Last week a client described central bank actions as ‘ouroborotic’. I instantly agreed, obviously having no idea what he was talking about. The word means ‘self-devouring’. It emanates from the ancient symbol of a serpent swallowing its own tail. A tail swallowing snake, I am led to believe, cannot easily be genetically mated with a butterfly but, if they were, the resulting animal would suitably exemplify the desperate illiquidity in modern-day markets. Like the renowned flutter of the butterfly’s wings, each small action central banks have taken have had resultant profound reactions elsewhere. In the last month we saw the Japanese central bank joining the cohorts of negative yielders. We now have more than 25% of all sovereign bonds yielding less than nothing. At least 11 Japanese money market funds have now either closed their doors to more business or closed their doors forever. The holders of those funds have had to rush further afield to hunt for any semblance of yield and join the disenchanted mob chasing for a vestige of interest, whatever left, in safe haven bonds globally. Meantime central banks desperately try to buy those bonds themselves in the final death throes of QE, making for a truly beautiful monetary bun fight.

As central banks, commercial banks and longer-term pension investors, the latter two governed by over-zealous regulation, cling onto these bonds, restricted or prohibited from selling them, the overall dealing liquidity has dried up almost totally. Central banks have inadvertently made themselves the central dealing counterparty. Each butterfly’s beat makes the snake swallow another chunk of its rear end. Maybe ‘Ouroborosis’ is too arcane a word to use when describing markets. Perhaps we need more blatancy when searching for an analogy. I am indebted to Monty Pythons ‘Big Red Book’:

Much to his Mum and Dad’s dismay, Horace ate himself one day.
He didn’t stop to say his grace, he just sat down and ate his face.
“We can’t have this!” his dad declared, “If that lad’s ate, he should be shared”
But even as he spoke, they saw Horace eating more and more:
First his legs and then his thighs, his arms, his nose, his hair, his eyes’
“Stop him someone!” Mother cried, “Those eyeballs would be better fried!”
But all too late for they were gone, they really didn’t last too long....
“Oh foolish child!” the father mourns, “you could have deep fried those with prawns, some parsley and some tartar sauce …” But H. was on his second course; His liver and his lights and lung, his ears, his neck, his chin, his tongue. “To think I raised him from the cot and now he’s going to scoff the lot!”
His mother cried “What shall we do? What’s left won’t even make a stew...”
And as she wept, her son was seen to eat his head, his heart, his spleen. And there he lay, a boy no more, just a stomach on the floor...
None the less since it was his. They ate it - that’s what haggis is.

This month’s Ghost in the Machine, steps early into the fevered debate of Brexit. Perhaps I should have used Horace for that instead. I hope you enjoy it and as always we welcome any interaction.

Andy Ash
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Maleeha Bengali

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Some leading Euro-sceptics in the UK expressed shock when Mr Cameron declared that his Government had made no plans to deal with the situation that would follow a referendum vote for Britain to leave the EU. They presented this as evidence that the Prime Minister did not seriously entertain the option of Brexit and, given his stance, would not be able to wring serious concessions from EU leaders. In fact, whatever Mr Cameron’s response to the question about Government preparations, he could not win. If he had said that contingency plans were well-advanced, he might have roused suspicions among EU heads of government that he was negotiating with them in bad faith. In the circumstances, he might well have felt it was not an issue on which he was obliged to be transparent. Probably, UK policymakers have given much thought to what they might have to do if the UK electorate were to reject continuing EU membership. It is hardly conceivable, for example, that officials at the Bank of England have not thought about the market implications of a vote for Brexit. Nevertheless, there can be no doubt that, should the UK decide in favour of a future which is independent of the EU, there will need to be intensive discussions between the UK Government and the EU authorities over the terms of separation.

Both sides in the referendum debate are presenting the case in black-and-white terms. Either the UK remains in the EU on whatever conditions Mr Cameron is able to secure, or there is a clean break between the UK and the EU, each going their separate ways. In fact, a Brexit vote would put the onus on the UK Government to state what it wished its future relations with EU member-states to be, and then to confer with EU authorities with a view to reaching new arrangements. The key question facing the UK would be whether to remain inside the European Economic Area (EEA) or to leave that also. This is not a question that will be presented to voters in the referendum but it might very well be crucial to how Brexit would work out in practice.

The fundamental point is that if the UK were to opt to stay in the EEA, alongside other non-EU members, Norway, Iceland and Liechtenstein, it would retain access to the EU’s internal market. To be sure, non-EU members of the EEA do not have a vote on changes to the internal market rules. However, according to the EEA Agreement, the EU is required to undertake extensive negotiations with non-EU members of the EEA before implementing any changes to those rules. A government that expected usually to be in a small minority in EU decision-making, under the ‘qualified majority voting’ regime, might see no practical difference, as far as trading relations with the EU were concerned, between participating in the EU and shifting to EEA status. The advantage in leaving the EU but staying in the EEA would be that the UK would take control of its own policies with respect to a wide
range of activities, including agriculture, fisheries, international trade, foreign relations, security, police and judicial matters. Leaving the EU but retaining EEA membership is popularly described as ‘the Norwegian model’. It might seem to offer the best of both worlds. However, there are substantial drawbacks to ‘the Norwegian model’ that might lead UK policymakers to prefer a different outcome, should Brexit be the people’s choice.

The UK government would be obliged under the EEA arrangements to make certain payments to support pan-European aims. The EEA is committed to financing policies to reduce social and economic disparities within Europe, which is also a goal of the EU though these EEA disbursements are not directed through the EU budget. The contributions of EEA member-states to financing this and other EEA expenditure are linked to the size of their respective GDPs. In the UK’s case, the payments would be substantial, though very likely much less than its current net contributions to the EU. Another problem is that the EU internal market, though supposedly the aspect of EU membership that the UK most highly values, has provided grounds for the UK government’s loudest calls for reform. The internal market is based on the so-called Four Freedoms, one of which is the freedom of movement of people. On the assumption that Mr Cameron secures some qualification of this freedom before putting the matter before the electorate, a Brexit vote would cast no light on whether EEA membership had also been rejected. After all, in such circumstances, voters could have voted against the UK’s participation in the internal market via the EEA as well as against EU membership.

The political campaign leading up to the referendum is most likely to see the Britain Stronger in Europe (BSE) group warning of the loss of trade with the EU if the UK leaves and the proponents of leaving the EU stressing the financial savings to be expected from Brexit. But, if the UK Government were to adopt ‘the Norwegian model’, the losses and gains might be nowhere near as large as protagonists on both sides claim. EEA participation might not be as advantageous to the UK as it is to Norway and Iceland, however. Those countries benefit from retaining national control over their policies with regard to fisheries, an important sector for both of them but now a very small segment of the UK economy. UK acquiescence in the free movement of people from the EU when there are doubts whether the EU has adequate control of its borders might well be a stumbling-block to the UK’s continued participation in the EEA.

A clean break with the EU would present more fundamental problems for UK negotiators. Chief among these, perhaps, would be the voiding of trade agreements with third countries. This trade is currently governed by treaties between those countries and the EU. If the UK were to leave the EU, there would no longer be any agreements to govern its international trade. The most elegant way of solving this problem would be for the UK to negotiate an inter-governmental agreement with the EU providing for existing EU trade treaties with third countries to continue to apply to the UK. Arriving at this outcome would depend on the EU’s goodwill but EU governments have an interest in maintaining friendly relations with the UK, not least for reasons of regional security. With a hostile power to the east of them, they would probably prefer not to have another hostile power offshore. The UK Government might, therefore, strengthen its case by undertaking to redeploy its military forces from far-flung operations in distant theatres of war to the defence of Europe. To avoid a shock to the EU budget, the UK might also agree to taper its payments to the EU.

As for trade between the UK and the remainder of the EU, a new set of treaties might need to be forged. But in most areas where trade is currently free, it might be uncontroversial to continue current arrangements and to embody them in a UK-EU treaty. The UK enjoys some protection from potentially discriminatory EU measures as a result of World Trade Organisation (WTO) rules that outlaw restrictions on trade. Similarly, in a situation where the UK imports far more than it exports to EU countries, these same rules would prevent the UK government from wielding the trade weapon in negotiations with Brussels. Possibly more to the point, to the extent that the current trade patterns optimise the balance of economic advantage in free markets, there would presumably be powerful private interests exerting pressure on both sides of the negotiating table in favour of a continuation of existing trade relations.

That would still leave the UK outside any future process of integration of the EU internal market.
Since the sector where that integration is less far advanced, namely, trade in services, is a vital concern for the UK, the UK government would be under pressure, in future, to engage in intensive negotiations with the EU authorities whenever new proposals emerged in Brussels or Frankfurt. It would be unlikely, though, and probably undesirable, for the UK and the EU to agree the final shape of the trade regime governing the provision of services during their negotiations over Brexit.

One important matter that would have to be settled, however, relates to the enforcement of legal judgments against powerful interests domiciled in third countries. It would be in the interests of an independent UK and of the EU, we may suppose, that such interests should not be able to play them off against each other, thereby rendering the public interest indefensible across Europe. In practical terms, this might be addressed by developing a set of rules common to the UK and the EU to regulate business practices throughout the region. This might give further reassurance to remaining EU member-states that the UK did not intend to use its independence to undermine EU nations' economies. To oversee these arrangements, a joint UK-EU body might be established by treaty. The final shape of the business regime, however, might well depend in large part on the fate of the proposed Transatlantic Trade and Investment Partnership (TTIP).

