MORNING BRIEFING
January 25, 2016

The Iceman Cometh Again

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(1) London and Zurich. (2) Room 666. (3) Nostalgia time. (4) Draghi still has fairy dust if not ammo. (5) Ice Age: Crashing below 666 to 550. (6) Stay Home continues to outperform Go Global. (7) Too late to panic? (8) Not enough growth and a strong dollar submerging the EMs. (9) Tett warns about capital flows, especially out of China. (10) BIS data: Fewer devils in the details? (11) Dalio's short-covering dollar rally. (12) US should weather global financial cooling.

Strategy I: The Omen. I visited our accounts in London all last week with a brief overnight roundtrip excursion to Zurich from Tuesday evening to Wednesday afternoon to deliver a speech at an investment conference. My hotel and the conference center were both a five-minute walk across the street from the airport. All very convenient and efficient, I must say. While I waited in the registration line at the Radisson Blu Hotel, a very fit young lady was performing a Cirque Du Soleil style acrobatic performance as she fetched a bottle of wine within a three-story glass tower in the middle of the lobby bar. After registering, I was handed a small envelope with the plastic key card to room number 666.

My initial reaction was to ask for a different room, since that number is associated with the Devil in folklore. I'm not superstitious, but then again why tempt the Fates? However, I spent the night in 666, because I actually have fond memories about this number. On March 16, 2009, I wrote: "We've been to Hades and back. The S&P 500 bottomed last week on March 6 at an intraday low of 666. This is a number commonly associated with the Devil. … The latest relief rally was sparked by lots of good news for a refreshing change, which I believe may have some staying power … I'm rooting for more good news, and hoping that 666 was THE low." The same day, QE1 was expanded to $1.25 trillion in mortgage-related securities and $300 billion in Treasury bonds.

On July 27, 2009, I wrote, "I prefer melt-ups to meltdowns. The S&P 500 has been on a tear ever since it bottomed at the intraday low of 666 on Friday, March 6. We should have known immediately that this devilish number was the bear market low. It took me a few days to conclude that it probably was the low. … I felt like Tom Hanks in the 'The Da Vinci Code.'"

However, my initial trepidation about staying in Room 666 seemed all too justified when the S&P 500 crashed 69 points to 1812.29 on an intraday basis on Wednesday, before staging an impressive rally closing at 1859.33, matching the two previous closing lows since late 2014 (*Fig. 1*). The market continued to rally on Thursday on news that ECB President Mario Draghi promised more monetary easing if necessary by March. At the beginning of his prepared remarks at his 1/21 press conference, Draghi said:

"Yet, as we start the new year, downside risks have increased again amid heightened uncertainty about emerging market economies' growth prospects, volatility in financial and commodity markets, and geopolitical risks. In this environment, euro area inflation dynamics also continue to be weaker than expected. It will therefore be necessary to review and possibly reconsider our monetary policy stance at our next meeting in early March, when the new staff macroeconomic projections become available which will also cover the year 2018."

As I noted last week, there is a widespread fear that the central banks may have run out of ammo. Apparently, they haven't run out of fairy dust, which still has the power to give global stock markets a high.

Stocks continued to recover strongly around the world on Friday as the price of a barrel of Brent oil jumped 15% from a low of $27.88 on Wednesday to $32.18 on Friday (*Fig. 2*). All week in London, I was asked what catalyst might reverse the stock market rout. I opined that stocks should rebound once the price of oil bottomed. It might have done so on Wednesday. It's too early to say for sure. However, one of our accounts in Boston sent me an email noting that the forecasts of the International Energy Agency (IEA) tend to be reliable contrary indicators. Sure enough, on Tuesday, the IEA made front-page headlines with its latest assessment that "the oil market could drown in over-supply."

All week in London, I heard from a few of our accounts that they had attended an extremely bearish speech on January 12 presented by Albert Edwards, an economist at Societe Generale. He is renowned for his pessimism since he has been predicting an imminent economic and financial "Ice Age" for several years now. About 950 investors attended his doomsday presentation, which suddenly looks more realistic since the start of the year. Edwards is predicting that the S&P 500 will crash right through 666 to 550.

