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2015 -- Testing the Limits

Markets turned testy in 2015. It wasn't so much that a tempest tore through the financial system; just that the tranquil prosperity of the past few years seems to have ended. For the most part, it was easier to lose money than to make money. And for investors in the wrong assets, plenty of money was lost.

The highlights include US equities turning in their worst performance since the great recession, with most major indices declining slightly. In an unusual twist, mega-cap stocks outperformed large caps, which outperformed mid caps, which in turn bested small caps. Owning the 10 or 20 largest stocks in the SP 500 for the entire year would have produced returns well above the rest of the US market.

In the bond market, Treasury prices held up despite the Federal Reserve finally moving off its zero-interest-rate policy. The 10-year Treasury note started the year with a yield of 2.17 percent, and ended the year at 2.27 percent. On the short end, anticipation of a Fed tightening drove 2-year Treasury yields 39 basis points higher, to a level not seen in over five years. Still, that level is just over one percent.

So if you owned US mega-cap stocks and Treasury notes, you had about as much fun as if you spent the year watching paint dry. At least you came away unscathed.

That was the good news.

Globally, equities continue to struggle. Developed markets including Japan and parts of Europe rose for the year, but for a US-based investor the nominal gains were offset by the strong Dollar. Emerging markets fared much worse, with a combination of weak local markets and declining currencies sending the MSCI emerging market index down 28 percent from its April high, all the way back to 2009 levels. Emerging market equities are now in the curious position of being among the best investments of the last three decades, and the worst of the last six years. Contrarians might sniff a buying opportunity, especially if US Dollar strength wanes. Yet emerging market stocks as a whole are still not cheap; nor are they immune to a global growth slowdown and commodity rout.

The year was painful for two other asset classes -- high yield bonds, and commodities. In the high yield market, interest rates moved dramatically higher, with the trend accelerating toward year end. Our most popular measure of junk bonds began the year with a quoted yield of 6.61 percent, up from below five percent in mid-2014. By year end, the yield approached nine percent. Given the high level of interest income, total returns were down only mid-single digit percentages, but the damage to the market seems far worse. In the course of 18 months, high yield rates have spiked nearly 400 basis points, even when including the 'quality' portion of the junk bond market.

The explanation is three-fold. First, as interest rates in the US and around the globe compressed in recent years, the search for yield moved money to higher risk assets, including junk bonds. This drove yields to historic lows in a 'risk on' trade that could not last. Next came the collapse of oil prices, and the energy industry, where a fair number of high yield credits reside, and where defaults are accumulating. Finally, the yield rally broadened to include non-energy credits, exacerbated by a structural flaw in mutual funds and exchange traded funds (ETFs). This flaw exists where large-scale selling of funds promising timely liquidity creates forced selling of illiquid underlying securities. The owner of a high yield fund can sell any day, with little friction; but the fund manager facing redemptions must then find a buyer for bonds that few investors desire. 'Bid wanted' is no rallying cry.

Commodities were the year's big loser. Crude oil prices have fallen by two-thirds from their mid-2014 highs, approaching their lows of the great recession. Natural gas is no better. Energy may be the poster child, but it is just the start of the pain in the commodity markets. Gold prices have fallen 40 percent from their highs. Zinc is down a similar amount. Silver has dropped 70 percent. Copper has been cut in half; iron ore by three-fourths. It goes on and on.

A year ago we questioned whether commodities were an investable asset class. Little did we know the carnage that was about to hit the commodity complex, its reflection of and implications for global growth. We generally favor low commodity prices, until it turns into a calamity, with miners and drillers forced to shut production, lay off workers, slash capital spending and do their best to survive. The pain travels around the globe, and right back to our equity and credit markets, where stock prices collapse and high yield rates widen at an alarming pace. This is a virtuous cycle turned on its head, a negative-feedback loop seemingly without end. It will find a bottom, we just don't know when.

That is the worst of it, and it was not all gloomy. In any year, there are always newsworthy events -- some perplexing, some hopeful -- and the past year was no different. Here are a few favorites:

How Low Can You Go Olympics
The European Central Bank doubled down on its easy-money policy, driving a key lending rate to minus 0.3 percent. Not to be outdone, the Swedish central bank lowered its lending rate to minus 0.35 percent; this for an economy growing by over three percent. In Germany, the government five-year note offers a yield just under zero. Yet the gold medal goes to Switzerland, where government note yields are negative all the way out to ten years, at minus 0.12 percent. European

credit markets are upside down, with yields in a race to the bottom as banks and investors willingly pay to lend money. Economic historians will cite this era as one of the world's most bizarre cases of financial market behavior.

It's My Party

In the US, the Federal Reserve refused to play along, instead exiting its zero-interest-rate policy after seven years of mixed results. It must be a good gig working for the Fed. When the economy is collapsing you set short-term rates near zero. As recovery sets in, you keep rates near zero. As nominal growth accelerates past three and four percent, you remain near zero. All of a sudden, seven years have passed and you have done nothing with your primary policy tool. The best part is, you still get paid.

In December, the Fed finally moved off the zero bound, raising short-term rates by a quarter point. The Fed then proceeded to talk back its policy move, doing its best to simultaneously assure and confuse markets about its motives and future intentions.

