Katonah Capital Group, LLC
B A L A N C E I N A C H A N G I N G W O R L D
Jason@KatonahCapitalGroup.com
80 Business Park Drive, Suite 304 • Armonk, NY 10504
p (914) 219-5880 • f (914) 273-6806

FOURTH QUARTER 2015 INVESTMENT ADVISORY REPORT

It's The Credit Markets, Stupid

In past reports we've focused on many of the major imbalances in the system such as the unwinding of the flood of credit that had flowed into the emerging markets (EM) over the past decade; the underlying deterioration of the broader US equity markets; or the gradual (sometimes not so gradual) unravelling of the Chinese economy and their capital markets. As we entered into the New Year, evidence of these trends has been on full display - so much so that events of the fourth quarter are by now practically obsolete.

Our recent client update noted that, according to Barron's, "***More than $2.2 trillion sucked out of global equity markets in just the first four trading days of the year*** (*emphasis added*)".[1] As of this writing, the markets have bounced back a bit, following a wild trading day on Wednesday (Jan. 20) which saw the Dow Jones Industrials plunge more than 500 points before rallying back sharply towards the close of trading.[2] Whether the markets stabilize here or just pause before resuming their decline remains to be seen. However, the damage has been significant. According to Tyler Durden at Zero Hedge, "It's official. **More than 50% of the "wealth" effect created from the 2011 lows to the 2015 highs has been destroyed** *(despite the world's central banks going into money-printing overdrive over that period)*. Almost $17 trillion of equity market capitalization has evaporated in just over 6 months with over 40 global stock indices in bear markets..."[3] Compiling data from Bloomberg, he offers the graph below;

[1] "Stocks Drop 6% in Worst-Ever Year Opening"; Barron's; January 11, 2016; pg. M3.
[2] http://finance.yahoo.com/echarts?s=%5EDJI+Interactive#{"range":"5d","allowChartStacking":true}
[3] http://www.zerohedge.com/news/2016-01-21/fragile-forty-how-world-lost-17-trillion-6-months

He further notes that "Emerging nations bore the brunt of the meltdown, accounting for two out of every three bear markets. Slowing Chinese growth, the 24 percent slump in oil this year and currency volatility have driven developing-nation stocks to the worst start to a year on record."[4]

The obvious question is do the markets stabilize here or just pause before continuing their downtrend? However, the question is potentially not relevant, depending on how you define "the market". We've written at length explaining how the popular focus on large-cap indexes such as the Dow Jones Industrials or the S&P 500 is deceiving. Much attention has been given to the low prices set by the S&P 500 last summer as a severe market selloff drove the index down to around 1867.[5] Many observers have been heartened by the fact that during this most recent selloff, the "market" (i.e. the S&P 500) briefly dropped below 1867 but then bounced back and (as of this writing) has essentially been holding above that level. However, as the charts below show, almost every other broader measure of the market has already significantly broken well below their August/September lows.[6] This is significant because a "downtrend", by definition, is a series of lower lows and lower highs. To wit, chart #2 – the "Unweighted S&P 500" – which equally weights every stock in its index and thus does not give greater significance to a few very large companies (such as the S&P 500 Index does, with stocks such as Facebook, Amazon, Netflix and Google) has clearly broken down. This market has not "held" its prior lows from last September and is now clearly in a downtrend. The accepted (albeit arbitrary) definition of a bear market is a 20% decline from the highs. By this definition, the Russell 2000 Index of small cap stocks is solidly entrenched in a bear market, and the S&P 400 Index of mid-sized stocks touched into bear market territory during the most recent selloff.

[4] Op. cit. # 3.
[5] http://www.google.com/finance?q=INDEXSP%3A.INX&ei=WCOpVumYJMbEe-OZntAJ
[6] Charts courtesy of Worden Bros. TC2000