Strategy II: Too Late To Panic? Needless to say, I felt better on the flight back home to New York on Friday than I did on the flight to London the previous Sunday, since I've stuck to our script that the wicked selloff in the stock market since the start of the year is another panic attack that should be followed by yet another relief rally (*Fig. 3*). However, there remain lots of known unknowns about the underlying concerns that have weighed so heavily on the market since the start of the year.

The All Country World MSCI stock price index (in dollars) is down 16.9% from its record high on May 21, 2015 (*Fig. 4*). The All Country World Ex-US MSCI stock price index (in local currency) is down 19.1% from its near-record high on April 27, 2015 (*Fig. 5*). The US MSCI stock price index is down 11.1% from its record high on May 21 of last year (*Fig. 6*). The only solace we take from all this is that our Stay Home investment theme continues to outperform the Go Global alternative.

Perma-bear strategists, like the Ice Man, must view any relief rally such as the one at the end of last week as an opportunity to sell more stock. One very seasoned pro in my London meetings wisely turned defensive late last year and believes that we are in a cyclical bear market within a secular bull market. So he is keeping his powder dry despite Draghi's fairy dust.

Joe and I believe that it may be too late to panic and that Wednesday's action might have made capitulation lows in both the stock and oil markets. We note that the Bull/Bear Ratio compiled by Investors Intelligence fell to 0.74 last week from 0.80 the week before, two readings in a row below 1.00, which has often been a very good contrarian buy signal (*Fig. 7*). The percentage of bears rose to 36.1%, the highest since late October 2011 (*Fig. 8*).

On the other hand, this bearishness-measuring series is somewhat correlated with the yield spread between corporate junk bonds and 10-year Treasuries. The spread rose again last week to the highest since October 6, 2011, when bearishness spiked to 46.3%. Also disconcerting is that NYSE volume has been rising along with bearish sentiment over the past year (*Fig. 9*). (Click ★ to add *VIX, Volume, and Put/Call* to MyPage.)

Strategy III: Ice Age. We are clearly betting that the known unknowns won't be as calamitous as still widely feared. We've discussed most of them since the start of the year. Let's examine the Ice Age scenario focusing on emerging economies:

(1) *Edwards' story.* According to a 1/18 Business Insider article about Edwards' "Woodstock for Bears," the big theme of his conference was that, "Global growth is no longer enough to service global debt. Creditors will have to take losses. Translated, this means the banks that lent the most money with the least amount of reserves may go bust.

"Worst hit are the emerging-market economies, many of which are dependent on China to stoke demand for the commodities they produce. This plan worked well for many years after the 2008 financial crash, and emerging markets loaded up on debt. But as the world shifts from buying more goods to buying more services, China is shifting its economy away from manufacturing and industry. Commodities prices have plunged as a result, along with the currencies of the countries that invested in them.

"This makes it more expensive to pay off debt denominated in dollars. Unlike debt denominated in emerging-market economies' own currency, they can't just print more.

"It's not just emerging markets that are in trouble. US companies have also loaded up on debt after central banks around the world lowered interest rates to record lows. How will it play out? In the words of Albert Edwards, 'It will turn very ugly indeed.'"

Another 1/13 article covering Edwards' views noted that he expects to see a minus 5% federal funds rate, a massive renminbi devaluation, currency wars, trade wars, and a deflationary depression.

(2) *Tett's story.* Gillian Tett, the widely respected *FT* reporter, hobnobbed in Davos last week and posted a 1/21 article titled "The tiny shifts that can signal huge changes." Like Edwards, she sees a potential for lots of trouble among emerging markets that borrowed in dollars:

"In recent years emerging markets companies in general--and Chinese groups in particular--have dramatically increased their dollar debts. The Bank for International Settlements calculates this now stands at $4,000bn for emerging markets as a whole, four times higher than in 2008. A quarter of this debt has emanated from China.