Start All Over Again, Again

South America, where politics and economics are joined at the hip, is seeing its latest socialist movement begin to fracture. The transition toward free markets and responsible government will not be easy. If history is a guide, it also will not be permanent.

Venezuela, home of 'Chavismo' rule, suddenly has voters turning away from the ultra-left-wing policies of the past decade. The leadership's problem is simple: when you promise your people everything, eventually you run out of both money and things to promise. One challenge facing the nation is an inflation rate estimated near triple digits; another problem is low oil prices. After solving these two issues, the other 50 will appear less daunting.

In Argentina, the populist rule of the Kirchner regime has ended. Newly elected as President is, of all things, a former banker. Apparently, 'Occupy Wall Street' and 'The Big Short' never made it to Buenos Aires. Among the first policy moves of President Mauricio Macri was to slash export taxes and ease capital controls, sending the Peso to a 25 percent devaluation. It is harsh medicine, but much needed. After years of neglect, any policy reversal is surely for the better. "What would Christina do?" is unlikely to become a popular slogan.

Brazil cannot act fast enough to face its demons, including a credit rating downgraded to junk status, rampant corruption, and President Rousseff's impeachment. The economy is in shambles, recently labeled as a 'depression', a word Wall Street uses with utmost discretion. This brings to mind a prophetic quip about the continent's largest country: "Brazil is the nation of the future, and always will be." For its own sake, let's hope not.

Better Late Than Never

In an overnight move 40 years in the making, Congress repealed its ban on US crude oil exports.

The trade restriction was a relic of the 1970s energy crisis, and if per chance it was a sensible mix of politics and economics at the time, it certainly was not 10, 20 and 30 years later. The policy change will have little immediate effect on oil markets. Instead, it serves as a reminder that in Washington, short-term political responses, once enacted into law, can live a very long life.

As for the year ahead, here are four wild cards -- known risks, which could swing for the better or worse -- that are crucial to US markets.

Profits

After more than doubling since the great recession, US corporate profits have stalled. The obvious culprits include a collapse in energy profits and the strong dollar. But there are other concerns, including slow global growth, a tightening labor market, and the fact that corporate profit margins are near record levels. If this sets the high water mark for profitability, then US equities are no bargain. There is an embedded growth assumption in most stock prices, and earnings need to re-accelerate to sustain the bull market.

Interest Rates

The Federal Reserve has entered into a new interest rate cycle, after nine years of flat or falling rates. While some view this as cause for alarm, it is well overdue and not worrisome. The issue is how far and how fast the Fed raises short-term rates. Given easy monetary policies around the world, and considering the reluctance of our central bank to initiate this rate cycle, expect a mild response from the Fed.

A federal funds rate on either side of one percent is probably a fair target for the next year, and will not be troublesome. If the Fed moves significantly beyond that, it is likely to pressure stocks and bonds. Likewise, markets can probably withstand a mild bump in the 10-year Treasury yield, currently at 2.27 percent. A rate somewhere under three percent should still be supportive, especially if it reflects stronger economic activity.

China

China is in flux, with elevated debt levels, slower growth, and a possible Yuan devaluation on the way. A soft landing is far from certain, especially on the currency issue. China may not always matter to US markets, but it is foolhardy to ignore the risks of the world's second largest economy, and primary contributor to global growth.

Market Dynamics

Advancing a theme from a year ago, US markets have become uneasy, marked by divergences, heightened volatility, and low returns. This is both natural in the late stage of a bull market, and at the same time unsettling. As mentioned earlier, only a smattering of large-cap stocks held the averages in place for the year. Two years ago, 74 percent of equities were in an uptrend, a sign of a healthy market. A year ago the number was 55 percent. Today it is just 32 percent. At mid-

year, the S&P 500 index retreated by 12 percent, its first correction in four years. Daily price swings are wider than in prior years.

This condition needs to be reconciled with an S&P 500 index just four percent off its all-time high. There is a limit to market resilience in the face of underlying weakness. Either the market broadens, with more stocks and other assets participating on the upside, or a serious downturn is possible.

These are the known risks, with uncertain outcomes.
Surely others will emerge, as they always do.

Happy New Year!!

Source:
Bloomberg
Pew Research Center
The Wall Street Journal

Tidbits..

One more time: OECD cuts global growth forecast for 2015, 2016; now projecting 2016 growth of 3.3 percent.
China signals intermediate growth target of 6.5 percent, lowest projected rate in decades.
And with it, likely emergence of the world's largest middle class.

Amazon opens first brick-and-mortar retail store, after 20 years of online sales.
Don't expect this to become a trend.

First-time buyers drop to lowest share of home purchases since 1987.

White House places final rejection on proposed Keystone Pipeline project.
A triumph of politics over economics.

US corporate debt issuance reaches all-time high in 2015, over 800 billion dollars.
Share repurchases by S&P 500 companies exceed 1.5 trillion dollars over the past three years, approaching record levels.
Leverage the balance sheet, an incentive of cheap money.

Pfizer and Allergan agree to pharmaceutical mega-merger valued near 150 billion dollars.
Canadian Pacific Railway proposes 28 billion dollar merger with US railroad Norfolk Southern.
Marriott International to buy Starwood Hotels & Resorts Worldwide for 12 billion dollars, creating the world's largest hotel company.
Dow Chemical and DuPont announce blockbuster chemical business merger valued at 150 billion dollars.
Global merger and acquisition activity, at 4.6 trillion dollars, sets record level.
More cheap money at work.

