Global Market Strategy – February 2016

"Extreme conditions unlike anything experienced before"

The US Federal Reserve's face-saving augmentation of interest rates in December by 0.25%, now shows Janet Yellen and her colleagues in a poor light.

To be fair, it's not their fault anymore. Rather than being in control of their own destiny, the US Fed is more and more at the mercy of global events. World growth is not what it needs to be to warrant a climate of rising rates. The start of trading in the first 3 weeks of 2016 was the most volatile and negative for equity investors since records began. All indices were down between 10-14% until Mario Draghi - rightly acquiring the pseudonym 'Super Mario' for the impact he seems to have on markets - hinted in his January press conference that the ECB was ready to embark upon its latest plate-spinning exercise in market stimulus.

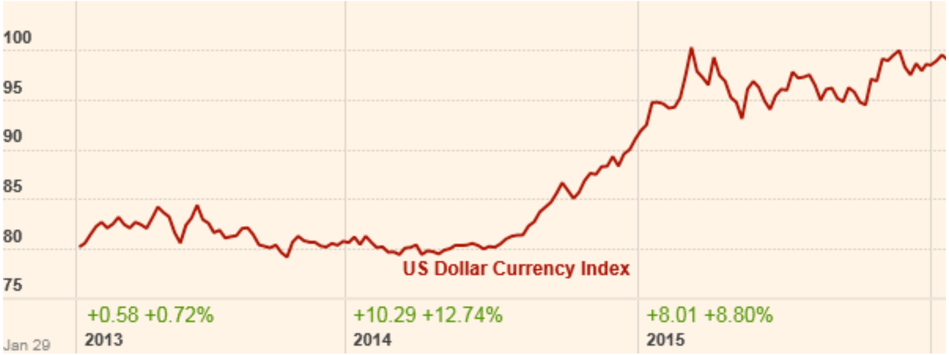
The dead-cat bounce lasted two days, with rebounds typically of 5-7%, before on Monday January 26th we woke up to another 6% fall in China. Western markets didn't fall that far but the tone was set, and then Apple's Tim Cook in his quarterly conference-call spoke of a "challenging global macroeconomic environment… we're seeing extreme conditions unlike anything we have experienced before… just about everywhere we look: Brazil, Russia, Japan, Canada, South-East Asia, Australia, Turkey, and the Eurozone, have all been impacted by slowing economic growth, falling commodity prices and weakening currencies… [there are also] some signs of economic softness in Greater China, most notably in Hong Kong."

The following day of trading, January 27th, Apple fell 6% at the open of trade, causing the Dow and S&P to fall more than 1%. Then, right at the end of the month, Bank of Japan announced they would begin to charge banks 0.1% for depositing "excess" funds on deposit, in order to encourage lending rather than 'parking'. The Nikkei promptly surged 3% but it was down 8% for the month. All major markets jumped 2-3% on the news from Japan but were down heavily on the month: the Eurostoxx 600 was down 6.4%, the S&P500 6.8%, FTSE100 4.0%, Ibex 7.7% and the Shanghai Composite a massive 22.5% on further fears of slower growth and maladministration.

So where now? Carolyn Boroden is given the nickname 'Fibonacci Queen' because she bases her technical analysis on the study of the medieval Italian mathematician Leonardo Fibonacci. He discovered that a key series of ratios tend to repeat themselves over and over again in nature and they can also appear at key levels in the stock market. Ms Boroden's study of the ratios prompted her to predict the top of the Summer rally in June would be 2138 on the S&P500. It actually peaked at 2134. The accuracy of her forecasts draws attention to her work, and now she is warning of a further drop soon in the S&P500 to around 1840 from its current level of 1907. If that's not bad enough, she says if the S&P falls through 1835, we could see falls equal to the magnitude of 2008/09. Charles Nenner, another technical analyst, agrees. He sees the Dow falling to 5000 over the next five years, from its current level of 16,200. Few believe either doomsters, but many are agreed it will be another tough year for the equity markets.

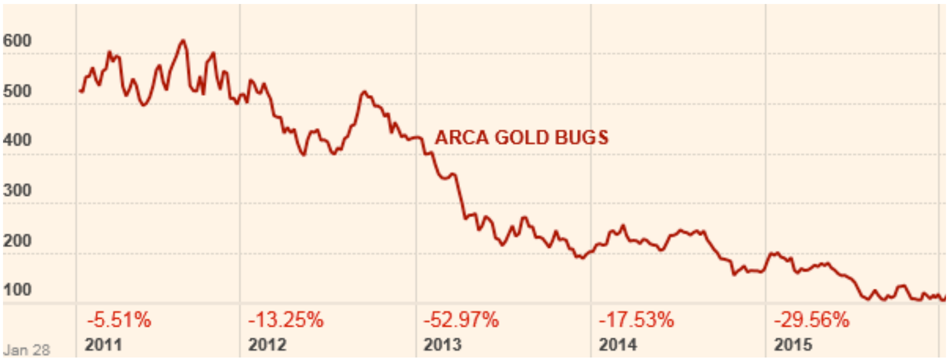
For sure, there has to be something to worry investors all the time, and yes, the inflating of real assets through central bank activity rather than through strong underlying wage and economic growth, is a concern. The US dollar, which strength has been the downfall of commodity prices and emerging markets, is at last showing signs of topping, and now, with the Fed's January statement signalling more caution about the upward trajectory of US interest rates, the US dollar could well weaken this year, sufficiently so to give EM and commodity stocks a lift.

