ZULAUF CONSULTING

INVESTMENT COMMENT

January 7, 2016
VOLUME 25, NUMBER 1

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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	Bearish
Gold	Neutral	Neutral
EUR/USD	Neutral	Bearish
USD/JPY	Neutral*	Neutral*
USD/CNH	Bullish	Bullish

* Indicates a new position or change in view

New Year With Old Problems

- Secular forces continue to restrain global economic growth, leading to another disappointing year.
- China remains key for the world economy and global asset markets. It is fighting the fallout from its credit and investment bubble by monetary easing, leading to a balance of payment crisis and a weaker yuan.
- Non-Japan (NJ) Asian currencies will weaken further against the USD and put downward pressure on the prices of globally traded manufactured goods.
- Deteriorating global liquidity is putting downward pressure on asset markets, including real estate, art and equities worldwide.
- The recovery bounce off the summer/fall lows is over, and global equity indices are in the early stage of their next downleg.
- Commodity prices are highly depressed and oversold, requiring more production cuts for a sustainable improvement.
- The geopolitical situation keeps deteriorating and is a negative for the global economy and most asset prices except perhaps gold due to rising uncertainty.
- Investors should remain highly defensive and stick to high quality. Continue to avoid long investments in the EM universe.

It's that time again, as every year, for investors and seers have a look into their crystal ball. In truth, most forecasts simply report what has already happened, while members of the investment industry confirm their optimistic bias. This year, we noted somewhat less enthusiasm, probably because investment returns disappointed so many last year.

Our view remains basically unchanged regarding the world economy. We are dealing with a recession in global manufacturing that promises to deepen somewhat in coming months due to high inventory levels in the U.S. and even more so in Asia. Hence, we expect production to adjust downwards to bring inventories and production in line with sluggish sales. Europe doesn't have that problem, but we expect exports to other regions to slow and also impact growth at the margin. Moreover, Europe's problems remain rooted in its project of "Greater Europe," which is showing more and more fault lines. The dichotomy between the

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relatively wealthy north and a heavily indebted periphery and between increasing Eurosceptics and Europhiles is growing ever bigger. The waves of immigration from other cultures has opened another rift between the socially generous and those who want to isolate themselves against immigrants from foreign cultures. We think this later problem will increase during 2016. Moreover, the Brexit question is also on the table for discussion, and it remains to be seen how the EU will handle these rising dichotomies among its member nations. In our view, the whole complex of questions will generate uncertainty, which is detrimental for economic growth and prosperity.

Manufacturing is only around 20% of GDP on average but as a rule somewhat higher in the emerging economies. The question therefore is whether the Service sector could carry growth further or whether the Service sector will get hit by weak manufacturing activity. In our view, the Service sector depends heavily on continued prosperity in asset prices. If stocks, real estate and art prices rise, the owners of those assets benefit, as their wealth increases and they tend to spend more generously – and vice versa.

> **The increasingly fragile geopolitical situation is an additional stumbling block that will reduce investor appetite for risk in the real and financial economy.**

According to several recent articles, anecdotal evidence suggests that real estate prices in formerly hot locations like London, the Hamptons on Long Island, Sydney or even Miami have peaked and are softening.

CHART 1

Price Action of Sotheby's Stock

Source: Bloomberg Finance L.P. © 2016

The wealthy from natural resource-based economies like Russia, Brazil or the Middle East are suffering badly under the commodity bear cycle and are less willing to pay high prices for extra homes. The Chinese are still there but their currency is declining, and their economic boom has cooled off. In addition to softer real estate prices, global equity markets have not performed well, and the average equity portfolio is rather down than up for 2015. And the fixed income markets have not performed well either, with bond prices down slightly for prime quality and a lot more for lower quality.

While the sale of Modigliani's "Nude", painted in 1917-18, sold for an eye-catching $170 million, it was $9 million less than Picasso's "Woman of Algiers," which sold in May of 2015. Moreover, anecdotal evidence suggests softening prices in the broad art market, as is nicely reflected in the price action of Sotheby's stock, which made a double top in late 2013 in the low $50s and in mid-2015 in the upper $40s, slumping to $25 recently. While the background noise in the art market may be similarly upbeat as when equity markets top, the incorruptible price action of Sotheby's stock suggests the broad art market is slipping lower (chart 1).