New York Governor Cuomo unilaterally moves to raise state employees' minimum wage to 15 dollars per hour, bypasses legislative consent.
Free money, by executive decree.

Spending related to climate change rises 18 percent in past year, to 391 billion dollars.
A mix of theory, politics, and economics, disguised as hard science.

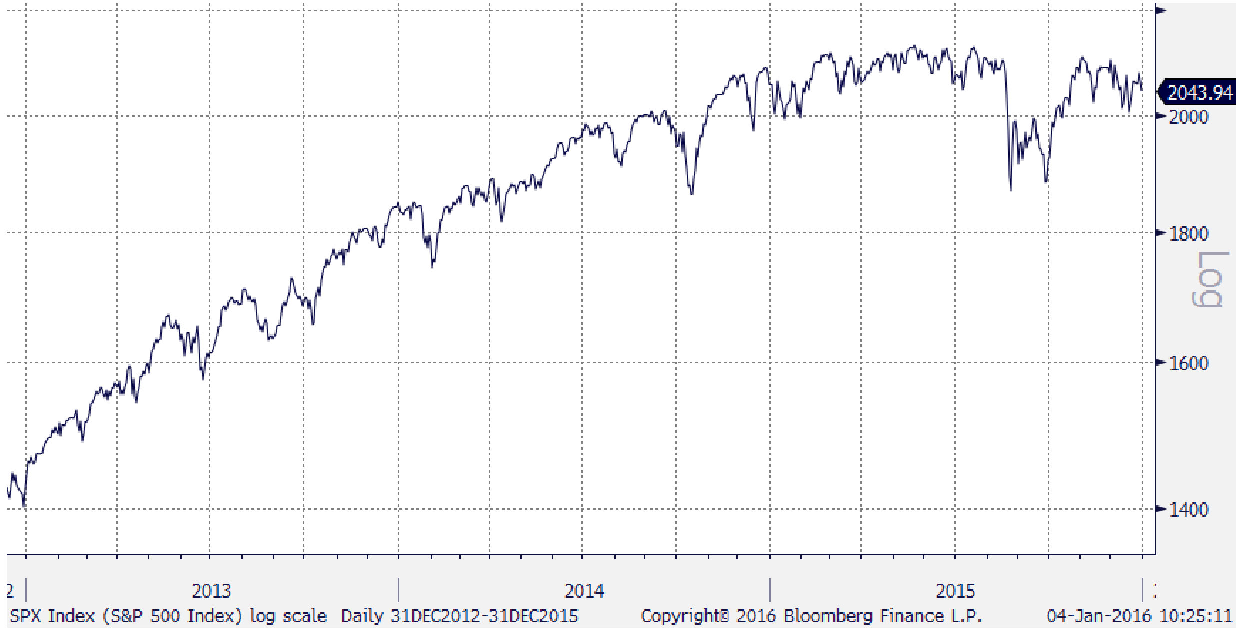
UnitedHealth Group, nation's largest health insurer, threatens exit from Obamacare individual exchanges in 2017 due to heavy losses.

US Treasury net new supply of notes and bonds predicted to drop by 26 percent in 2016.

Pew Research Center study shows fewer than 50 percent of Americans are now part of the middle class, with growing upper and lower classes.
This cannot be healthy.