Would that be good for gold? Possibly it would, but why? Mohamed El-Erian, formerly Bill Gross's No 2 at the world's largest bond mangers, PIMCO, said last week that he believes the world will have to get used to low growth and low equity returns for many years because the actions of central banks have caused [US] gains to be 'borrowed' from the future. Either we have to generate economic growth to stimulate world economies in order to "validate" inflated asset prices, "or we slip into global recession", he said, and one or the other will occur within the next 3 years. It's the global recession part which could, justify holding gold as an insurance policy, and if we do slip into recession, or if at the very least there is danger of that happening, there are not going to be anymore rate rises from anyone, and the dollar will weaken. Gold cannot rise in the face of a strengthening dollar but if the dollar weakens because there are no more rate rises, gold will rise, particularly if there is deflation or a recession, and if the metal rises, gold stocks will soar.



US dollar currency index over 3 years (Source, Financial Times)

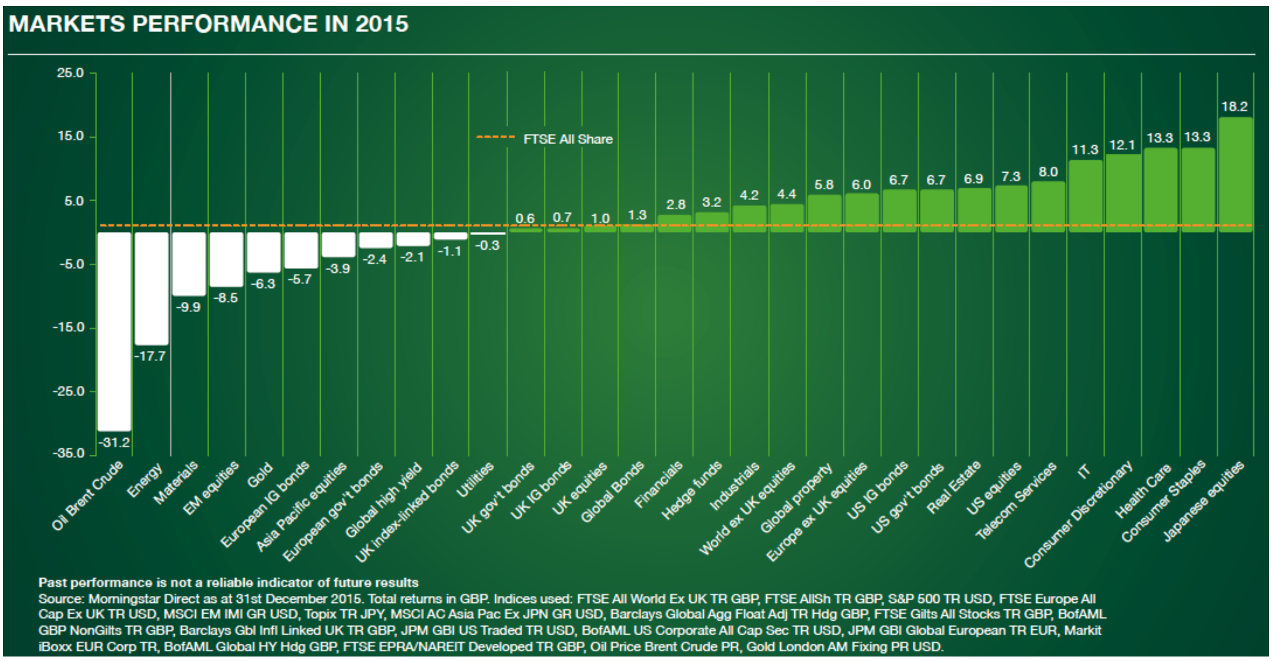
The NYSE Arca Gold BUGS Index is a modified equal dollar weighted index of companies involved in gold mining. BUGS stands for Basket of Unhedged Gold Stocks. It is also referred to by its ticker symbol "HUI". Since 2011 when gold rose to $1910, the gold miners have plummeted far faster than the metal itself, and according to technical analyst Nicole Elliott, we are not yet at the point when gold and the miners will make a sustained move higher. "Gold", she writes, "… is not even close to cheap…it is not in the least bit oversold. Very long term support comes in closer to the $900 area than the psychological $1000."



ARCA Gold Bugs Index HUI:PSE over 5 years (Source: Financial Times)

It may be too early to embark on a high risk strategy of buying gold stocks but it would probably be just the right time to bolster portfolio investment by deploying long/short equity absolute return content.

We had better get used to greater volatility, as both Marc Faber and Mohamed El-Erian said last month.



Favoured investment plays:

Nil risk: USD & GBP cash (in preference to Euro cash)
Cautious risk: AAA Corporate / Government bonds (short duration)
Balanced risk: Managed / Multi-asset funds / Long-Short Absolute Return funds
Market risk: UK**, European equity**
Adventurous risk: **Japan,** Asia**,** US equity
Speculative risk: Timber, Water, **China,** India,

Disclosure:

Nicholas Chappell has the following personal investment exposure: Technology (US) 15%, US smaller cos 1%, (Other) US equity 7%, UK smaller cos 10%, (Other) UK equity 15%, Iberia 1%, European Telecoms 1%, (Other) European equity 8%, India 2%, Japan 10%, China 4%, (Other) Asia 11%, Energy 2%, Pharmaceuticals 10%, Long-Short Hedge 3%.

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