In other words, the financial situation of the wealthy, not to mention the average middle class citizen, has at the margin deteriorated. Hence, it is in our view more likely to see the Service sector adjusting downwards than to see the Manufacturing sector moving upwards – at least for the first half of 2016.

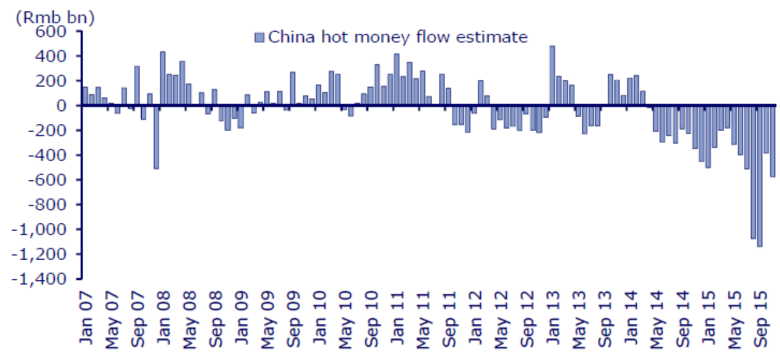
The increasingly fragile geopolitical situation is an additional stumbling block that will reduce investor appetite for risk in the real and financial economy.

A Weaker Yuan and Weaker Non-Japan Asian Currencies

We have been making the case for a long time that China's boom is over and that the Empire of the Dragon will face the usual fallout, like any other economy after an extreme boom. It seems, however, the Chinese are fighting tooth and nail to prevent or hide a hard landing. What is surprising is the dichotomy between creditsgrowing at double the rate of nominal GDP. This may be another sign that lending institutions keep simply adding interest to their outstanding loans because borrowers seem unable to service their debt. It seems the central bank is supporting those activities, as it keeps providing liquidity to the (primarily state- owned) banks. Well, this is nothing more than procrastination at its best, but it does have consequences. At the surface, the economy might look more stable than it really is and leave the world impressed with continuing (manufactured data) growth. However, creating liquidity at the source weakens the currency, and recent days have shown a distinct weakening of the CNY and CNH despite still heavy interventions. Central planners should be aware that they can control some key variables but not all. If they make liquidity plenty available for the domestic banking system, they will weaken the currency, as capital tends to flow out (chart 2). Heavy interventions have markedly reduced China's forex reserves, and we doubt China is interested in losing most of its liquid reserves when letting the currency drop could even help its manufacturing

CHART 2

China Hot Money Flow Estimate



Note: Estimated hot money flow = Change in financial institutions' position for forex purchases - trade balance - utilised FDI + Outward direct investment. Source: CLSA, CEIC Data, PBOC

Source: CLSA, CEIC Data, PBOC

economy. Hence, we continue to expect further weakening of the on shore and offshore yuan. Our first target remains about USD 6.80, and our final target remains around USD 7.50 from currently 6.52 and 6.63, respectively.

In view of the slow Asian economies and the weakening of the yuan, other Asian currencies will continue to weaken in synch with the Chinese unit, except the Japanese yen. We remain bearish on all those Asian currencies against the US dollar, particularly the Korean won but also the Singapore and the Taiwan dollar. In November, we made the mistake of turning bullish on USD/JPY, and we are correcting this by turning neutral again, as the yen usually holds up well when there is global risk off. However, we don't expect a major weakening of USD/JPY but rather a sideways range trading that is unattractive for forex traders and investors for a while. Other Asian currencies weakening will eventually bring the BoJ back to weaken its currency to protect its position in global trade.