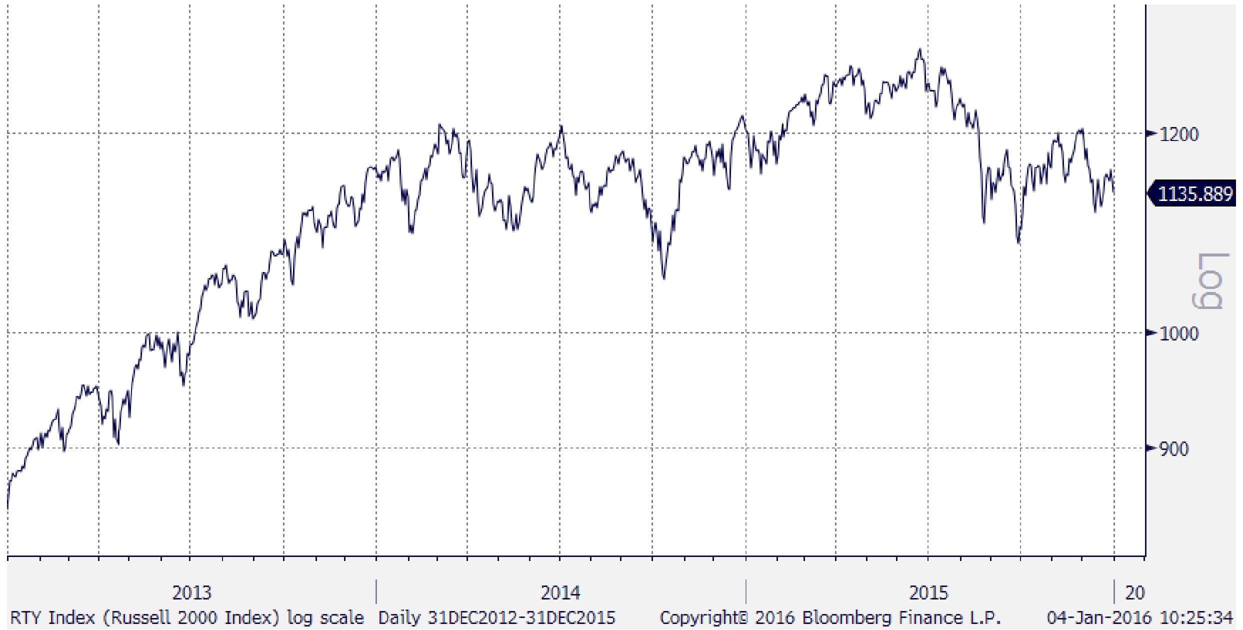
Equities

SP 500 Index 2013-2015



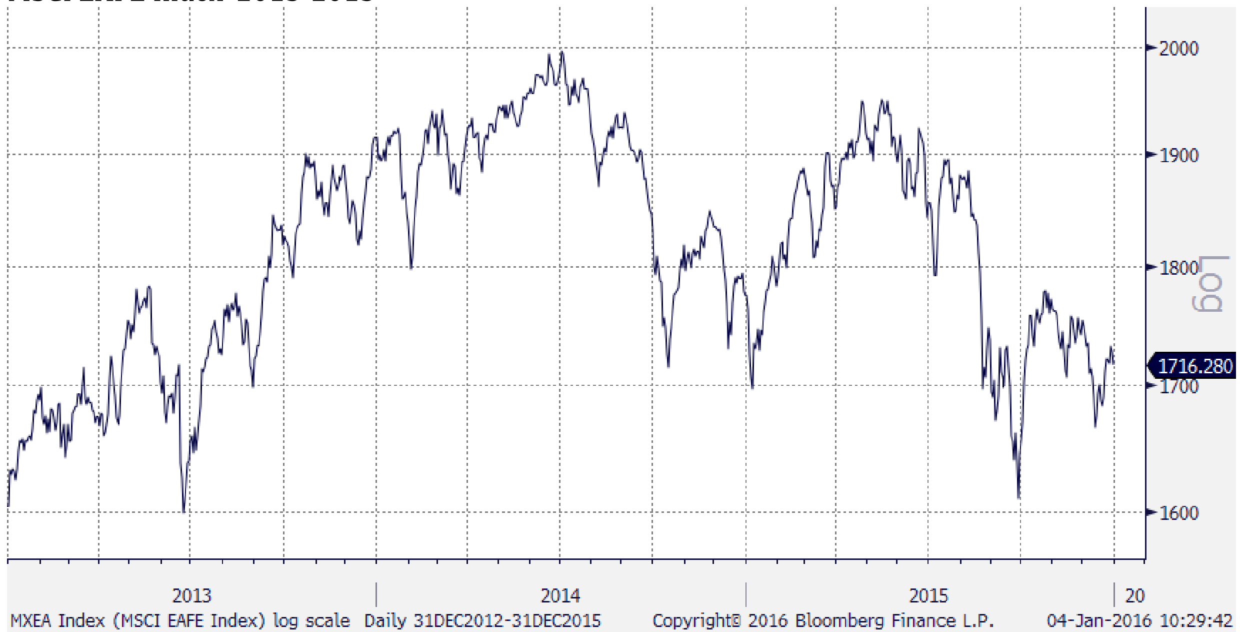
US large cap equities were trendless in the past 12 months, ending the year slightly lower, with far more stocks in a downtrend than an uptrend.

Russell 2000 Index 2013-2015



Small cap stocks continue to underperform, another sign of weak market dynamics.

MSCI EAFE Index 2013-2015



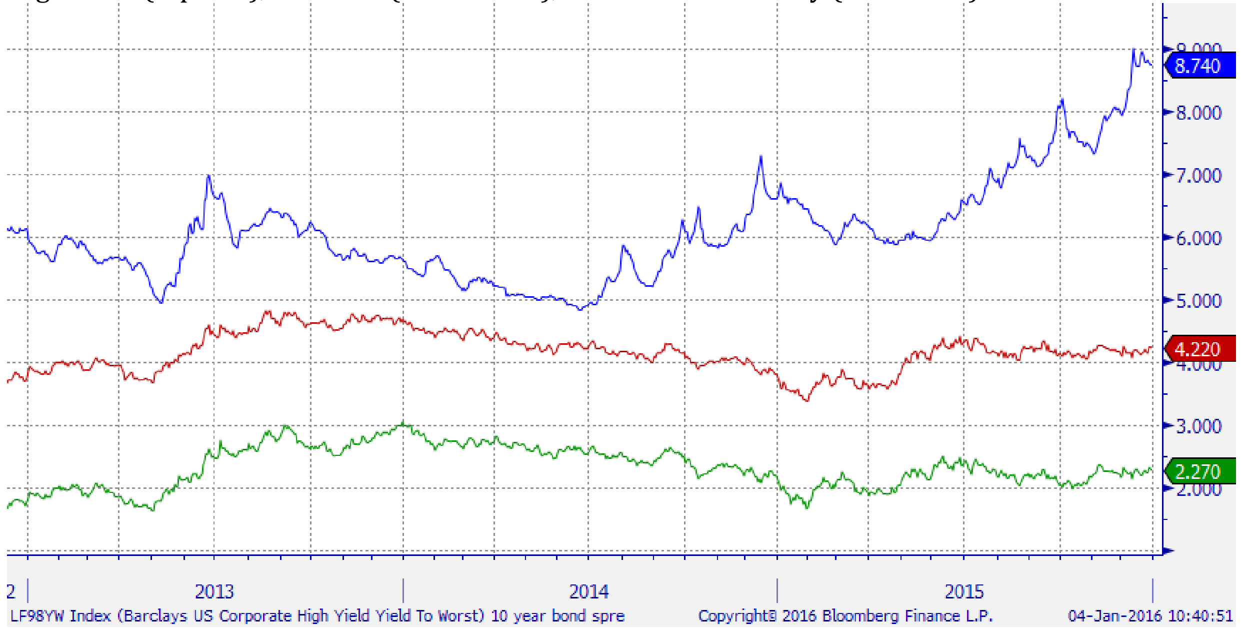
Developed international markets rose in local currencies, but the strong Dollar wiped out most gains for US investors. Viewed over a multi-year timeframe, this is still a trendless market.

