value Line or the New York Composite are much weaker and most indices have undercut the summer/fall lows of 2015 thereby confirming the primary downtrend.

## Investors should use these bounces to get more defensive.

Technical indicators show global equity markets deeply oversold on at least a short-term basis, although we doubt the medium-term decline is already over. We remain bearish expecting an above average bear market that has further to run during this year and will most likely surprise the majority because the mechanism at work differs very much from all previous bear cycles. We are working with an official minimum target for the S&P 500 of 1600, but actually believe this is an above average bear. The reasons are that monetary excesses in the upcycle were bigger than ever before and that our quarterly coppock indicator MSCI World Index (chart 2) has turned down in combination with the monthly indicator. Since WW II, such a combination resulted on average in a 54% decline of the Dow Jones Industrial Average. So far, the fundamentals driving this bear market have not been addressed and as long as the yuan has not reached its new equilibrium, the deflationary mechanism remains intact.

**CHART 2**  
**MSCI World Index**



Source: Courtesy of the Notley Information Service, Taniscott Capital, Inc..

All markets are now swinging together again. Equities and yields of safe haven bonds are bouncing for a few weeks, as will commodities. EM currencies participate in that rhythm, but their magnitude will be more muted as the fundamental adjustment process works primarily through them. Major currencies like the EUR/USD may congest for some time. Draghi intervened to prevent EUR/USD from bouncing but its downside is also limited, for a while. The USD index keeps creeping higher but at declining momentum, pointing to an increasing risk of a correction at some point, most probably from a somewhat higher level.

All of this happened after a severe decline in global equity markets and after a deep oversold condition has been reached. Our short-term indicators have turned positive and we do expect markets to bounce and correct in part recent sharp moves. Our medium-term technical work, however, remains bearish and that's why we expect bear trends to resume after these short-term countertrend moves. We assume such bounces could last at most 3-6 weeks and most likely it will be front loaded and extremely volatile.

Investors should use these bounces to get more defensive or short equities, EM currencies and long bonds. Gold may come back into favor as soon as central banks signal an easier stance and/or Asian banking system problems begin to show up, which we expect during this year (more about that in a future report). Hence, some gold accumulation is recommended over the next few weeks.



Felix W. Zulauf  
*January 25, 2016*

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