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EUR/USD is a much more difficult call than other currencies. In our view, the positioning is one-sidedly bearish for the euro, while all the easing activity is known and discounted and we don't expect any further easing steps. Moreover, the U.S. economy may surprise more toward weakness than Europe – not the least because of the weakened euro over the last two years – while expectations are for better U.S. growth and further rate hikes that we don't see. In fact, we would rather bet on no rate hike for at least the next six months if not longer and potentially even some verbal intervention towards an easier monetary stance by the Fed. This may in fact offer trading opportunities, as the December 2016 Eurodollar future prices in a bit more than two more rate hikes, which will in our view not happen.

Equities Are Sliding Down the Slope of Hope

While years ending in 5 usually have the best performance in the decennial cycle, 2015 proved again that the current cycle differs in so many ways – including this one – as the major (U.S.) indices were slightly negative and the vast majority of stocks closed down for the year. Historically, U.S. election years have had a weak first half followed by a better second half, closing up for the year.

In recent comments, we expressed our view that global equity markets are already in a cyclical correction or bear market, although not yet visible across all major indices. The pacesetting U.S. equity market has been extremely bifurcated, and only a few large-cap stocks sustained the major indices at high levels, while the vast majority of stocks are already down 10%, 20%, or more.

Such a bifurcation has historically been a sign of a mature bull market and usually leads to the strong stocks correcting and getting in synch with the weaker rest of the market. The current market set-up is classic, and this catching up on the downside by the "nifty global darlings" seems to have started. Hence, in our abstract cycle diagram, we expect the darlings to correct sharply over the next few months and the broad market to begin its second down-leg, likely reaching a 2Q low.

Far ahead in the cyclical bear market are energy and some other commodity-related industries and stocks. We see them in their third down-leg, but are monitoring them for increasing relative strength in a declining market. A few may reach new lows, but many in that group have the potential to improve their relative strength versus the major indices for the first time in the last few quarters, which could be a harbinger of some bottoming action. At present, we would not buy them, but wait until we see improving relative strength in a declining market. The fundamentals of the resource sector stink, of course, and we don't see them taking a turn for the better, yet. However, at important lows, the future always looks bleak and the fundamentals are usually weak. Announcements of more production cuts would certainly help improve the demand/supply situation.

We would still stay away from EM equities in general, as the balance-of-payment crisis of several major economies needs to force those authorities – and particularly the corporate sector in those economies – to initiate fundamental changes (cutting costs, labor, debt, etc.). So far, we have not seen any convincing steps, and we therefore remain bearish. Moreover, with the downcycle in China and related economies underway, we still see the potential for a financial crisis of some sort in the Asian or natural resource regions. While China may be able to cover things up for some time, Singapore is in our view the most vulnerable financial hub. Hong Kong is benefiting from capital inflow from mainland China, which helps the banking industry, while Singapore's banking industry has been losing deposits from foreigners since it changed its foreign exchange regime. Capital outflow and rising non-performing loans due to loss-making carry trades is a dangerous cocktail.

We expect the darlings to correct sharply over the next few months and the broad market to begin its second down-leg, likely reaching a 2Q low.

The EM world is in a classic balance-of-payment crisis with large capital outflows. The structural current account deficits in nations like Brazil, South Africa and Turkey are clearly the most vulnerable.

Those currencies have already declined substantially. However, even current-account-surplus nations can fall into a balance-of-payment crisis – which many experts don't understand – when capital outflow all of a sudden grows decidedly beyond the current account surplus. That is now the case in China and other Asian economies. In such a situation, a country has the following options: a) to support its own currency by intervening and thereby shrinking the forex reserves and domestic liquidity, which weakens the economy; b) raising interest rates and making the currency more attractive versus others, which also weakens the economy; or c) let the currency drop until it finds its equilibrium in the market place. The last option is a free-market solution and is best suited to economies that are not large net importers.