"Until lately, using dollar-based markets to issue bonds or take loans seemed a smart strategy for Chinese groups. After all, the US Federal Reserve has kept dollar rates at rock-bottom lows and the renminbi has strengthened against the dollar in the past decade. But now the US interest rate cycle has turned and the renminbi has weakened. Moreover, contrary to assurances made in Davos by China's most senior regulator that Beijing is committed to maintaining a stable currency, most delegates I have spoken to expect the renminbi to fall 10-15 per cent against the dollar in the next year."

Tett warned: "Deep in the bowels of the system all manner of financial flows are switching course, creating unexpected knock-on effects for many asset prices. Capital flight from China is one example. The energy sector is another. While the collapse in the oil price has prompted investors to stage a high-profile flight from the sector, oil-producing countries are furtively selling their holdings of US Treasuries and withdraw money from asset managers because governments need the cash. Meanwhile, the prospect of political fragmentation in Europe is causing many big asset managers to reassess their exposures there, too."

(3) *BIS's story.* The Ice Age story about emerging markets with dollar-denominated debt is mostly based on data compiled by the Bank for International Settlements (BIS). The December 2015 *BIS Quarterly Review* shows these data in Table 1 on page 31.

It's not the easiest data to sort out, and the BIS review admits that there are lots of known unknowns. For example, "banks in China and Russia, according to national sources, rely to a considerable extent on domestic dollar deposits to fund dollar loans at home." I guess that means they owe it to themselves.

Even more encouraging: "[D]ollar bonds outstanding have grown faster than dollar loans since 2009. In part, this reflects the retrenchment of global banks, which suffered losses on their cross-border credits during the Great Financial Crisis of 2008-09 and which have since come under pressure from shareholders and supervisors." This supports our view that most of the "bad stuff" this time has been financed by the capital markets rather than the banks. We still believe that the former can better absorb losses than the latter, thus reducing the likelihood and magnitude of a global financial contagion.

(4) *IIF's story.* The 1/20 *FT* reported that "on Wednesday the Washington-based Institute of International Finance said outflows increased as overseas investors pulled out of emerging markets and Chinese companies scrambled to pay off overseas loans in the final three months of the year amid a weakening renminbi. …

"Emerging markets saw an estimated $735bn in net capital outflows last year with all but $59bn of that coming from China. In October the global finance industry group had predicted 2015 would see net outflows from emerging markets of $540bn, the first since 1988."

(5) *Dalio's story.* Ray Dalio, the founder and CEO of Bridgewater Associates, said Wednesday during an interview with CNBC in Davos that the dollar will strengthen temporarily as foreign investors rush to buy the currency so that they'll have enough on hand to pay off their massive dollar-denominated debt. He also said, "I think the China situation with the currency is very important. If there's significant currency weakness, that will mean more imported deflation [to the U.S.]. And it'll make things more difficult."

All of these stories certainly explain why the dollar has soared 22% since July 1, 2014 (*Fig. 10*). It's done so recently despite a relatively stable euro and a stronger yen (*Fig. 11* and *Fig. 12*). That's because EM currencies, especially the yuan, have been very weak (*Fig. 13* and *Fig. 14*).

Many of the EM currencies have been weakening since 2014, but there has yet to be an EM debt crisis. That's one of the many fears that have hit the stock market since the beginning of the year. It hasn't happened so far. But it could still happen. Would that mark the beginning of the Ice Age? It might for EMs, but we think that the US will weather such a climate change better than any other country.

CALENDARS

US. Mon: Dallas Fed Manufacturing Index -14.0. **Tues:** Consumer Confidence Index 96.0, S&P Case-Shiller 20-City HPI 0.7%m/m/5.7%y/y, FHFA Price Index 0.5%, Richmond Fed Manufacturing Index, FOMC Meeting Begins. (Bloomberg estimates)

Global. Mon: Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 108.4/112.6/104.1, Japan Leading & Coincident Indexes. **Tues:** None. (DailyFX estimates)