Relations with Ireland would present a special challenge to a post-Brexit UK. Fortunately, Ireland, like the UK, does not participate in the Schengen Agreement. As long as Ireland retained control of its borders, there would not necessarily be reason to change the present freedom of movement between Ireland and the UK. The problem is that, whatever the Dublin government has thought about 'ever closer union' across the EU, it has regarded common membership of the EU with the UK as pointing to the ever closer union of the Republic and Northern Ireland. With this hope irrevocably dashed by Brexit, the future of Ireland would be cast into doubt. The sensitivities are evident in the alignment of Northern Ireland political parties ahead of the referendum. The Democratic Unionist Party is supporting Brexit, while the SDLP and Alliance parties are campaigning for the UK to stay in the EU. Most significantly, Sinn Fein, which south of the border has been critical of the EU, has come out in support of the UK's continued EU membership.

Though the referendum campaign is likely to be waged on narrow economic issues, especially relating to trade and the movement of labour, there is much more at stake than that. A rational judgment on the advisability of Brexit would take full account of the benefits and risks of the UK's staying in the EU, and not merely the balance relating to leaving. After all, Mr Hague once likened the euro arrangements, at the EU's heart, to being trapped in a burning building with no exits. If that were right, it would not bode well for the EU's future, though Mr Hague seems to have woken from this nightmare vision recently. How the EU is likely to develop is, even so, an important question when considering whether the UK should remain inside.

Another key issue to consider is what impact Brexit would have on the EU's development (or decline). It would deliver at least a jolt to Continental ideas, owing to Hegel, of the inevitability of the historical process. Since it is not clear what tendencies the EU has been keeping in check, any weakening of confidence in the EU project could unleash negative forces from which the UK could not wholly insulate itself. These forces could, of course, predominate even if the UK remained in the EU. As an EU member, the UK might then be even more exposed to the negative fall-out than if it went its separate way. But, as with the 1975 referendum, when the price of butter became the key issue, the Brexit debate is unlikely to focus on these major historical questions.
“If you look back over the past centuries, there were a number of centuries where British common sense prevailed, and this was generally very positive. But if you look back over the last 50 years, British common sense has been neither as common nor as sensible as it was before.” Helmut Schmidt, 2013

Britain’s relationship with the EU and indeed Europe, has often been less than harmonious, though it would be wrong to describe it as antagonistic or outright confrontational; fluid and occasionally mercurial would be more appropriate. An important distinction to note, which many on the European continent find surprising, even baffling, is that the vast majority of the British do not identify themselves as being European, whereas even the Irish and Icelanders, while being proud of their national identities, consider themselves to be European. As Helmut Schmidt observed on many occasions, most recently in December 2011: “The history of the continent might well be regarded as a never-ending succession of struggles between the periphery and the centre and, vice versa, between the centre and the periphery.” Britain’s role in mediating many of the conflicts on the continent over the past four hundred years, whether to lean against imbalances of power and/or primarily motivated by self-interest, is more than well documented. Nevertheless it was Winston Churchill, who most aptly depicted the relationship with continental Europe in a 1938 newspaper article: “We are with Europe, but not of it. We are linked but not comprised. We are interested and associated, but not absorbed.”

It is worth recalling that, for all that the founding of the European Coal and Steel Community (ECSC) in 1951, and the European Economic Community (EEC) in 1957 were ostensibly about free trade and helping the economy of Europe, the aim of averting future wars and establishing a federal Europe were also clearly envisioned by the accompanying proposals for the European Defence Community (1950) and the European Political Community (1952). France was in fact as instrumental in ensuring that both of the latter proposals never got off the ground, just as it was in rejecting Britain’s applications to join the EEC in 1963 and 1967, on concerns about an ‘unacceptable loss of sovereignty’ and, in the case of the British application about Britain’s close economic and strategic ties with the USA and indeed the Commonwealth. One might add that the latter was predicated on de Gaulle’s ‘vision’ that France “give precedence to its interests, to ensure that the voice is heard, to make it respected, and to assure its survival”, and he clearly perceived Britain being a member of the EEC as a threat to that esprit de ‘grandeur’, in so far as the other members of the ‘founding six’ were either relatively small, or in absolutely no position to assert their national interests in the aftermath of World War II. It seems fair to observe that this effectively established “exceptionalism” as a key plank in the EEC’s and EU’s “modus operandi”, which has become very deeply rooted.

Be that as it may, the post World War II division of Europe, and Germany’s de facto position as a key locus of the ‘Cold War’ confrontation between East and West also dictated the need for détente, and pragmatic co-operation, with the US often playing a critical role in ‘mediating’ intra-European tensions,
as part of what was known as the ‘Pax Americana’. Even if that role was frequently resented at both a political and public level during that era. This may seem obvious, but such externalities were absolutely critical in achieving a veneer of cohesion and common purpose, just as much as their abeyance since the end of the ‘Cold War’, allied with a clear shift in emphasis in the focus of US foreign policy from Europe to Asia, and latterly the global financial crisis and ensuing Eurozone crisis has eroded that cohesion to the current critical juncture.

However it also has to be recognized that there were a number of decisions taken in the immediate aftermath of the collapse of the Soviet Union, in respect of the terms for German reunification, and above all the Maastricht and other EU reform treaties, as well as the moves to enable central and eastern European nations to eventually join the EU, which signalled and prompted a sharp shift to a much more technocratic EU, effectively superimposed upon its already cumbersome and externally opaque bureaucracy. Many of the decisions were born of the moment. A moment in which noble sentiments were (and typically always will be) expressed about solidarity, promoting peace and prosperity, improving the security of its people, and promoting a common framework for justice, human rights and democracy. But as with so much political rhetoric, it is both idealistic and utopian, often foundering on the rocks of reality, particularly when crises emerge. Indeed, such rhetoric effectively ignored the already obvious and deep divisions among then EU members over the Maastricht Treaty, which ultimately culminated in the unsurprising rejection of a new EU constitution in 2005, which left the 1990s narrative of “common European goals” and continental European solidarity in tatters.

The immediate question that Europe faces with regards to the UK's Brexit referendum is one that is not dissimilar to the one that has (and will continue to be) faced with keeping Greece in the Eurozone, at least at an existential level, what sort of precedent would a British exit from the EU set? Would it effectively establish a revolving door, which ultimately renders any discussion of any form of European identity as being redundant? Quite clearly, the context is very different to that of Greece. Britain is a creditor of the EU, and its geo-strategic position with respect to Europe has never been under any question whatsoever, and it is also very firmly anchored in many other European and western institutions. But the fact remains that 'Brexit' would set a precedent, and one which Germany above all stands to lose most from, in so far as Britain has very often been a key ally in leaning against demands and initiatives from the Mediterranean nations. This could prove to be critical in so far as Germany, or rather Frau Merkel and Herr Schäuble, have demonstrably been left isolated on a number of occasions during the Eurozone crisis.

But the loss of a key ally would not have as far reaching consequences as the precedent of exit, in so far as exit, whether enforced or voluntary, would then be ‘on the table’ as a crisis resolution mechanism, and could be wielded in a way that exceptionalism never has or could be. However whether this does or does not prove to be, it implicitly imputes a degree of causality on the 'Brexit' debate and referendum, despite the latter being symptomatic rather than causal. Crises are frequently cumulative in causal terms, and often due to the intended consequences of prior decisions upsetting an operating equilibrium (however deficient the latter might appear to be, above all with the wisdom of hindsight).

To make any assessment of where Europe’s future lies, one should probably revisit the rationale for some of the prior decisions and their intended goals, and examine whether they are relevant to Europe in the context of the world at the current juncture. The ever closer European union that was envisaged by de Gaulle and Adenauer, by Schmidt and d'Estaing, and even Kohl and Mitterand was premised above all on safeguarding the continent from war, and recognizing that both France and Germany would have to co-operate and work together at all times, whatever problems they might face, and acknowledging that neither country had outright leadership. It also has to be remembered that when the Maastricht Treaty was signed and the Single European Act came into force, the EU only had 12 members states, and per se there was a working assumption that the envisaged common currency (excluding Britain and Denmark) would operate in a similar way to the ERM (Exchange Rate Mechanism), of which Greece was notably not a member. The simple point in both cases is that they were fashioned “in” and
of” an era. in which the scars of two World Wars and the fact of the “Cold War” were very much at the forefront of political processes and public conscience. There was little realization that the ‘peace dividend’ would usher in a period of rapid technological advances, let alone globalization of the world economy and capital flows. Equally, the undestandable spirit of solidarity which ‘informed’ the decision to invite the newly ‘liberated’ countries of Central and Eastern Europe not only to join the EU, but also the Euro rode roughshod over the need to revisit and revise the economic and operational parameters for both. Meanwhile Germany faced little choice but to opt for a 1:1 conversion rate for Ost Marks to Deutsche Marks that would spell a very portracted period of economic and budgetary pain, though it is debatable whether a more favourable exchange rate might have saved money, but had rather more profound social order consequences. Be that as it may, the wisdom of hindsight, these acts of solidarity proved to be perhaps the seminal moment at which the indefatigable political will to drive European integration forward evaporated, as Germany dealt with the enormous challenges of reunification, and stasis took root elsewhere.

What ensued has been a long run of crises, most notably the failure of the EU constitution treaty in 2005 and most recently the Eurozone bail-out and refugee crises, which have highlighted both increasing divergence, in no small part due to a much too rapid and poorly planned expansion, as well as the colossal flaws in the system of governance for both the EU and latterly the Eurozone, which a now deep seated culture of exceptionalism has only served to exacerbate. The latter has, in turn, fuelled the all too observable rise of populist nationalism, borne on the wings of a failure to deliver the prosperity and opportunities that were promised and, above all, due to rising inequality. Against the backdrop of its adverse demographics and its prospective dwindling share of the global economy, the challenge that Europe faces, if it is not to become largely irrelevant in a world, is to break its obsession with establishing inflexible principles and procedures, which do little more than establish a stagnant, bureaucracic superstructure that serves none of its nations. If the post World War II consensus is not to prove to have been an aberration, Europe above all needs to re-establish the will to co-operate in the context and recognition of the plurality of its nations, and thus allow it to adapt to ever changing and evolving processes in the world as a whole. Skepticism is probably appropriate, as Helmut Schmidt observed in 2012, rather than more than optimism or pessimism.
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Even those who lack a chemistry degree are fully aware that a fire requires a certain environment in which to strive. If that environment does not exist, it makes the capacity to burn extremely challenging. Over the last decade, the metaphorical furnace at the heart of the UK steel industry has been struggling to burn – a notable change in environment alongside a global economic slowdown has starved the industry of its fierce heart.