SP-500 (Standard & Poors 500)
Jan 27 2016 02:29:28
© TC2000.com
jwax
SP-500 Day
-2.65
-0.14%
SP-500 Avg 200 Avg 21 Avg 50 PSAR 0.02 0.20
2,200.00
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Jun Jul Aug Sep Oct Nov Dec 02:29:28
Vol Avg 50
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SPEW-X (SP500 Equal Weighted Index)
Jan 27 2016 02:31:12
© TC2000.com
jwax
SPEW-X Day
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SPEW-X Avg 200 Avg 21 Avg 50 PSAR 0.02 0.20
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Vol Avg 50
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MID--X (S&P Midcap 400 Index)
Jan 27 2016 02:21:07
© TC2000.com
jwax
MID--X
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-0.06%
MID--X Avg 200 Avg 21 Avg 50 PSAR 0.02 0.20
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1,500.00
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S&P Midcap 400 Index
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Vol Avg 50
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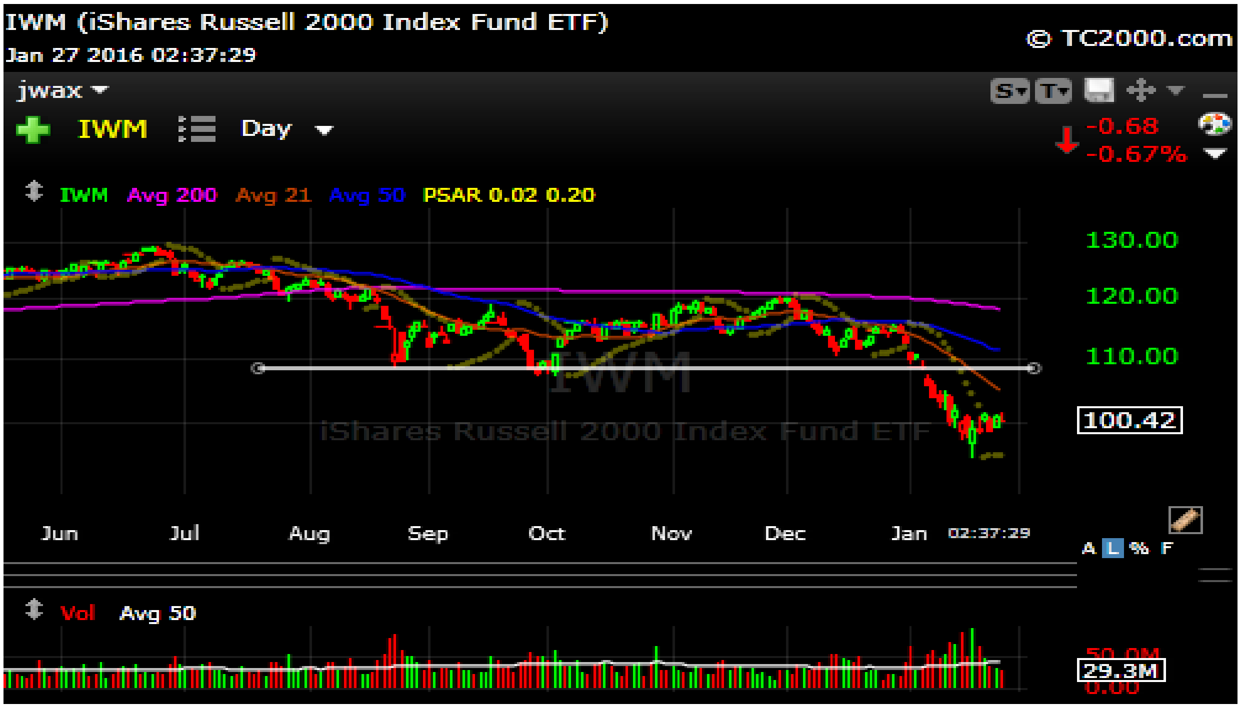
IWM (iShares Russell 2000 Index Fund ETF)
Jan 27 2016 02:37:29
© TC2000.com
jwax
IWM
Day
-0.68
-0.67%
IWM Avg 200 Avg 21 Avg 50 PSAR 0.02 0.20
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iShares Russell 2000 Index Fund ETF
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Charts (and technical analysis in general) are very useful on many levels, but they offer no perfect insight on the future direction of a market. They only offer insight into where we've been; what's occurring now; and possibly they can inform an attempt to quantify probabilities of future market behavior. So, possibly the charts are merely saying that things are cheaper now and this is a good opportunity to "buy the dip". In fact, many Wall Street pundits do view all this as a buying opportunity. In general, their bullishness stems from their assessment of the real economy – here, in the US domestically, in Europe, and in China. In the US, the oil "tax cut", along with strengthening employment numbers, do argue for buoyant consumer spending going forward. The bulls point out that if you strip out the Energy sector then earnings growth has done quite well, and in any case, the worst of the oil price declines is probably past us and will stabilize from here on out. Europe is still early on in their easing cycle. China, while slowing down from their torrid growth rates of the past decade, is still growing nicely and at more sustainable rates. And while many of the emerging economies (Brazil, Russia, Argentina…) are in really bad shape, exports are only a small percentage of our overall economy so the impact on us domestically will be minimal.

