MARKET
PERSPECTIVES

STC Investment Committee
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The global equity market posted steep losses in the first half of the month of January amidst increased concern over a Chinese economic hard landing. Two surprises came out of Asia over the month: the Bank of China's renminbi devaluation at the start of the month as well as Japan's late-month move to negative interest rates. In addition, two 25-year records were broken in January that, rightly or wrongly, investors felt were directly linked: China growth and market sensitivity to oil prices. China experienced its largest growth decline, with its reported 6.8% fourth-quarter growth either overstated or at least believed to be unsustainable as capital outflows reached a record high.

Equity markets moved down, in line with oil prices that fell below $30, as the 2016 correlation between the S&P 500 index and the price of oil reached record highs.

While hopefully not indicative of a new trend, U.S. fourth quarter gross domestic product (GDP) grew at only 0.7%, reflecting slowing consumption growth and a weak export sector. Without question, a number of indicators that pre-sage recession are flashing warning lights:

- The ISM Manufacturing Index had its fourth straight monthly decline;
- More importantly, since manufacturing is only 10% of our economy, the bigger news is that the ISM Non-Manufacturing Index, while still showing growth, had its lowest reading since early 2014; and
- Stock prices face headwinds given that fourth quarter 2015 earnings per share declined more than 6% year over year.

The dollar continued to advance, as more dovish Federal Reserve Board (Fed) commentary was more than offset by the spread of negative interest rates elsewhere, particularly in Japan. The Chinese currency contagion fear is less about what has happened (Chinese Yuan was only down 1.3% in January), but more what happens if a Chinese hard landing and uncontrolled currency devaluation leads to a global currency war just as recession fears are increasing.

Global equities were down mid-single digits across the board with the Russell 3000 down 5.6%, Europe down 6.6%, Italy down 13.6%, Japan down 8.2% and emerging markets down 6.5%. Emerging markets in Asia fell 7.3% on China contagion, with China down nearly 13%. Despite the fall in commodity prices, Russia was the top performing major equity market, down less than 1%.

In the U.S., small-cap growth stocks declined double digits, but mega-cap growth remained a relative safe-haven, declining only 4.8%. Utilities were the only sector with significant gains, up 5.4%. The energy sector outperformed most other groups, down only 3.6%. At the other extreme, materials fell 11% and the NASDAQ biotech index fell more than 20%.

Investors quickly marked down the odds of any 2016 interest-rate hikes, given this Fed's hyper-sensitivity to deflation risks and asset prices. This mark down was reflected in a massive downshift in near-term bond yields, with the 2-year Treasury yield plunging 30 basis points to 0.76%, the broad Treasury index gaining over 2% and long-dated Treasuries gaining 5%. Despite these benchmark gains, corporate bonds returned only 0.3% as credit spreads widened 28 basis points. Five-year municipal bonds gained 1.15% but municipals, particularly higher yielding issuers,

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underperformed Treasuries. The corporate high-yield market was weak and quite bifurcated, returning -1.8%, as higher rated (BB) issuers lost less than 1%, while lower rated (CCC) issuers declined almost 4%. Emerging market debt actually rallied in January, as gains from declines in benchmark global bond yields and scattered rallies in some emerging-market currencies offset macro-risk-off headwinds.

Commodities fell as a whole in the month of January, as the GSCI, a commodities index, was off 5.2%. Oil was down 9.2% for the month and fell below $30/barrel intra-month as inventories reached 85-year record highs and the Iran export ban was lifted, potentially adding up to one million barrels a day to global supply. Gold was up 5.3% for the month as the commodity benefitted from central bank moves to negative interest rates. Expectations that Fed rate moves might be pushed back or even reversed, and generalized market fear also contributed to lifting the commodity. Real estate investment trusts performed more like equities than bonds, losing 4.3%. Master limited partnerships fell an additional 11% after the 33% decline in 2015 due to continued pressure from falling commodity prices, deteriorating credit markets and increasing counterparty risk.

Hedge funds had a difficult month in January, with trend-following Commodity Trading Advisor strategies delivering positive results on the back of continued Treasury bond gains and commodity price declines. Equity long/short strategies were the worst performing sub-sector, whether due to directional equity exposure, a spike in correlations or liquidity-driven losses, as funds tried to exit positions at the same time. Many were also whip-sawed by the intra-month volatility, which saw them reducing exposure over the first two weeks just in time for a partial second-half recovery.

Over dinner in New York last week with a successful hedge fund executive, we characterized our divergent investment views as a battle between "The Model" and "The Market." Traders (like my dinner partner) observe that parts of the market are at close to recession levels. They note that the economic releases are generally consistent with a strong likelihood of recession and have positioned themselves for additional quantitative easing, a lower-for-longer Fed, falling corporate profits, deflation and even lower interest rates.

While admitting that global growth risks are to the downside particularly in China, I have a hard time seeing a substantial risk of recession in the U.S. and believe Fed rate increases remain in play. First, global growth should still be roughly in line with 2015, even if my 3.4% forecast is too high. The labor market remains healthy as December's 300,000 job growth figure seems inconsistent with the fourth quarter's anemic 0.7% growth, let alone a recession. Homebuilding is in recovery mode, auto sales are strong, the consumer has reserve buying power given that much of the oil price gift has been saved and government will be less of a fiscal drag. Finally, my outlier call for renewed inflation received at least some support as the futures curve is pricing in $40 oil by year-end and January core consumer prices spiked the most in four years. Consequently, the odds of at least one Fed rate increase have moved from 11% on February 11th to 44% today.

Portfolio positioning will need to reflect what will almost certainly be volatile markets as the news flow supports one side of "The Battle" or the other. In addition, because hedge fund psyche is quite fragile at present, given years of disappointing performance and a horrible start to 2016, traders are likely to fade rallies and book profits should rallies start to fail.

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