The blame from Mittal, Tata, SSI and other steel producers is placed firmly on the Chinese market, which is pumping out cheaper steel at “below production prices” in a market where many are just happy to sell their steel for any income. Pair this scenario with a decline in demand and a shrinking global economy and you have an increasingly worrying situation forming for the steel industry in Europe. As the crisis deepens, many have commented that even the steel giants like Mittal may be forced to shut down plants in the US as well. The epidemic has started to filter into Europe, a favourite dumping ground for the Chinese steel exports. The most recent casualty is Arcelor Mittal who has mothballed its plant in Sestao by shutting its electric arc furnace.

Despite the struggles of the well-established industry leaders, there are opportunities to be seized and one such company is making a name for itself. Liberty House has been quietly gaining momentum. Whilst the spotlight has been on cutbacks and closures, Liberty have been quietly building up their balance sheet and snapping up assets.
Additionally, in a scenario where Britain leaves the EU, one would assume that the ability to cross-border trade would be rendered increasingly difficult and, as a result, the free flow of investment and goods would be hindered. However if Europe, as it is becoming ever more obvious, is the next victim of a steel crisis then it would seem disastrous to discourage – or even prohibit – the great work that companies such as Liberty have done on UK soil.

When there is a dearth of hope and optimism in both the UK and European steel markets, some would argue that the focus should be on unification rather than separation.

Late last year they re-opened the Newport Steel plant in the same week that Tata announced it would make 1,200 workers redundant at their plants in Scunthorpe and Lanarkshire. Liberty in fact purchased the Newport site in 2013 and maintained its workforce for 2 years whilst they carried out the necessary developments, a true testament to the Company’s investment and long-term belief in the steel industry in the UK.

Liberty offers a glimmer of hope with its enthusiastic stimulus which has evidently helped to prop up businesses in the UK. Their latest acquisition of Caparo Tubular Solutions demonstrates their desire to diversify within the steel industry and has been noted as “a major complement” to the Company’s hot rolled coil production, according to Chief Executive Sanjeev Gupta. Despite the obvious commercial benefits, Liberty’s purchase has again preserved precious jobs, totalling 333 this time.

There are those that believe the participation of Britain in Europe has, and will continue to, harm the steel industry on UK soil. This belief stems from the fact that cheap Chinese imports are flooding into the European market at a frightening pace.

This surplus of steel is the major contributing factor to the decline in the UK. Many believe that if the UK were in a position to prevent these imports then progress would be made to re-build and re-establish what was once the driving force behind UK industrial sector.
Traders will have been forgiven for thinking that the NY sugar market's recent collapse is because of a raft of bearish fundamental stories. Odd given that prices had rallied from 11.28 in August to 15.85 in early December on production deficit talk for the coming season after 5 years of surpluses. Chuck in concerns over El Nino, economic mayhem in Brazil and it appeared to be a recipe for even higher prices. So why, two months later, do we find prices at their lowest level since the beginning of October last year and some 18% off the highs? 'It’s the macro' is the resounding cry from the side-lines. Strong US dollar, weak commodity currencies (especially Brazilian real) weakest crude prices in over a decade and frail Chinese demand for commodities are all reasons for the frighteningly weak macro picture seen since the beginning of the year. Others cry 'It’s the technicals'. The technical picture recently turned negative after several months of signalling higher prices.

So this begs the question – what impact do fundamentals have on price if any? The answer is, surely, yes. Fundamentals must have a huge impact on price. However, their influence has always been medium to long term. But, nowadays, the big volume is generated by the short term funds/speculators, HFT, and algorithmic traders. They care little for the underlying commodity and even less for the fundamentals. Their trading strategies are based on technical and macro considerations with some holding positions for milliseconds
while others for no more than a trading session.

Many of the large funds exclusively trade using technicals. Technical trading systems work well for multi-contract funds whereas fundamental based systems have to be very much tailor-made for each contract.

Many a hedger has cursed the funds for exaggerating moves and causing undue volatility. However, commercial traders also realise that the funds/speculators are essential for the markets. It has often been said that for every hedge trade there is a speculators on the other side. Who would buy when producers want to sell? Who would sell when end destination want to buy? In the last quarter of last year, prices rallied from multi-year lows as the funds reversed their net short position of around 65k lots to go long of around 200k lots by year end. As prices improved, producers took advantage and sold heavily. Conversely, as the funds have aggressively cut longs recently, end-destination has been predominant buyers.

It may seem odd to many that fundamentals, the vital supply and demand of a commodity, do not have much more of a daily influence on prices. For many in the investment fraternity, fundamentals are too arbitrary and uncertain. Often a piece of fundamental news will be seen by some as bullish but by others as neutral or even bearish. Over time fundamentals can change. Weather is a classic example. When does dry weather become a drought or just an insignificant period of dry weather? Too much uncertainty. There is no confusion with technical considerations. A technical signal is either bullish or bearish. Whether the market reacts to the signal is a different story! However, ultimately, fundamentals will always prevail not least because the NY sugar contract is deliverable. Futures will equal physical values by expiry. Too high and no one will want to take delivery too low and traders will not deliver. But before expiry, whatever the prevailing price, it is the most true and transparent value at the time with all the very different information having been taken into consideration.
Earlier this month I had to undergo a couple of psychometric tests for a course I am doing. As the organiser was discussing the results, he shifted one seat away from me. I am hoping this was not because the results presented me as a psychopathic axe murderer but assumed it was more due to my enjoyment of a chilli garlic chicken the night before. I mention this frivolity because my most extreme reading on the test was an ‘emotional’ one. In trying to explain this – apart from the obvious, that I do blub after my fourth gin and tonic – he was interested that I had found a lot of the multiple choice questions similar to what my interpretation of market moves might be.

Questions like, do you view yourself as empathetic or theoretic? Like a distressed dog, there are a lot of ‘tics’ in that question but it is similar to asking how one interprets market moves. This was totally relevant to how, in January, the downturn in equities has been resolved.

A client forwarded me a piece by Howard Marks, which was a stern warning to not assume markets know more than you. The market is, after all, just a collection of individuals. It was, in essence, a solid ‘the market is not efficient’ summary. On this I agreed but I also had to assume that Mr Marks’ marks (a play on words there!), on his psychometric test, would not have had as excellent emotional readings as myself!

Most market participants naturally assume that markets are instant gauges of news, whereas in reality they are gauges of flow and positioning. We can combine this presently with the obvious tenet that no investor likes to be told when and why they got it wrong – rule one of stockbroking. So the press and the analytical community rally round on any market correction (not on any equivalent rise) to explain what has occurred and that no-one could have possibly been expected to have seen it coming. By only concentrating on recent ‘black swanish’ moves, investors feel they are exempt from any blame, even though, in truth, the detrimental moves were glaringly obvious. No-one likes to be seen as a ‘smart Alec’ and in a tense loss making environment, there is no point at all in suggesting what has occurred was pretty logical and happened many months before and therefore losses could have been avoided, because it is not that easy. It is more comforting though to huddle into a crowd.
and all suggest it was impossible to have pre-empted such moves. By doing so, however, and still not grasping the rudimentary reasons for the moves, avoiding them in future becomes even less likely. I mention this because I have scoured the newspapers over the last couple of weeks and found minimal mention of QE. Lots of China, lots of EM, lots of Oil, No QE. There might be other reasons for the ‘turmoil’ but it can be no coincidence that every curtailment of QE (1, 2 and 3) has been followed by sell-offs and, in the immediate aftermath, no-one has identified the event and the cause. Every two-bit prop trader wants to know when a large buy order finishes in a stock so he can sell the last chunk but perversely no-one seemed willing to sell the top of the market when a trillion $ buy order (QE) had finished and was announced as such. Three occasions, all identical. At the same time, the ECB’s QE programme was revealed to be ineffective in terms of the central bank’s inability to execute the buyback, with such low rates and illiquid markets. The signs at the top were blatant (terrible breadth, total lack of hedging, apathetic sentiment etc) but no one indicator more blatant than the end of an enormous QE buying programme. We can now see the outcome. In two weeks of January, we achieved what the induced fervour of QE3 took months and years to put on.

If, after 2008, you had been told where global debt levels would be now, you would not have believed it. Corporate borrowers had $4 trillion of debt in 2004 and now have $14 trillion of debt. We have had 8 years to clean it up but look as though we will have to try to expand it again.

Mr Marks (wouldn’t it be lovely to call your son Pass or Top…or even Spencer) surmised that markets don’t trigger events: “It seems clear to me: the market does not have above average insight, but it often is above average in emotionality. Thus we shouldn’t follow its dictates” …however this importantly omits the modern-day derivative influences and the domino effects. As the market’s butterflies flap their wings, they cause unwinding to occur in other markets and asset classes. Greece, for instance, would have had no problems if the market had not forced its interest rates up to a level where it did.