MSCI Emerging Markets Index 2013-2015

Emerging market equities suffered large losses in 2015, have declined in four of the last five years, and have erased all gains since mid-2009.

Bonds

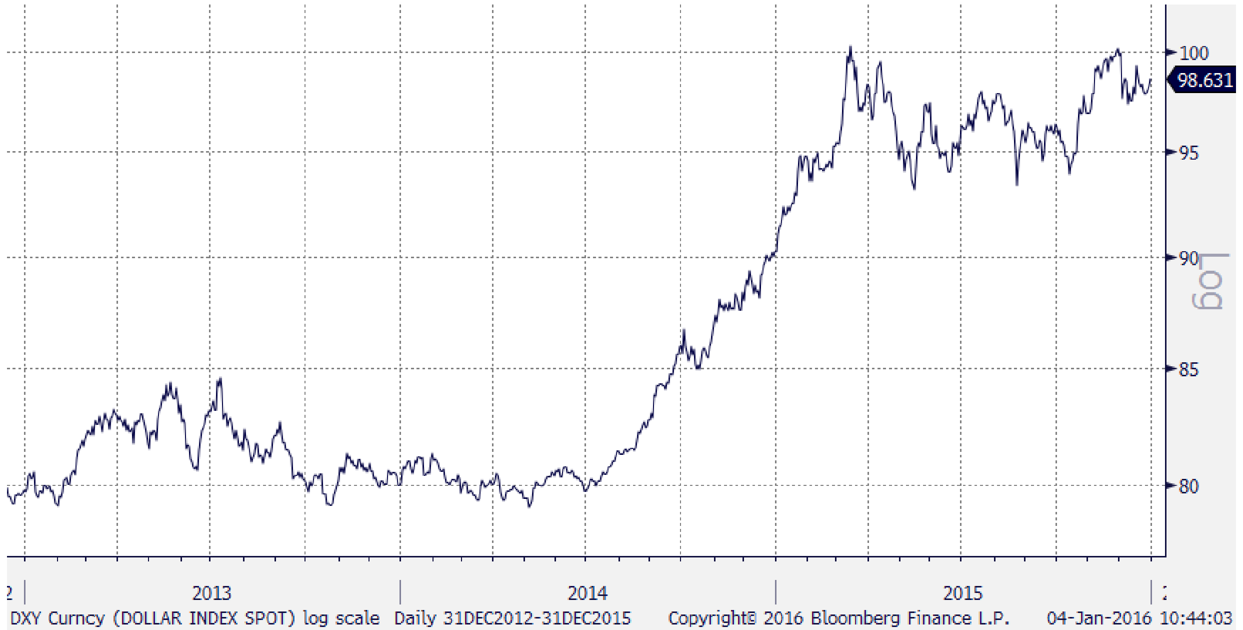
Bond Yields 2013-2015
High Yield (top line), AA rated (middle line), 10-Year US Treasury (lower line)



10-year Treasury yields traded in a narrow range throughout the year. Not so for the junk bond market, where yields have widened by 400 basis points since June 2014.