According to Bloomberg BusinessWeek; the economy has created 8.2 million new jobs in the past 3 years; total aggregate weekly pay for US private workers is up by one third from six years ago; the number of job openings has doubled from 2010 to 5.4 million; new jobless claims for unemployment insurance is in a well-defined downtrend; lower oil prices translate into cheaper home heating bills and gasoline expense which translates into more disposable income for consumers; consumer debt levels as a percentage of their disposable income has been decreasing as Americans have been deleveraging; consumer sentiment remains strong and housing affordability remains well above the worst levels of 2006-2007. So, what's not to like?

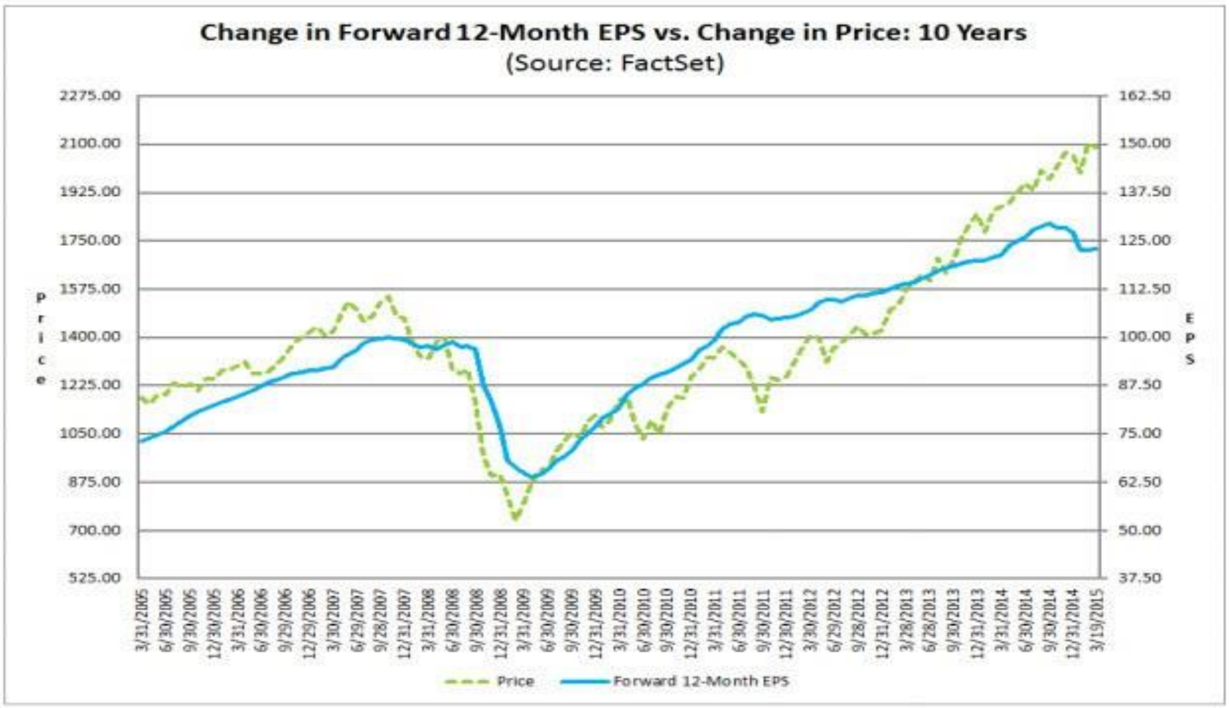
In general, we have no argument with any of this data and on the surface at least, the arguments are valid. We would take exception with the actual strength of the employment data. Just anecdotally, we know too many people in the Northeast who are unemployed (and maybe have given up on looking for work so are now therefore not considered as part of the labor force), underemployed, or employed and earning significantly less than they were 5-10 years ago. The oil tax cut, on the other hand, we believe to be unequivocally positive – at least for the US consumer and for commodity importing countries globally. It is one of the primary factors that lead us to believe that although we are indeed in a bear market for equities, it is a "garden variety" cyclical bear, and not a longer term, secular bear market nor the onset of a financial collapse such as experienced in 2008.