Recently, I put out a story from Hong Kong about a massive $40bln derivative position that had been triggering a lot of forced selling in the HSCEI. Retail investors had been sold a structure that meant they were leveraged losers below the 8000 level. Forced selling drilled the market lower, down to 7825, before it could manufacture a bounce. Earlier in the same week, I highlighted a similar put position that was triggering in the SX7E (the banking sector ETF); “a very big buyer of December 2016 110 puts over Xmas and New Year, such that there is 200 k OI now …. on a delta of one this would be 1.1 billion euros of stock ...as we pass through the strike, I am sure the gamma must enforce some selling to re-hedge by the shorts ...adding further pressure”. Both these are relatively small isolated examples of how the domino effect created by market moves push further than it should, consequently causing greater stresses that could plunge individuals and institutions closer to default.

The ability of the dollar to strengthen allowed other currencies to weaken. Of course this has since then run out of control, as commodities have collapsed, ironically partly on the strength of the dollar. From what was a benign market-friendly momentum scenario, we have moved into an EM debt trap again. At the same time that QE was curtailed, the strength of the dollar had been well ‘fingered’ as the criminal factor in slower US corporate earnings growth and a stagnant growth of the US economy. That was the first alarm bell to currency devaluations not being a balanced economic weapon to use in the absence of any others. QE in itself had not meanwhile created the growth panacea that it was meant to do; it had simply unbalanced the market positioning and risk profile.

I liked the fact I had a strong emotional reading in my test. Perhaps it makes reading greed and fear, supply and demand, and even derivative nuances more easily; perhaps it just means I am more suited to a career in Art but what might start as short-term emotional triggers, can easily roll into medium and longer-term economic problems, especially when central banks become beholden to markets. This is when emotion moves over into fundamental annotation and this is the element I felt Howard Marks, in his excellent piece, missed.
THE US CHOOSES

The 2016 US presidential campaign moved into higher gear on 1 February as the Iowa caucuses marked the opening of the state primaries season. Casual observers of the US political scene could be forgiven for thinking that the process of choosing a successor to Mr Obama had been well under way already; potential candidates had been on the stump since last summer. But the serious business of collecting delegates to the party conventions only begins this month. So far, the political debate has revolved not, as in some previous elections, around the specifics of competing policies but more around values, ideologies and personal qualities (or the lack of them). What has emerged in the course of the campaign is that US voters are disenchanted with Washington politics – nothing new there - but also feel a deeper malaise, a sense that the USA is heading in the wrong directions politically, economically and, above all, socially. This sentiment has favoured non-standard candidates, on the Republican side, Mr Trump and, earlier, Mr Carson, and on the Democratic side, Mr Sanders. A few months ago, the GOP mainstream feared the nomination of Mr Trump as their candidate, thinking he would be too extreme for most US voters. Now, many Republican leaders seem to regard the maverick billionaire as offering the best chance of winning the White House, so well does he appear to capture and express the public mood.

Popular rejection of the status quo is not a phenomenon evident only in the USA, of course. Over the past two or three years, it has been a potent element in the politics of many European states also. Its causes are not too difficult to fathom. For years there has been a widening gap in the advanced economies between the real value of median earnings and the incomes and wealth of the top percentiles of the population. This growing chasm reflects the shift in the balance of returns, as between labour and capital, since around 1990. The process of globalisation of production has tended to depress returns to labour in the advanced economies. At the same time, technological developments have benefited disproportionately those with the capital to exploit them and have displaced labour. The humanist secular ideology that leading political circles in these economies have peddled has not been sufficiently appealing to the masses, on an emotional level, to compensate them for the material losses they feel they are suffering. But, at least until 2008, the new economic
and political order appeared to work smoothly. The global financial crisis and its aftermath have raised doubts about not only its social justice but also its sustainability. At a time of accelerating change, politically, economically, technologically and, above all, in social values, the financial markets, fixated as they are on the day-to-day actions of the central banks, are not paying much attention to the investment implications of these broader historical forces.

This is why the US election campaign is important for the markets. It is likely to focus attention on how far and how rapidly the world is changing. If Mr Trump, fresh from his New Hampshire triumph, continues to set the pace, investors may well have to take seriously a scenario in which he enters the White House. A much longer shot would be Mr Sanders, with his 'socialist' agenda, emerging victorious at the end. The best hope for those who would like the world to revolve, much as it has for years past, is an ultimate Clinton victory. The chance of such an outcome is far from negligible but is certainly not assured. Ms Clinton has headed other Democratic candidates by wide margins in opinion polls, until very recently. Latterly, there seems to have been a swing in support behind Mr Sanders. The danger for her is that her campaign might splutter and fade, after initial setbacks, as it did in similar circumstances in 2008. The next few weeks could, therefore, be decisive from a world-historical viewpoint.

Following the state-by-state progress of the primaries is testing for the non-specialist. The first point to note is that there are no general rules governing the selection of state delegates to the two parties' national conventions, at which their respective presidential candidates will eventually be chosen. Each state party sets its own rules, sometimes within overall guidelines established centrally. Some state parties hold caucuses while others stage primaries. The difference lies in the method of selection. In a primary, voters register their preference at polling-places, as in an election. With a caucus, delegates are chosen at meetings held in each precinct within a state. Consequently, the caucus process is open to stronger influence from the state party organisation than a primary would be. There are also differences in the rules regarding who is eligible to take part in the selection of delegates. Some state parties restrict the process to those who are affiliated to the party. Others hold completely open votes, in which any registered voter may participate, regardless of his (or her) own party affiliation. Yet others opt for semi-open voting in which both party affiliates and independent registered voters may take part but from which supporters of the opposing party are excluded. Any individual, though, may only cast a vote in one party's primary or caucus. There are a few states where voting is not for the presidential contenders themselves but for delegates to attend a state convention; such delegates are not always bound to vote for any particular candidate.

On the Republican side, states have their own rules on whether delegates are chosen and bound to presidential contenders in proportion to the votes cast in caucuses or primaries, or whether the winner of the popular vote takes all the delegates. There are also complicated hybrid rules for allocating delegates to contenders, whereby some are chosen by one method while others are selected on a different criterion. Where proportional selection is involved, there are differences between states on whether or not a minimum proportion of votes cast is needed to qualify for an allocation of delegates and, where a minimum is specified, what that proportion is. On the Democratic side, the rules are rather simpler. All allocations of delegates, either on the basis of votes in congressional districts or state-wide, are proportionally-based, with a 15% cut-off to qualify. For both the Republicans and the Democrats the rules governing the number of delegates each state sends to the respective national conventions are complex but are related, among other factors, to the number of votes cast in each state at the preceding presidential election (or elections) for that party's candidate.

The rules governing Iowa's Republican caucuses, historically, have been so arcane as to have prompted calls from some party leaders to deprive that state of the honour of standing first in the calendar. In response, the state party simplified the procedure for the 2016 voting. Since, previously, delegates elected at the caucuses in the precincts did not need to declare which candidate they preferred, it was not always clear what the outcome had been. Indeed, in 2012, of the votes cast at precinct level, Mr Romney was initially declared to have won the largest proportion though, on subsequent recount, the result was reversed in Mr Santorum's favour. The results from eight precincts went missing. In the
event, though this result had some influence on the national campaign, it had no bearing on the delegates Iowa sent to the national convention. Because the delegates chosen at the caucuses were not pledged to any candidate, the subsequent state convention was free to vote heavily in favour of a third candidate, Mr Ron Paul, who received 22 of Iowa’s allocation of 28 delegates to the national convention. It was because this outcome was not regarded as an entirely fair reflection of the opinion of Republicans in Iowa that the rules were changed for this year’s election. This time, delegates chosen in the precincts were bound to support specific candidates. For the Republicans, the caucuses were ‘closed’, that is, restricted to party affiliates. Voting was proportional with no lower threshold. The rules relating to the Democratic caucuses in Iowa were even more complicated than those of the Republicans. There was no voting but rather intensive debate at precinct meetings between supporters of the various candidates, from which delegates to county conventions were then selected. Given the peculiarities of the Iowa caucuses, their results are unlikely to be indicative of the final outcome at national level.

In the New Hampshire primary on 9 February, Republican delegates were elected on a proportional basis, with a 10% minimum in order to qualify. For both parties, eligibility to vote was semi-closed, that is, registered voters of the opposing party were excluded. New Hampshire is a far from typical state though. While Mr Trump and Mr Sanders are celebrating their victories, the results do not extinguish the hopes of other candidates. Most of those still standing will probably press on, funds permitting, at least a little further into the primaries season.

The next important events will be the primaries in South Carolina, a mid-sized state, (20 February for the Republicans and 27 February for the Democrats) and the caucuses in Nevada (20 February for the Democrats and 23 February for the Republicans). The Nevada caucuses are ‘closed’; the Republicans will award delegates on a proportional basis with no lower threshold. The South Carolina primaries are both ‘open’ and may therefore provide a pointer to the strength of Mr Trump’s cross-party support. The Republican vote is conducted on a winner-takes-all basis, giving a successful candidate a chance to take a small lead in the race to the nominating convention. Much more significant, however, will be the 1 March primaries and caucuses, the so-called ‘Super Tuesday’, when Republicans in fourteen states and Democrats in eleven (both including Texas) will establish their preferences.

The ‘Super Tuesday’ results are very likely to whittle down the Republican candidates to three or four from the nine who are currently still in contention. For the Democrats, Ms Clinton will be looking for a strong showing, seeing that several of the states in this round of primaries are in the South, where she enjoys relatively solid support. Even after ‘Super Tuesday’, only 25% of pledged delegates to attend the Democratic National Convention and 33% of those to the Republican National Convention (to be held respectively during the week of 25 July and on 18-21 July) will have been chosen. Also attending the conventions will be ‘unpledged’ delegates or so-called ‘superdelegates’. These are, in large part, elected office-holders and party officials. For the Republicans, there are generally three ‘unpledged’ delegates for each state, comprising the party’s state chairman and two committee-members. Though ‘unpledged’, they are supposed to reflect opinion in their states. They make up less than 7% of the total number of delegates to the convention. On the Democratic side, the ‘superdelegates’ are rather more significant, since they include members of the Democratic National Committee and Democratic members of Congress and State Governors. They make up about 15% of the convention delegates. Surveys suggest that almost half of these have already decided they favour Ms Clinton, which is a source of encouragement to her campaign, though allegiances could shift before July.