PERFORMANCE & ASSET ALLOCATION

Global Stock Markets Performance (*link*): The US MSCI index rose 1.4% last week, ranking 19th of the 49 markets as 26 markets rose in US dollar terms--compared to 17th a week earlier, when it dropped 2.3% as only two markets rose. The AC World ex-US index underperformed, falling 0.5% versus a 3.2% decline a week earlier. The best-performing regions last week: EM Eastern Europe (3.2%) and EMU (1.3). The week's worst: BRIC (-0.4) and EM Latin America (-0.3). Russia and Colombia were last week's best performers among countries, with gains of 6.7% and 6.3%, respectively. Last week's biggest decliners: Greece (-10.1) and Egypt (-3.9). The US MSCI is down 7.0% ytd, ranking 17/49 and ahead of the 8.9% fall for the AC World ex-US. All countries are down ytd, but the declines for Morocco (-0.3), Thailand (-1.5), and Hungary (-1.6) are the smallest. The year's worst performers so far: Greece (-23.9), Egypt (-20.6), Brazil (-15.2), and China (-14.4). The best-performing regions ytd, albeit with declines: EMU (-7.7) and EAFE (-8.6). BRIC (-13.0) is the worst performer ytd and EM Latin America (-11.4) the next worst.

S&P 1500/500/400/600 Performance (*link*): All three market-cap indexes rose for the first time in four weeks as 25/30 sectors moved higher. LargeCap was the top performer again, this time with a gain of 1.4%, just a hair ahead of MidCap's 1.4%; SmallCap lagged with a 1.0 advance. However, the poor start to the year puts all three indexes at big declines both ytd and from their record highs in 2015. LargeCap is down 6.7% ytd and 10.5% below its May 21 record high, followed by MidCap at down 7.9% ytd and 16.9% below its June 23 record, and with SmallCap lagging at an 8.5% decline ytd to 17.1% below its June 23 record high. LargeCap is now 2.1% above its August 25 low, but MidCap (-4.7) and SmallCap (-4.5) are below their lows then. Eighteen of the 30 sectors are below their lows then too. The best performers ytd: LargeCap Utilities (1.2), LargeCap Telecommunication Services (1.1), and SmallCap Utilities (0.9). The worst performers ytd: SmallCap Energy (-19.2), MidCap Energy (-16.1), and MidCap Telecom (-16.0).

S&P 500 Sectors and Industries Performance (*link*): Eight of the 10 S&P 500 sectors rose last week as the index rose 1.4%. That compares to just one 10 sector rising a week earlier, when the index fell 2.4%. The index is now 10.5% below its record high, but that's still up 2.1% from its 2015 low of 1867 on August 25. Five sectors outperformed the S&P 500 last week led by Telecommunication Services (4.4%), Consumer Discretionary (2.5), and Information Technology (2.4). Telecommunication Services and Consumer Staples (1.8) outperformed the S&P 500 for a third straight week. Last week's three biggest underperformers relative to the S&P 500: Financials (-0.5) and Industrials (0.0). Utilities and Telecommunication Services are the only sectors up so far in 2016 with their gains of 1.2% and 1.1% easily outpacing the S&P 500's decline of 6.7%. Seven sectors still trade above the market's August 25 low. The exceptions: Materials (-4.6), Financials (-4.0), and Energy (-3.6).

Commodities Performance (*link*): Twenty of the 24 commodities we follow rose last week, up from five rising a week earlier. Last week's best performers: Brent Crude (10.6%), Heating Oil (6.2), Unleaded Gasoline (6.0), Crude Oil (5.9), and Feeder Cattle (5.1); the biggest laggards: Sugar (-3.4) and Cocoa (-1.1). Seven commodities are positive so far in January, and 17 are lower. January's best performers: Lean Hogs (15.4), Gold (3.4), and Corn (3.2). January's laggards: Crude Oil (-13.1), GasOil (-13.1), Brent Crude (-12.8), and Unleaded Gasoline (-12.8). Seven commodities were positive in 2014, but just three were positive in 2015: Cocoa (10.3), Cotton (5.0), and Sugar (5.0). 2015's worst performers: Nickel (-41.8), Heating Oil (-38.7), and GasOil (-35.9).