Currencies

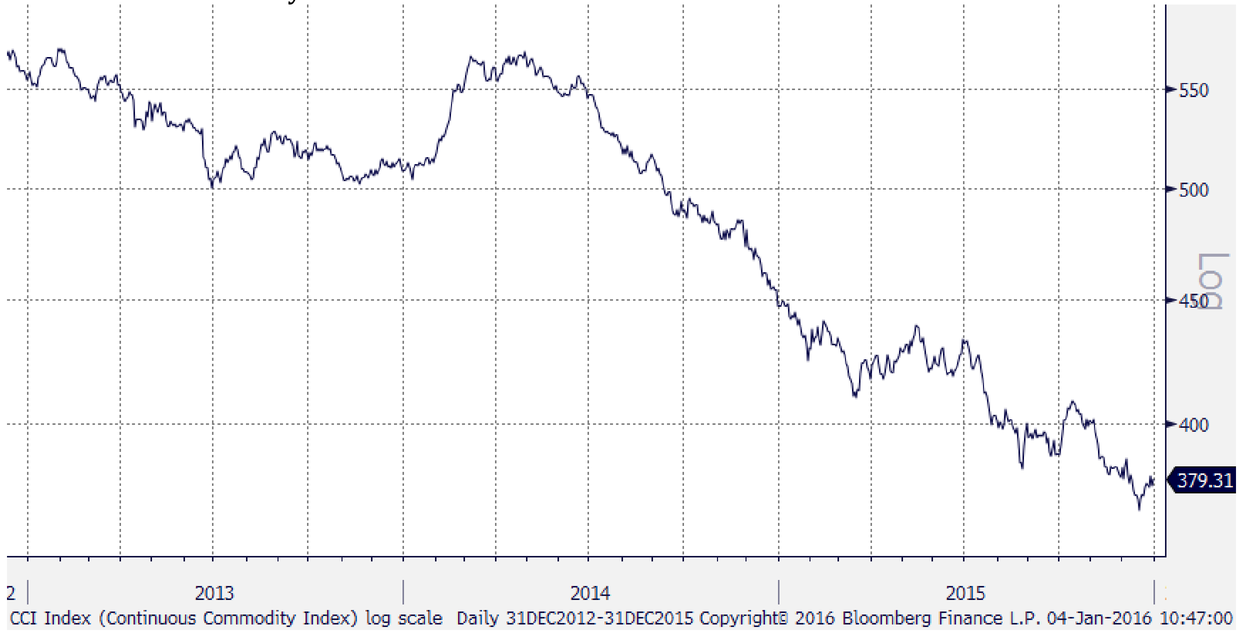
US Dollar Index 2013-2015



The US Dollar was among the best performing asset classes in 2015. Further dollar strength from this point would be unwelcomed, weighing on US corporate profits and warning of global financial stress.