The signs are that politics will be a dominant influence on financial markets as 2016 progresses. At the moment, the spotlight is on Ms Merkel’s problems and the fate of the EU. However, markets could well be distracted in the months ahead as the US primaries focus attention on the historic challenges confronting the world’s largest economy. The issues at stake are more fundamental, perhaps, than in any presidential election since 1932.
For grains, 2016 looks as 2015 ended. There is too much supply and not enough demand to lower ending stocks significantly. Higher US dollar could reduce the demand for US exports. 2015 was an El Nino global weather year. This was good from crops in US, EU, FSU and South America. There were lower crops in South Africa and India and there is some concern about crops in SE Asia. Eventually, El Nino should weaken in 2016. Key is when.

Early change to neutral could suggest drier than normal weather across parts of the US Midwest. Globally, 2016 looks mostly normal especially in EU, FSU and China. (see map). Dryness could be seen in US south plains, parts of Argentina, NW Africa and west Australia. Early indications suggest US farmer may plant the same amount or a little more corn and soybean acres in 2016 than 2015 and fewer wheat acres. Globally, world protein demand should increase which could lower world soybean end stocks. World corn supply could increase more than demand which could increase end stocks. World wheat production could drop which could lower end stocks from current record high levels.

2016 weather will be different for many areas relative to that of last year. Wetter-biased conditions are expected this year in Southeast Asia, Europe and the Western CIS and Northern South America. The drier biased areas will be in Argentina, the Southern US plains, North Western Africa, Eastern Spain, South Africa and possibly Western Australia (later in the winter and early spring seasons).
Just over a year ago, three men in Zurich set off a bomb. It was a huge bomb. It immediately affected all in Switzerland and also knocked out entities around the world. Fallout was immense and victims still suffer in countries as far from Switzerland as Croatia and Poland. Yet there was no giant explosion in Zurich (where it happened) and no direct deaths at the time. Even today the Bahnhofstrasse looks and sounds fine with trams still trundling. This was a financial explosion the like of which hadn't been seen in Europe since Black Wednesday in 1992. The three man Governing Board of the Swiss National Bank had pulled their long term support of the EURCHF at 1.2000 and stepped away from the FX Market detonating the SNBomb. Shortly after the event, I wrote in GITM a more or less timed blow-by-blow account of what had occurred in the Swiss Franc FX market following SNB's exit. Now I'd like to tell you what I think may or may not have been learnt since then starting with where we are now.

What's changed...just stick to FX rather than wider issues? Well, for a start, there are fewer FX Prime Brokers. Why would you - as a bank with pressure on capital, constant regulatory headaches plus ‘Fixing’ scandals and ‘Last Look’ issues in FX – why would a FX bank use precious capital in a business that may wipe out a decade or more income in a day? There are also fewer Retail Brokers and many are still recovering from the haemorrhaging they received then. Spreads and margins have widened...and come back in a bit, there's nothing like shutting the stable door after the horse has exploded...won't happen again of course (???).

What hasn't changed...again, just in FX? Those three are still there – the Governing Council of the SNB. Swiss Franc depo rates are still negative though not as much as following the SNBomb though still more negative than 2014. EURCHF itself is currently around 1.0975 some 0.1025 below the old peg. Elsewhere, FX codes of conduct are still being debated, ‘Last Look’ is still here and overall the FX Market is still with us.

So – what’ve we learnt? I’ve pondered, seen, crossed my desk or otherwise generally thought about this and here is my short list.

Pegs...don't work. My first close up of a peg that didn't work was in another market. It was the Tin Crisis of 1986 and it scared the living daylights. At the time I not only thought ‘...I may not have a job...’
Don’t trust Central Bankers. Central Bankers are nice people, I’ve met many and they’re perfectly reasonable, it’s just in handling FX Markets they range from obtuse, through naïve to incompetents. As Economists they’re wonderful but frankly when it comes to the real visceral world of FX trading, I wonder sometimes whether they should be allowed out alone or into cutlery drawers. As previously said – the three CBs of the Governing Council are still there. On the anniversary eve of the SNBomb detonation, UNIA – the biggest Swiss trade union appealed for them to resign as their ‘...decision had choked the economy and already destroyed 10,000 jobs.’ But no - they’re still there.

Where were your mates? Really, where were your mates? You as the SNB, came to pick a fight with the biggest market (yes...FX) in the world and you came alone? Forget your mutual swap lines with other CBs, where were your mates? Where was the ECB, the Fed, the Old Lady and the rest...? Never, ever, EVER...come to pick a fight with the FX markets unless you arrive mob handed. That’s a lesson for all CBs. Work together through true multi-level cooperation with no egos...otherwise the market will take appropriate measures.

Retail fade...no! Along with many others, I worried the big recent growth area in FX, Retail FX, was mortally wounded from the detonation that the SNB had ‘...poisoned the well for a generation...’ However, happy to say Retail FX is more resilient than I’d imagined. Though turnover is off, Retail FX is still a major market element...thankfully.

No one goes to jail. Relates to my point above. I’m reminded of a line from the film National Treasure. The Harvey Keitel character says to the Nicholas Cage character (Ben) ‘Someone's gotta go to prison, Ben’. Only here no one has! If public service in a Central Bank was as another public service...say the military, then perhaps military discipline would help. This refers to the Swiss tradition of all adult males being in the military until I believe 40.

Too many things with the letter ‘L’. Too much Leverage from brokers and banks that ought to have known better. Too much reliance on Liquidity that really didn’t exist but was being recycled again and again. Too much Last Look with too much reliance by banks and brokers when not appropriate and now too many Lawyers involved in Litigation. Yes – the industry should have Learned from the past. I’d add the Law of Unintended Consequences. Farmers in Poland, Croatia and wherever suddenly find their Swiss Franc mortgages a crippling burden...to be honest, they also ought to have known better as well – something for nothing... really.

The FX Market doesn’t always work. For many, many minutes back then, the CHF FX Market was not fit for purpose. It ceased to exist! We now know that stops...they do not always work, nor did some FX platforms and nor did some brokers. Conflicts of interest happen; systems break down or are deliberately mangled to cover inadequacies...no...it doesn’t always work. WE need to do better.

Hindsight’s a wonderful thing so I’ll finish with this. I’m basically an optimist. I wake up knowing mostly how stupid the world is and I still get up and at it each day. So I say as an optimist – this will happen again - sometime. Somewhere, a CB will be convinced to set up a peg, maybe as part of Brexit if it occurs, a peg the FX Market will crush. I’m just hoping optimistically it will be later...much later.
JPM Global FX Volatility Index

This brings us to another momentous event right at the end of the year. Or was it? Did the Fed hike to save face after backing themselves into a corner OR is the Fed action the first sign that CBs concede that monetary policy, conventional or otherwise, is having little impact on the economy and that inflation targeting in its present form is redundant? The Fed have raised rates while their best measure of core inflation runs well below target. But more than that, they see little increase in 2016 in that inflation measure and yet would “still” raise rates another four times. That’s what “gradual” looks like. I think the Fed’s confidence in the economy and what they feel QE has allowed them to do is misplaced. I also believe that if you promise still low inflation you risk a liquidity trap - therefore how can you forecast another four rate rises? Best estimates for the U.S. economy are for slightly weaker growth and still low inflation. The inference from the Fed though, if it was a momentous policy decision, is that they are done and that fixing the global economy takes more than monetary policy, asset inflation or currency devaluations. We have had that and it hasn’t worked. The implications for other CBs and governments is most profound. I’m thinking of the BOJ and Mr Abe and the ECB and the EU leaders. What is required are structural reforms such as increased immigration (yes Mrs Merkel, take note Mr Cameron and Mr Abe), root and branch labour reforms in stagnant countries (take note Mr Hollande) and borrowing and spending by those governments who can afford it (take note Mrs Merkel). Without these policies the world will be stuck at zero rates for a very long time and the widow maker will stalk all the rich world and not just Japan.

Source: Bloomberg

You can take from the above that currency volatility will be a key asset class this year and getting the currency right will not be easy.... making forecasting, as I said in my opening line, dangerous. As U.S. fund managers hold most of the money these days, it probably means getting the dollar right. Whether that concentration of capital is right and whether it’s being put to good use is a moot point but it remains a fact. As I mentioned earlier, we have a U.S. Election this year. Some real nutters on the Republican side. If the Fed are wrong and the economy dips again we could get Trump or Cruz with their wild and wacky policies of no immigration or taking us back to the gold standard. Ms Clinton would be favourite against either but not a favourite with the markets.
Indeed, Healthcare, a long time income fund favourite both in the US and in Europe, could be vulnerable to any policy action on pricing. Clinton has already outlined how she will tax the wealthy in a presentation last month suggesting that the Buffet tax would be the minimum threshold for the tax treatment of wealthy individuals. Brexit will also be on the agenda as Mr Cameron lurches and stumbles towards his resignation. The fact that we have three simultaneous “NO” campaigns should count against their chances but such is the growing mess in Europe, with the distinct possibility of a government collapse in Germany, that the referendum pitches will be made against the background of a Europe in turmoil. Yes, currencies will be key, and one consensus seems to be building - a strengthening YEN. Are the BOJ done? JPM see the Yen at 115 by March. Our Mr Lewis sees another snap election in the lower house this year. Mr Abe will have to start delivering on his third arrow if the BOJ are out of ammo. Recent developments would suggest that action from the BOJ at the end of January is a close call. Another peg under pressure is the Riyal and another currency to focus on is the Riyal. The budget delivered in December caused another weakening of forward rates as the Saudis cut subsidies on petrol and utilities in order to address a rising deficit. The Saudis are burning through their FX reserves and the cost of keeping the peg is becoming very expensive. A devaluation could be bad for oil but a change of policy within OPEC could be the eventual outcome. The market will take that positively initially but I just wonder how much influence OPEC now has over world oil prices. It will again be up to them, and up to them alone, to cut aggressively to effect a large price rise. The oil market has moved on. Despite its promise of reform, Saudi Arabia has not. There will have to be a revolution in Saudi Arabia before the regime (or what is left) embrace the kind of reforms that are needed that will divert the country’s fortunes away from its dependence on oil. Crown Prince Mohammed Bin Salman, the young gun, who is effectively running the administration now, is inexperienced and hot headed, plenty of room for policy errors.