Assets Sorted by Spread w/ 200-dmas (*link*): Spreads between prices and 200-day moving averages (200-dmas) rose last week for 14/24 commodities, 0/9 global stock indexes, and 1/30 US stock indexes compared to 10/24 commodities, 1/9 global stock index, and 6/30 rising a week earlier. Sugar trades 11.1% its 200-dma, the highest among the commodities and indeed all assets we track; the next highest among commodities is Lean Hogs (1.9%), which turned positive in the latest week. Silver improved the most w/w, as it rose 2.6ppts to -7.2%. GasOil lags all other commodities and assets, trading 44.6% below its 200-dma, but Heating Oil weakened the most last week, falling 4.7ppts w/w to -42.2% below its 200-dma. Commodities' average spread edged down w/w to -14.6% from -14.4%. All nine global indexes continue to trade below their 200-dmas. Indonesia leads the global indexes at 6.1% below, as all global indexes weakened w/w relative to their 200-dmas. Brazil is the lowest at 22.8% below its 200-dma, followed closely by China (-22.2). The global indexes' average spread fell to -13.4% from -10.9%. Just one of the 30 US stock indexes trades above its 200-dma, down from four a week earlier, as their average spread weakened to -12.8% from -10.7%. SmallCap Utilities leads all US stock indexes at 5.3% above its 200-dma, but LargeCap Telecommunication was the best performer last week, rising 1.0ppt to -1.3%. At the other end of the spectrum, SmallCap Energy continues to lag all the indexes at 42.5% below its 200-dma, but MidCap Telecommunication Services was the weakest US stock index last week as it fell 6.6ppts to 25.3% below its 200-dma.

S&P 500 Technical Indicators (*link*): The S&P 500's technical picture improved last week as the index rose 1.4% for its first weekly gain of the year. However, the index's 50-dma fell further below its 200-dma and sunk deeper into a Death Cross. Just three sectors remain in a Golden Cross (Consumer Discretionary, Consumer Staples, and Tech), unchanged from a week earlier. The S&P 500 has been below its 50-day moving average (dma) for seven straight weeks and falling for the past four weeks; it's also been below its 200-dma for four weeks and falling for three weeks after struggling to move higher since August. The S&P 500 improved to 5.7% below its falling 50-dma from a five-month low of 7.8% below a week earlier, and improved to 6.9% below its falling 200-dma from a three-month low of 8.4% a week earlier. Its 50-dma relative to its 200-dma dropped to a seven-week low of -1.3% from -0.7% a week earlier. Telecommunication Services joined Utilities in the latest week as the only sectors trading above their 50-dmas. Consumer Staples joined Utilities as the only sectors trading above their 200-dmas. The 50-dma turned higher for Consumer Staples and Telecommunication Services in the latest week and joined Utilities as the only three sectors rising. Consumer Staples has its 200-dma edging higher now and is the only sector doing so. However, four sectors are seeing their 200-dma barely falling now: Consumer Discretionary, Information Technology, Telecommunication Services, and Utilities.

US ECONOMIC INDICATORS

Leading Indicators (*link*): Leading indicators dipped in December after a solid rebound the first two months of Q4. The Leading Indicators Index (LEI) slipped 0.2% after gains of 0.5% in both October and November to a new cyclical high. According to the Conference Board, "The index continues to suggest moderate growth in the near-term despite the economy losing some momentum at the end of 2015. While the LEI's growth rate has been on the decline, it's too early to interpret this as a substantial rise in the risk of recession." Five of the 10 indicators contributed negatively to December's LEI, four contributed positively, while the average workweek was once again unchanged. The negative contributors were the new orders diffusion index (-0.13ppt), building permits (-0.12), jobless claims (-0.07), stock prices (-0.05), and consumer expectations (-0.01). These declines were partially offset by positive contributions from the interest-rate spread (0.22), the leading credit index (0.05), and real core nondefense capital goods orders (0.01) and real consumer goods orders (0.01).