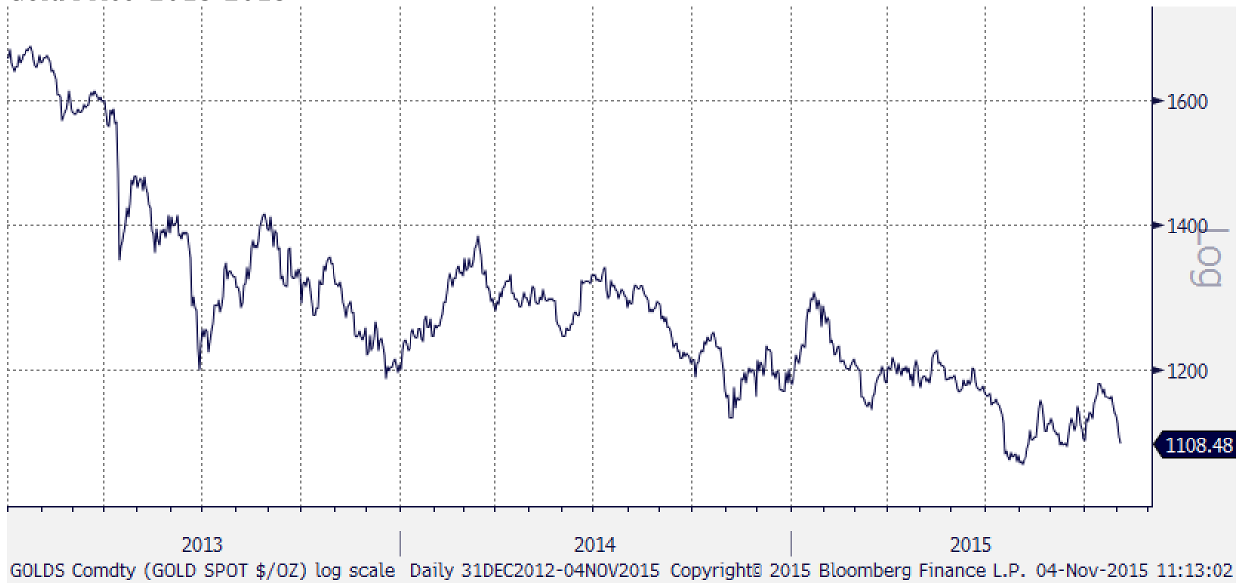
Commodities

Continuous Commodity Index 2013-2015



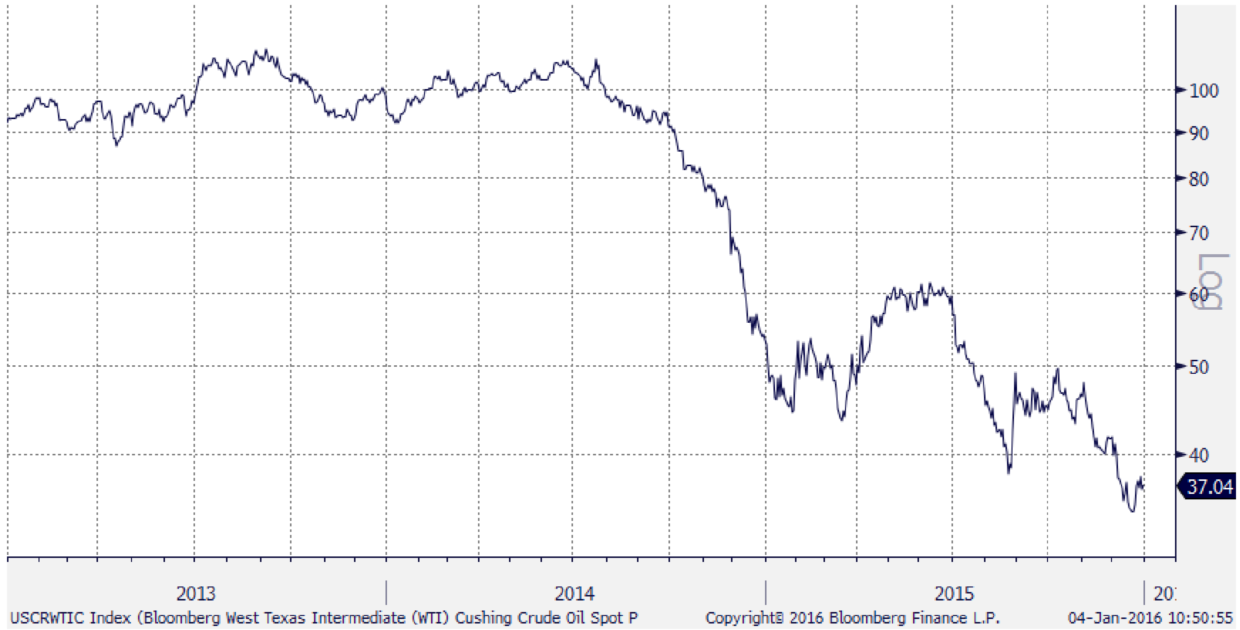
There was no relief for commodity prices, as the rout extends well beyond the energy complex.

Gold Price 2013-2015



Gold prices fell 10 percent in 2015, declining for three straight years.

West Texas Intermediate Oil Price 2013-2015

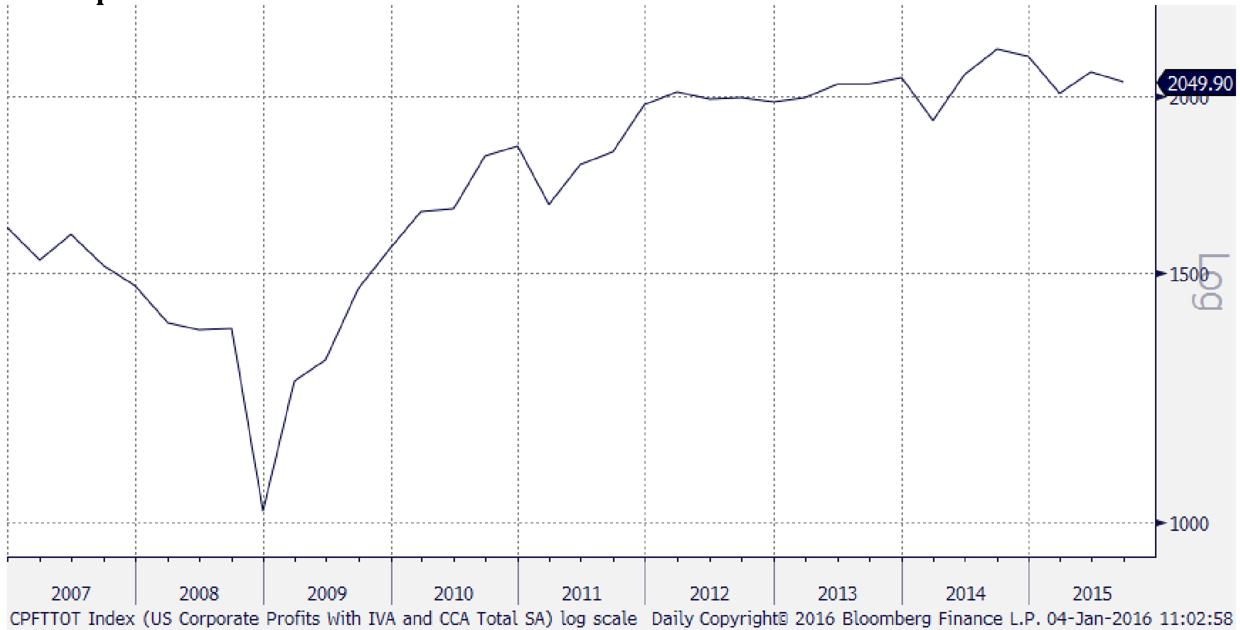


The world is awash in oil, with prices dropping by two-thirds since mid-2014. Near term, oil may trade lower. Longer term, it seems unlikely that these low prices can persist.