The world and his wife keep saying that the US is not going into a recession. It’s just oil? Isn’t it? The yield curve is too steep? Well I’m not sure. I believe the lower oil price is a disease that is now starting to infect general investment plans in the US. The last two manufacturing PMIs have been below the 50.0 level. It’s not recessionary yet but the direction of travel is worrying and with the FED in tightening mode a cushioning policy response looks unlikely – they have little room anyway. I would keep an eye on other recession signals in the U.S. I track IYT/ XLU and XLY/XLP and they are both through key support.

Many commentator’s forecasts for 2016 are already in shreds. It was always going to be a difficult assignment but an even more perilous exercise this year. If we just look back to the historic events of the tail end of last year it would seem very brave, some would say churlish, to make a stab at predicting the likely path of asset classes this year. It’s pretty clear that the Chinese have broken their peg to the USD. This is a momentous event. Late last year markets appeared happy with the pace of decline in the Yuan (I don’t know why) against the USD but in January that apathy was smashed. There is a genuine fear that the Yuan could slip anchor and spark another round of currency devaluations in Asia and a deep recession in China and Asia as a whole. The Chinese authorities themselves have tried to calm fears over this outcome but I have heard from more than one source that the Chinese New Year could be the time when a large devaluation is undertaken. There are a number of reasons why the Chinese would not embark on such a policy, not least of which is the cost incurred on some companies who have borrowed in USD. AND would they want to irk the US in an election year and impact on the result. But if nothing else, volatility is back in CNH. Volatility generally should be higher in Global FX. The Chinese currency de-peg is a momentous development AND still under-priced.

One stock I would take a look at early doors this year is CCL.L. It has become a proxy for the...
Chinese service sector. Record earnings on 18th December have propelled the stock to new highs and for good reason. It seems that the Chinese have a passion for cruising and CCL are steaming full ahead towards meeting that demand. Indeed they recently moved their COO, Alan Buckelew, to Shanghai to oversee their expansion. The Chinese, government are also keen to promote the business as part of a rebalancing of the economy. The Chinese, it seems, also spend a lot more on board, they are big gamblers and big purchasers of gifts.

I have seen some upside interest in options in the U.S. recently and it does look a good story but the rest of the world is weak, for example, British cruise numbers have been in decline since 2013, and it remains a bet that China’s slowdown does not intensify or that the cruise bug is not a mere fad. But as the next three months are the busiest for bookings (3rd of all sea holidays will be booked) this stock could run further. These are probably good levels after January’s plunge.

2015 may have been a laboured year in terms of returns but may prove to have been a momentous year in terms of the shifting in some of the tectonic plates of policy regimes and currency unions. 2016 will likely bear witness to the volatility earthquakes to come.

Until next time.
The Ghost in The Machine

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UNITED KINGDOM

Heavy flooding in the North of the UK matched the mood surrounding potential Brexit as support for staying within the EU appeared to wane. This weighed further on GBP. The Government pledged an extra £1.2bn for new housing; in addition to the £2.3bn announced in the Autumn Statement. UK Government finances thus far have been disappointing with the market keen to see the January figures (due 19 February), where a very large surplus will be required in order to get back on track for the OBR borrowing target of £73.5bn for the fiscal year (currently £74.19bn). Without the reclassification of housing association finances from private to public, the borrowing target would have been £4.6bn tighter. Consumer credit increased to the highest levels seen since early 2008 and lending secured on dwellings also grew rapidly at £3.9bn. The trend for both remains clearly to the upside. New car registrations increased 8.4% YoY vs. 3.8% in November. PMIs showed the services sector in the UK remained robust, while manufacturing continued to struggle.

The DMO auctioned £3bn UKT 2% 2025 for a 1.62x cover at 1.88% on Tuesday 5. Thursday’s £1.5bn UKT 4% 2060 was not so well received, with a 1.25x cover at 2.33%. We think this lack of interest was due to flight to quality flows driving yields down too far (to 2.32% from 2.50% end-2015) ahead of the supply. The FTSE All-Share Dividend Yield at 3.89% vs. Linker 2044s at -0.73% made for nigh-on the worst terms ever to switch equities into bonds, dropping 461bps.

Toyota added to Brexit chatter on Tuesday 12 with reassurance of its commitment to UK manufacturing operations in the event of any exit from the EU. Cable dropped from 1.45 to 1.425 on the week (with the trade-weighted sterling index falling from 89.3 to 87.8 confirming underlying weakness) on the Brexit concern and the BoE cutting its 4Q15 and 1Q16 GDP estimates (-0.1ppt to +0.5% est. for both periods). The near term CPI trajectory was also expected to be weaker. There was no change to base rate at Thursday’s meeting with an 8-1 majority. On Friday 15 it was reported that residential rental prices increased faster than wages – for 2015 the average rental price increased 3.8% while wages improved just 1.9%. The DMO auctioned £900mn UKT 0.125% 2046 on Tuesday 12.
Inflation figures out Tuesday 19 were slightly tighter than expected. Market reaction was tempered, however, when Mark Carney stated that now was not the time to raise interest rates, damping expectations for rate lift-off in 2016 and sending GBP lower. By the end of the week sterling had recovered its loss, rebounding from a 1.408 low which is very close to a key long-term technical support level of 1.40 – in technical terms there is little chart support below this until 1.20. It was reported on Thursday that many homes across England can expect a 4% increase in council tax – there are also calls for an end to the council rate freeze in Scotland. In this inflationary regard we also note the recent rise of the JoC Industrial Commodity Price Index when rebased in GBP, a product of sterling’s decline.

The DMO came close to its first failed auction in many years on Wednesday 20 after attracting just a 1.07x cover with a 4.2bps tail at its 5yr auction. In redemptions, a short £33bn UKT 2% 01/16 matured on the 22, £8.4bn of which was held by the BoE; these proceeds were set to be reinvested the week beginning 25 Jan and 1 Feb via the Asset Purchase Facility (£1.4bn each auction, six auctions total).

MPC member Kristin Forbes spoke on Monday 25, saying that she would like to see wage and labour cost data pick up further before any rate increase. Carney reiterated on Tuesday 26 that “conditions [are] not yet in place for a rate increase”. Chancellor George Osborne announced on Thursday 28 that he was postponing the final sale of the government’s stake in Lloyds Banking Group, scheduled for Spring 2016, stating that “now is not the right time”. The BoE buyback of >15yr Gilts on Tuesday 26th was covered just 1.29x, with that part of the curve remaining well-supported for the remainder of the week/month. Gilt futures gapped up on the open every day this week and on each occasion eased back to fill. The exception was Friday where the market held on to a large part of its gain, assisted by end of month flows and the BoJ policy decision. It was announced on Friday 29th that Societe Generale will cease to act as a GEMM with effect from February 5th citing regulatory change as the reason. This leaves sixteen wholesale GEMMs.

UNITED STATES

Countering some who considered December’s rate rise to have been a close call given soft inflation, the FOMC Minutes on Wednesday 6 revealed that gradual tightening was agreed with the expectation that the labour market would continue to grow, moving beyond full employment with higher wages and solid consumer spending. Fed speak throughout the week toed this line and was reinforced on Friday 8th with a positive US labour report which included a strong revision to the previous month’s non-farm payrolls. Average hourly earnings came in below market expectation, but remain on an upward trend.

The New York Fed on Monday 11 released its December Survey of Consumer Expectations. The December monthly budget statement released on Wednesday 13 showed a larger deficit than forecast at $14.4bn vs. $10.0bn, where receipts increased 4.3% YoY while outlays increased 9.2% YoY. Later on Wednesday, January’s Beige Book reported that growth was still modest with signs of wider wage pressure. Services were deemed strong while manufacturing and agriculture were weak. December retail sales out Friday 15 came in softer than forecast due to weakness in gasoline, clothing and auto sales.

The drought in corporate debt issuance, which came to define the month, was quenched briefly on Wednesday 13 as Anheuser-Busch kicked off the first round of a jumbo supply programme following its acquisition of SABMiller. The most significant issuance of the year so far raised a total of $46bn across seven tranches of senior unsecured debt, attracting combined orders in excess of $110bn. The Fed auctioned 3s, 10s and 30s that were all received well.
A holiday-shortened (Martin Luther King Day Monday 18) week saw the US Congressional Budget Office release its Budget and Economic Outlook Summary on the 19, the same day as the IMF World Economic Outlook (covered later in this publication). The CBO forecasts a jump in the US budget deficit this year ($544bn est. vs $438.9bn 2015), ballooning out to $1.4tn by 2026 if no remedial measures are undertaken. On the US economy, it expects solid expansion in the next two years, with the ebbing “slack” in the economy expected to push up inflation and thus interest rates; the CBO projects that Fed funds will rise to 1.2% in 4Q16, reaching 2.2% in 4Q17 and settling at 3.5% in 2Q19.