Coincident Indicators (*link*): The Coincident Indicators Index (CEI) hit yet another record high last month. The CEI rose 0.1% in December after gains of 0.1% and 0.2% the prior two months. The CEI hasn't posted a decline since January 2013, climbing 7.0% over the period. Three of the four components advanced last month, each once again reaching new record highs: 1) Nonfarm payroll employment climbed 0.2%; it hasn't posted a decline since June 2010. 2) Personal income--excluding transfer payments--increased for the 25th time in 26 months, up 0.3% m/m and 8.7% over the time span. 3) Real manufacturing & trade sales climbed for the sixth time in seven months by a total of

2.3%. 4) Industrial production remains the one outlier, falling for ten of 2015's 12 months, down 0.4% m/m and 1.8% y/y.

Regional M-PMIs (*link*): Early indications from regional PMIs suggest that manufacturing activity continued to contract this month on a very weak reading from the New York Fed. Just two Fed districts have reported so far: New York and Philadelphia; we average the composite, orders, and employment measures as data become available. The two regions show the composite index was negative for the sixth month, coming in at -11.4 this month--the weakest since August 2011. New York's was negative for the sixth month, deteriorating to -19.4 (lowest since March 2009) after improving steadily from -12.9 in September to -6.2 in December. Philly's index was negative for the fifth month, but improved from -10.2 to -3.5 this month. The new orders measure fell from -8.6 to -12.5 as New York's gauge plummeted from -6.2 to -23.5 (weakest since March 2009); Philly's improved from -11.1 to -1.4. The employment index posted its fourth negative reading, slipping from zero in September to -7.5 this month, after a string of positive gains stretching back to December 2013. New York (from -16.2 to -13.0) manufacturers continue to cut jobs at a fast pace, while Philadelphia's (2.2 to -1.9) remain hesitant to hire.

GLOBAL ECONOMIC INDICATORS

US M-PMI Flash Estimate (*link*): Manufacturing activity picked up a bit this month after growing at its slowest pace since October 2012 last month, according to Markit's M-PMI flash estimate. The M-PMI climbed to 52.7 after falling the prior two months from 54.1 in October to a 38-month low of 51.2 in December. The headline PMI signaled a moderate improvement in overall business conditions, though the latest reading was the second-lowest since October 2013 and weaker than the post-crisis trend (54.2). Both output and new business grew at faster rates in January, while job creation slowed to a four-month low.

Eurozone PMI Flash Estimates (*link*): January's Flash Composite Index signaled a further solid upturn in business activity in the Eurozone, though the increase was the weakest since February of last year. It slipped from 54.3 to an 11-month low of 53.5 this month. The M-PMI fell for the first time in four months to 52.3 after advancing from 52.0 in September to a 20-month high of 53.2 in December; the NM-PMI dropped from 54.2 to 53.6--the first decline in four months. The report noted, "Firms appear to be looking to brighter times ahead, with business confidence improving, linked in turn to backlogs of work rising at the fastest rate since the spring of 2011. With plenty of orders-in-hand to work through, hiring remained encouragingly resilient at the start of the year." Germany's Flash Composite Index (from 55.5 to 54.5) shows growth slowed to a three-month low this month, though Germany continued to act as a major source of growth for the region as a whole. Both the M-PMI (53.2 to 52.1) and NM-PMI (56.0 to 55.4) eased a bit during the month. Activity in France grew only modestly, with its Flash Composite Index (50.1 to 50.4) just above the breakeven point of 50. Its NM-PMI (49.8 to 50.6) moved back above 50, while the M-PMI (51.4 to 50.0) fell back to 50. The rest of the region continued to enjoy strong output and employment growth, though at slightly slower rates of expansion than the peaks seen late last year.

Japan M-PMI Flash Estimate (*link*): Japan's manufacturing sector continued to grow at a solid pace in January. Its Flash Composite Index (from 52.6 to 52.4) barely changed from December's 21-month high. According to the report, production rose at a rate little-changed from December's joint 21-month record, while new order growth eased to a six-month low. Data suggested that the slowdown in total new order growth was mainly attributed to domestic demand; international demand rose at a faster rate.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333