Natural Gas Price 2013-2015

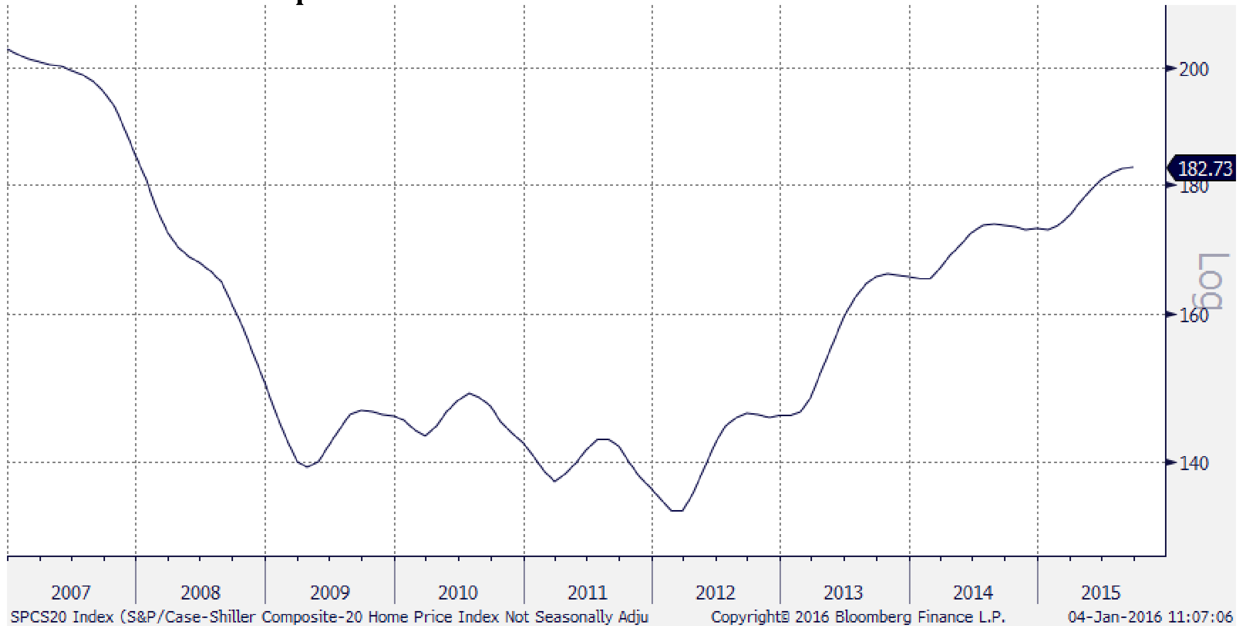
Natural gas cannot catch a break -- there is always too much supply and not enough cold weather.

US Corporate Profits 2007-2015



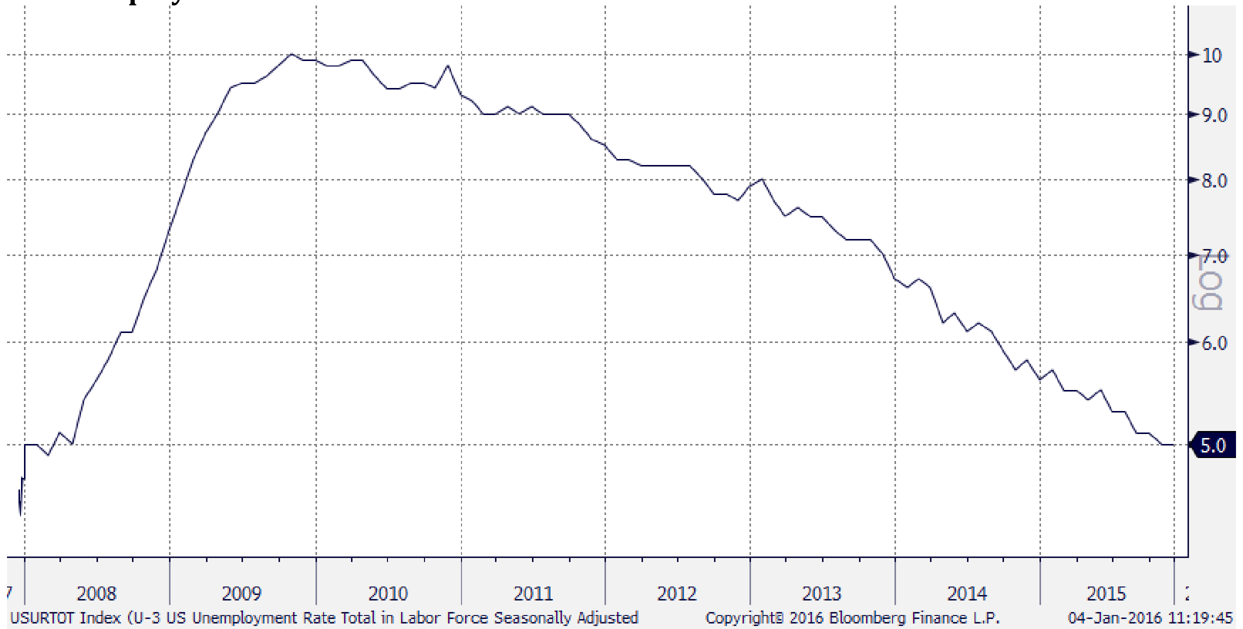
US corporate profits plateaud after doubling since the great recession. A resumption of profit growth may be necessary to drive stock prices to new highs; yet this growth is far from certain.

S&P Case-Shiller Composite Home Price Index 2007-2015



Home prices are rising by mid-single digit percentages, far from the boom years yet well above inflation. Not everyone needs to own a home, but first-time buyers waiting for their chance are mis-timing the market.

US Unemployment Rate 2008-2015



The job market continues to strengthen, with unemployment falling to five percent and wages beginning to improve.

Still, a low labor participation rate -- a smaller labor force as a percentage of the working-age population -- is an ongoing problem.

US Labor Force Participation Rate 2008-2015