January consumer confidence out Tuesday 26 rose more than expected to 98.1 from 96.3 in December. USTs failed to respond to the rally in equities and held gains to end the day with 10yr yield below 2% once more – all eyes appeared to be on the FOMC statement accompanying the Wednesday 27 rate decision, where there was hope in the market that the Fed would concede that the global outlook would likely lower its intended rate trajectory. In the event, there was little new information to analyse, with the specific recognition of economic drag from overseas representing, in our view, more of a “due diligence” acknowledgement than any outright dovishness. QoQ GDP out on Friday 29 was slightly softer at 0.7% vs. 0.8% forecast. Personal consumption, however, came in robust at 2.2% vs. 1.8% expectation, complementing Tuesday's consumer confidence. USTs rallied throughout the 2yr, 5yr and 7yr supply in the week, supported by end of month flow and the BoJ policy move.

EUROPE

The December Eurozone inflation estimate came in below expectation at 0.2% vs. 0.3% (core 0.9% vs. 1.0%), which led some to believe that the ECB might feel the urge to ease further. December Eurozone Manufacturing PMI was a little firmer, however, including an upward revision to the November figure. The Services PMI also came in stronger than forecast a few days later. German factory orders on the 7 jumped higher posting +2.1% YoY vs. +1.1% forecast, with small downside revisions to the November figures.

Draghi spoke following the Thursday 21 static ECB rate decision. He indicated that additional easing measures were under consideration and that there were “no limits” to accommodation. The subsequent risk-on move energised global stocks and weighed on bonds.

JAPAN

JPY was buoyed as BoJ governor Kuroda stated that the economy had been recovering gradually and would continue to do so into 2016. The market had been anticipating further easing measures towards the end of 2015, but Kuroda stated that Japan was out of a deflation situation and the 2% inflation target could be achieved with current policy. He confirmed that additional easing would be carried out should it become necessary. JPY ended the week strong, rallying to approx. 117.00.

In the run up to Japan's policy meeting result on Friday 29, prominent yen bear Nomura warned of “irreversible damage” to the economy if additional stimulus was not undertaken to counter yen strength. Poor household spending and industrial production numbers were followed by surprise stimulus on Friday. Widely unexpected considering Kuroda's previous comments on negative rates (which included “we don't think we should institute negative deposit, interest rate as a central bank”), a tiered negative interest rate system on central bank deposits, similar to that in place at the ECB, was implemented after a 5:4 vote. The rate of JGB purchases remained unchanged at ¥80tn/yr, where there is some concern that banks may be more reluctant to participate in the buybacks now that the 0.10% deposit rate on excess reserves now stands at -0.10%. JPY weakened from 118.60 to 121.42 in the initial move before settling down in the 120.50 area.
CHINA

Perhaps the most widely discussed event was the repeated tripping of the new-for-2016 “circuit breakers” in the Chinese CSI300 – a 15 minute break for a 5% move and a closure for the day after a 7% move. The limits, intended to calm violent price movement, lasted just four days before suspension after they proved to have quite the opposite effect – the market opened for less than half an hour on Thursday 7 before being stopped out. The PBoC allowed the CNY to weaken by cutting the reference rate fix from 6.5032 Monday to 6.5646 by Thursday which further undermined equity markets.

Chinese Premier Li Keqiang on Thursday 28 spoke with the IMF’s Lagarde, where he stated that China will not fight a currency war and that there was no basis for further CNY depreciation. He said that China “will maintain yuan stable at reasonable level”, while promoting reform of the CNY’s exchange rate formation mechanism.

CRUDE OIL

Saudi Arabia cut diplomatic ties with Iran on Monday 4 following heavy criticism surrounding the execution of an imprisoned Iranian cleric. This led to a brief respite in the fall of crude oil prices that defined the week, accelerated by the diplomatic fallout from North Korea’s alleged test of a hydrogen bomb on Wednesday 6.

Brent crude dropped below $30/bbl for the first time since 2004 on Wednesday 13 after the EIA reported crude inventories rose by 234k to 482.6mn bbl. Equities suffered as a result; the Dow gave up nearly 400pts on the day. Bonds rallied despite the 3s, 10s and 30s supply in the week.

There were numerous articles Thursday morning (21) where technical analysis placed oil in the final throes of a down trend. The Chairman of Saudi Aramco spoke later that day from Davos, where he labelled prices below $30/bbl “irrational” but affirmed the Kingdom’s commitment to maintain output. Crude ended the day sharply higher and continued the rally into Friday 22, compounded by the interpretation of Draghi’s comments.

Just as diverse as forecasters’ calls on USTs have proved so far in 2016, so were those on crude as it rarely left the headlines flitting either side of $30/bbl. The CEO of Kuwait Petroleum spoke on Tuesday 26, announcing a $100bn five-year investment plan in order to boost oil production and protect/enhance market share. This was the latest addition to a series of similar moves across the traditional/OPEC producer countries which, in addition to the lifting of Iran’s international trade restrictions, and reports of US oil stockpiles reaching capacity, kept any rebound in price from the previous week in check. The strongest upward pull on oil came on Thursday 28 when Russian Minister of Energy Alexander Novak announced a meeting with OPEC members in February where a 5% output cut may be discussed. Oil continued to rally on Friday despite reports that several OPEC members were not aware of this meeting or any potential output cut.

WORLD/MISCELLANEOUS

The IMF felt compelled on Tuesday 19 to update its World Economic Outlook with a 0.2ppt cut to its 2016 and 2017 global economic growth forecasts (now +3.4% and +3.6% respectively), citing China headwinds, EM trouble and lower commodity prices.

Global corporate bond supply was slim to non-existent for the month as the poor market backdrop kept all but the most able/essential out of the market.
We have a differentiated view, so differentiated that we have yet to find anybody else who shares it, although we doubt that we are alone. It’s a politically incorrect view in that our argument is that it’s less important how many people vote for or against Brexit than who counts the votes. Controversial obviously, and it brings the debate back to politics. The leadership in the UK government wants to remain in Europe and we fully anticipate that the UK will stay in. With hindsight, we doubt that the political establishment, never mind the “crown”, would have liked to have seen a break up of another union on their watch.

The biggest issue for the UK equity market right now is probably the near-term outlook for commodity prices – especially oil, copper and iron ore – given the relatively heavy weighting of energy and mining companies.

In turn, the key issues for commodities right now are the outlook for the dollar and the Chinese economy.

We expect further dollar strength to limit the upside in commodities for another several months at least. Besides the Eurodollar liquidity issue (see next page), the Fed is still expressing a desire for multiple rate increases during 2016, even if the financial markets are only pricing in (approximately) one more 25bp hike.

Before the Fed implemented the first hike in December 2015, we speculated on why it was determined to press ahead, even though other DM central banks either have an easing bias or are standing pat. We suggested three possible motives.

1. It could be that a rate increase is warranted because the US economy is sufficiently strong and inflation is poised to rebound in robust fashion;

2. It could be that the Fed realises that it has created yet another asset price bubble - although that is highly unlikely because the Fed is serially incapable of seeing asset bubbles; or

3. Alternatively, and some of my colleagues will disagree, it could also be a case of shoring up the threat to the Fed’s credibility if it hasn’t begun raising rates before the next recession. In other words, does the Fed sense that the window for moving rates off the zero bound is closing?

We were leaning more towards the third explanation and that remains our position. Pursuing that line of thinking, we expect that the Fed will have to perform a U-turn on the potential for 3-5 rate increases this year. At most, we think that there will be one or two and don’t rule out the
possibility that rates could be on a declining trend before the end of the year.

Before the December 2015 rate increase, we highlighted the remarkably good inverted correlation between long term Treasury yields and (short-term) repo rates.

This correlation has continued since the liftoff in rates. While we are struggling to explain the rationale, we view the decline in long-term Treasury yields as a negative signal.

It is possible that the markets are judging the Fed's rate increase as a policy mistake. Looking back in time, declining 10-year yields have almost always signalled that the Fed would ease policy, if not immediately, then in the fairly near future.

The Citi Economic Surprise Index shows how the declining trend in US data versus expectations has deteriorated further during the last two years.

There are other market signals that suggest that the US economy is weaker than the Fed would like to believe and that the desire for several rate increases will need to be toned down at the very least. For example, indicators of inflation expectations are noticeably weak.

In the real economy, one would expect a robust trend in US imports if the economy is strong and especially given the strength of the dollar. But au contraire…

The Fed's narrative regarding economic strength
has been largely based on the jobs market. Looking at initial claims, the improving trend appears to be levelling off...

...which makes sense as we reach the limits seen in earlier expansions.

So, it looks to us that we have a weakening US economy, but the Fed will maintain its upbeat stance and tightening bias for some time yet.

This is good news for the dollar, but not for the other key issue which is Chinese economic growth.

The stress in the financial system’s plumbing remains focused on the ongoing run/shortage in Eurodollar liquidity and the Chinese banking system in particular. Eurodollar illiquidity causes Yuan/RMB illiquidity and the PBoC is fighting an increasingly desperate battle.

If the PBoC provides dollars for its banking system in exchange for Yuan to help the banks roll their dollar funding, it tightens Yuan liquidity in the Shanghai and Hong Kong banking system, which has a negative effect on the economy. But...if the PBoC provides more monetary stimulus to revive the flagging economy, e.g. via further reductions in the RRR for the banks, it risks further speculation against the Yuan. A falling Yuan raises the value and funding costs on a short US$2 trillion of dollar debt.

The PBoC’s current tactic seems to be to support the Yuan by limiting capital outflows as much as possible while employing (lower profile) open market operations to provide the banks with Yuan liquidity. This is going beyond anything we’ve seen since China’s Eurodollar issue first surfaced in the run up to the unexpected Yuan devaluation in February 2014.

Currently, this is stopping the heavily managed overnight SHIBOR from spiking and strangling weaker domestic Chinese banks with higher funding costs.