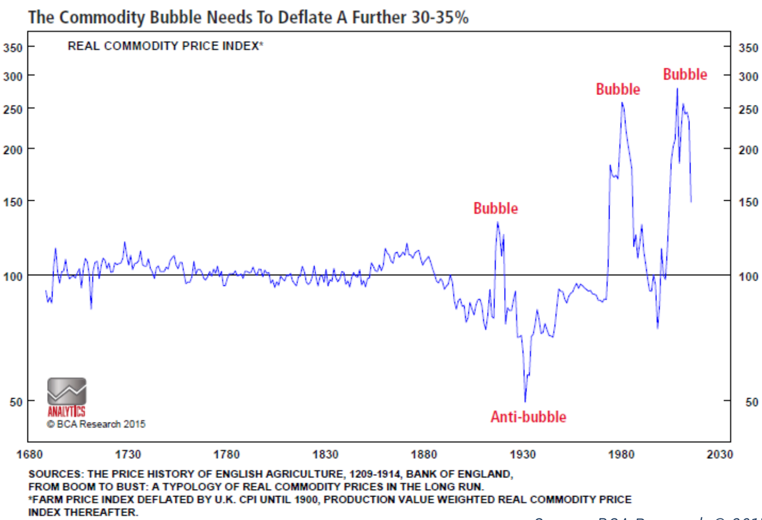
> We expect some relief recovery attempts at some point in 2016, but consider them as contrary to the remaining bearish secular trends.

China operated with option a), but is in our view moving to option c) as option a) is becoming too costly and even counterproductive from a monetary policy point of view because it drains liquidity from the credit system. Option b) is counterproductive given the fragile condition of the country's economy, and only those in deep trouble – like Brazil or South Africa – have moved to this option.

In sum, our bearish call for global equity markets remains that th weaker currencies of major exporting

CHART 3

Commodity Price Index



Source: BCA Research © 2015

nations in Asia will put downward pressure on prices of globally manufactured goods, revenues and profits of the corporate sector in other regions in a world economy suffering eroding growth.

Still Weak Commodities

The CRB Commodity Index is down over 50% from its 2011 high and down more than 60% from its 2008 historic high; it has even broken the lows of the mid-1970s. Other commodity indices have also been weak, but not quite as extreme, and are still trading far above the lows of the late 1990s. However, the Baltic Dry Index (shipping freight rates) has also reached new lows, even below those going back to the mid-1980s. What has happened so far in the commodity complex qualifies as a structural bear market; the question for investors is whether this decline is about to end and whether the commodity complex could be an attractive investment.

The precondition for a cyclical change in the commodity complex must be either production cuts or an increase in demand. Without any major fiscal initiative to stimulate economic growth, the demand side will in our view remain sluggish as global economic growth continues to grind lower due to restraining structural factors (demography, indebtedness, regulation, thrift, etc.).

While Chart 3 suggests that commodities have more to correct on a secular basis, our cyclical models are deeply oversold. Hence, we expect some relief recovery attempts at some point in 2016, but consider them as contrary to the remaining bearish secular trends. Such a recovery attempt can develop for different reasons. Some of them could be more production cuts, increasing geopolitical tensions and war activity, or a correcting US dollar after its strong advance. We have no firm conviction of what it will be, but a US dollar correction at some point would force short sellers to cover their positions, leading to a sharp but temporary countertrend.

Prefer Quality Bonds

Our analysis shows a world economy with intensifying deflationary pressure. Without any policy changes, it seems the world is again moving towards a major financial-crisis event. Under this assumption the highest quality bonds should be the preferred assets. First, inflation will remain low and may move even lower. Second, risk assets will decline and high quality bonds then usually become a safe haven. Third, there will be downside economic surprises, which are bullish for quality bonds.

We are fully aware that bond yields trade at levels that are extremely unattractive from a secular point of view. Moreover, we have seen several central banks defending their weakening currencies or currency pegs to the US dollar, thereby going from structural buyers to structural sellers. However, we expect most of them to eventually give up and let their currencies go, and consequently stop selling bonds and other assets.

It is not that we are screaming bulls for quality bonds, but we think there is at least another bullish episode for long quality bonds, particularly those denominated in US dollars. We expect 10-year U.S. treasury yields to trade down to below 1.90% and 30-year T-bonds to drop to 2.50% or lower (from the current 2.25 and 3.01, respectively).

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In contrast, we would still stay away from lower quality bonds as quality spreads are expected to widen further in the outlined scenario.

Felix W. Zulauf
January 7, 2016

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