The CNY chart is strongly suggestive of renewed
PBoC intervention which was in place from March-August 2015, before the dam broke.

Here is something to ponder. The PBoC let the Yuan devalue in August 2015 and three months later – November 2015 - the same thing began to unfold once again.

Question. Could the PBOC be using 3-month swaps versus the dollar to support the spot price of CNY? If so, might we see renewed CNY weakness as we go through February 2016?

Meanwhile, we believe that the rapid slowdown in the investment/manufacturing part of the Chinese economy is a more powerful headwind than the financial markets currently realise.

There is an epic slowdown in construction.

It suggests that the consumer sector appears to follow the industrial sector...something which intuitively makes sense to us given China’s current stage of development.

Part of the bull case for China is that the consumer/services sector of the economy will take over from the slowing investment/industrial sector. We are slightly sceptical about a seamless handover between the two. Indeed, the next chart shows that there is a fairly good correlation between the growth rate in industrial production and the growth rate in retail sales eight months later.
Information from External Sources

A special thanks to the following non ADMISI contributors in the subsequent pages for their thoughts and analysis. We are truly grateful for their efforts. ADMISI would like to extend the opportunity to receive additional external contributors’ analysis for inclusion in subsequent editions of ‘The Ghost in the Machine.’ Please contact Andy Ash for further information. Tel: +44 (0) 20 7716 8520 or Email: andy.ash@admisi.com

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“What stands out here?”

1. Sudden Chinese yuan devaluation moves caused a sell off in global markets, leading investors to doubt the extent of the US recovery and question valuations in Developed Markets (DM). After recent ~ 10% falls, value emerges in selective broader markets, namely in S&P 500 (SPY) and Stoxx Europe 50 (SX5P).
One of Nostradamus predictions was for the End of the World in 2012. It seems investors are convinced that 2016 is the year for financial armageddon judging by the way Equities and all asset classes have traded in the few two weeks of the year. At least Equity strategists on CNBC and Bloomberg do not feel the need to drape themselves in dark robes and pointy hats to sound more convincing. There are so many moving parts to the overall macro story, it’s much easier to turn superstitious than actually figure out what is driving these markets and why.

What caused the sell off at the start of the year?

The devaluation of the Chinese yuan caused global jitters across markets in August 2015, and also instigated the sell off at the start of this year. China is seeing a growth slowdown as it moves from an infrastructure led growth to a consumer oriented one. This slowdown is causing capital outflows and China needs its currency to fall to offset that impact to support its economy. After the big one day move back in August of 2% which spooked markets, officials laid out a strategy to fix each day within a narrow band to provide stability. In December the central bank said that it would move towards navigating against a basket of currencies, still within a narrow band. Then in January it allowed the currency to depreciate sharply! This lack of consistency causes room for concern.

Chart 1 below outlines the Chinese Yuan/USD spot rate and the level of its foreign-exchange reserves historically. In 2014, Chinese foreign-exchange reserves stood at $4 trillion. As the dollar keeps rising, Chinese companies who have huge debt in dollars, need to sell the yuan to make up for it. By intervening in the FX markets, Chinese central bank bought yuan from the Chinese banks, effectively taking money out of the system. The PBOC has burnt over $700 bln of foreign exchange reserves to maintain the yuan’s peg to the appreciating dollar; these reserves now stand at $3.3 trillion. The falling yuan puts downward pressure on inflation in rest of the world at a time when US and Europe are trying to lift it to 2%. Its sharp move in January rang alarm bells for investors who were convinced that China was slowing down a lot more than was being suggested and possibly wanted their currency to fall faster.

The sharp drops in the yuan/usd rate caused a sell off in Chinese stocks, global stocks, Commodities, and all related asset classes. Slowly and surely, deflation and recession headlines wrapped all tabloids and media sources. It is not the move that is worrying in and of itself, it is the way the yuan is adjusting, lacking regularity. The big sudden movements and lack of open communication by the chinese central bank is bound to create more Nostradamuses amongst us!

1) Developed Markets are now looking cheap given the ~ 10% sell off in US markets and European markets on the back of Chinese yuan devaluation scares:

Coming into the year, China and emerging economy weakness was well forecasted as US and European economies were expected to grow at 2.25% and 1.8% respectively in 2016, keeping the global growth robust. But the last few weeks of Q4 2015 showed signs of weakness filtering into DM as well. The November PMI data showed US manufacturing and non-manufacturing surveys both down, while survey data on both counts picked up in Europe, with data in Japan and the UK mixed. The official Caixin China PMI manufacturing showed a larger drop to 48.2 (from 48.6 previously vs. expectations of 48.9). In the US, the ISM manufacturing index dropped to 48.2 from 49 previously, its lowest level since 2009! For the Euro area, however, the Manufacturing PMI increased to 53.2 from 52.8 previously.
The graph illustrated on Chart 2 below explains this trend. It plots a proprietary Goldman Sachs global leading indicator that shows that although growth of the US subcomponent remains positive, it has been in decline for several months, while growth of the non-US subcomponent is up slightly. Accordingly, the Goldman Sachs Current Activity Index (CAI), predicts the run rate of US growth at only 1.7% as of November, down more than 2.5 percentage points from last year’s run rate. This slowdown in US growth relative to Europe and Japan is worrying a few bulls as robust US economic growth formed the basis of their global growth call.

**Chart 2: Global Leading Indicators (Source: Goldman Sachs)**

The manufacturing side of the US economy had been showing signs of softness, but it is the recent softness in the services side that the market is trying to battle with. The labour market is expected to be supported by a strong consumer market (currently running at about 3% y-o-y growth) that benefits from falling retail pump prices and a rising housing market. If this is not the case, then there can be some cause for concern, but for now we do not have any evidence to suggest this. Consumer and domestic cyclicals have all been hit on this sell off in addition to Banks and Commodity stocks, despite the data to back the move. It seems investors are pricing in US growth at or below zero; a tad bit too pessimistic and presumptuous for now.

**What do Q4 2015 earnings tell us about the state of the market?**

Q4 2015 earnings start in full swing this week, but estimates have been revised down over the last few months as seen in Chart 3. Earnings growth for the S&P500 are now expected to be -5.7%.

**Chart 3: S&P 500 Quarterly Earnings Growth Forecast**

Expectations for Q1 2016 have also adjusted downwards. On September 2015, they stood at +4.9%, today it shows -0.6%! So the market is a bit more sanguine this time around. As and when companies report, the bar is a lot lower so there is a chance that investors can be pleasantly surprised if earnings are not as ominous as they expect.

**What does AAII Investor Sentiment Survey tell us about the current positioning in the markets?**

The AAII BULL vs. BEAR index is a great short-term indicator that shows how optimistic or pessimistic the market currently is. As you can see in Chart 4 below, the white line is the BULL vs. BEAR indicator trading at lows going all the way back to 1989! The orange line is the level of the S&P 500 index. As seen in the past, when this ratio reaches extreme levels, it can cause a sudden move in the opposite direction in the underlying tracking index.

**Chart 4: AAII BULL vs. BEAR Index Positioning At All Time Lows**
How can the recent moves in Equities and Bonds impact asset allocation decisions near term?

Asset allocators are constantly evaluating their Equity vs. Bond portfolio holdings, especially when moves like the one we saw in January occur, their weightings can get displaced quite fast. Chart 5 below plots the ratio of the FTSE Equity yield vs. the UK Gilts yield. The red arrows all start at the beginning of the month and end at the end of the month. Months where the yield ratio moves the most, one can see a good bounce back at the beginning of the next month. This is due to rebalancing effects that occur at the end of the month to balance portfolios. For example, if Equities fall by 10% and Bonds rally by 5%, pension funds currently allocated 60% to Equities and 40% to Bonds would suddenly find themselves with “less” Equity exposure and would be forced to buy to keep portfolios in line with their allocation on a notional basis.

In January, UK Equities are down 8% and UK bonds up 2.4%, a rebalance favouring buying into UK Equities can be expected next month to keep allocations constant.

Chart 5: The UK Equity vs. Gilt Yield Ratio

It is important to distinguish what markets have sold off the most and why. Tempting as it may be to chase the one that is “cheapest,” it may not be the right one to buy for a bounce. Emerging markets are still coping with their respective growth slowdown phases, and valuations are still not attractive enough yet. Investors are desperately trying to call the bottom in Oil, especially after its 25% fall in January alone. These markets are not cheap. At least not yet. They suffer from too much supply and the price will only find a bottom when that excess supply is cleaned up. What producers are unable to do, take production off line permanently, the market is forcing them to do as sub $30/bbl is the result of serious stress in the system given physical Oil has no home causing a collapse in cash prices.

Draghi appeared last week and suggested that he would do whatever was needed to boost inflation to 2% implying more stimulus potentially at the March meeting. The fate of the Euro has once again been sealed. Central banks stimuli continue to be the opiate of the investors. The Euro should start to fall once again vs. the USD. It is times like this when macro displacements provide fundamentally mispriced opportunities; Developed Market Equities look cheap now and are worth buying.

YTD PERFORMANCE:

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Maleeha Bengali - Founder, MB Commodity Corner

Maleeha Bengali graduated from Cornell University with a Bachelors of Science degree in Engineering in 1997. For the past 14 years, she has worked as a Portfolio Manager/Trader for various Hedge Funds and Proprietary Trading desks across both US and Europe including UBS O’Connor, Goldman Sachs J. Aron, Merrill Lynch Commodities and Noble Group, where she launched and managed their Commodities and Equities investment funds specialising in Energy and Basic Resource Equities and the respective Commodities. Over the past 8 years, her strategy has generated a compound annual growth rate (CAGR) of 12% using systematic delta neutral investment trading strategies; minimising market and directional risk while maximising returns, focusing on alpha generation.