The nearer term ramifications of the collapse in oil prices, however, are significantly detrimental because of the resulting dislocations to credit flows. Past quarterly reports have highlighted Saudi Arabia's need to liquidate US held assets in order to fund their budget deficit. According to the Wall Street Journal, it is estimated that Saudi Arabia needs the oil price to be around $106 per barrel in order to finance their domestic needs.[7] Venezuela needs $117.50 oil; Nigeria $122.70; Iran $130.70 and Iraq needs the price back at $100.60. Crude oil for March delivery is currently trading on the New York Mercantile Exchange for around $32.00![8] Bloomberg reported findings from consulting firm Insight Discovery estimating that Saudi Arabia withdrew as much as $70 billion from global asset managers just over last summer alone.[9]

[7] http://graphics.wsj.com/lists/opec-meeting
[8] http://finance.yahoo.com/
[9] http://www.bloomberg.com/news/articles/2015-09-28/saudi-arabia-has-withdrawn-billions-from-markets-estimates-show

It's generally accepted that all the central bank QE's and stimulus, while avoiding a global financial crisis (for the moment), has been effective in pumping up the prices of financial assets, but very much less effective in generating new demand and real economic growth. The plight of Saudi Arabia (and all the other OPEC nations) hurts both asset prices as well as economic growth. In short, it's deflationary!

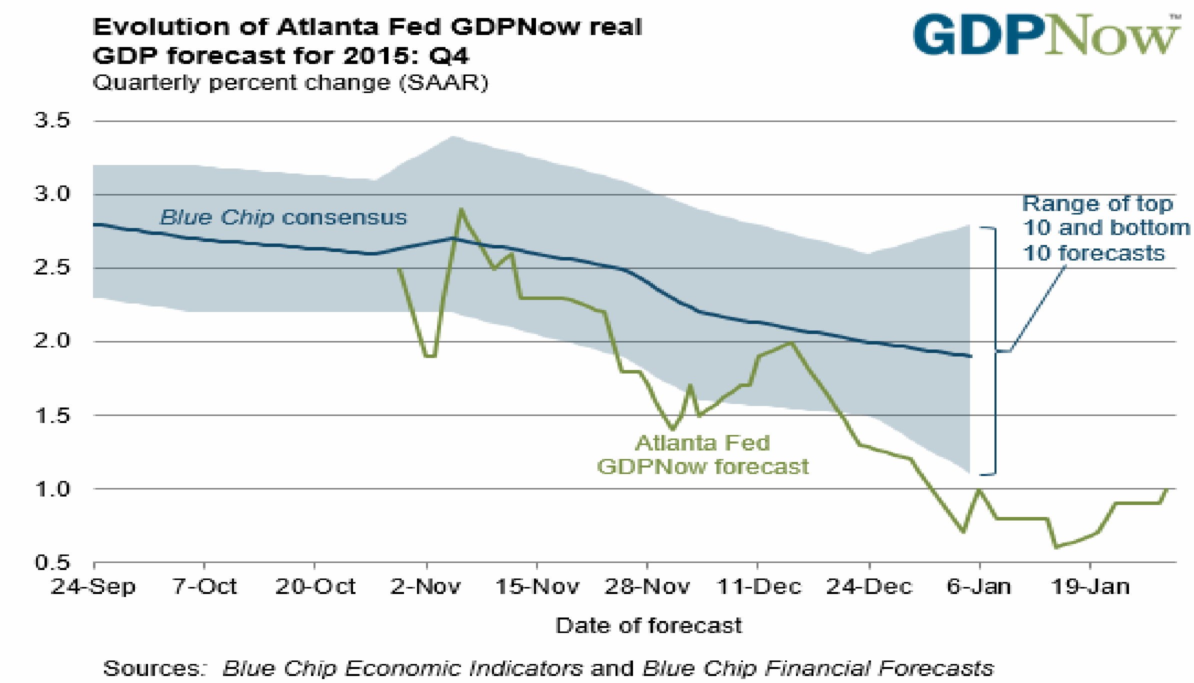
As for earnings, the chart below from Factset shows analysts estimates for future earnings (blue line) and the price action of the S&P 500.[10] Even Wall Street analysts, who tend to be a more optimistic lot, have been dialing back their estimates for earnings growth. What's more striking, though, is the disparity between the estimates and the stock market as the market floats higher and higher on the sea of central bank liquidity. The last time we had a similar disparity was the period leading up to 2008. That period did not end well!



This is still not a guarantee that the S&P will turn down to come more in line with corporate earnings. And certainly this is not a good timing indicator, as the S&P 500 outpaced earnings for several years prior to the 2008 crash. But an increase in global growth, and thus corporate profits, could certainly resolve the disparity by trending the blue line (forward 12 month EPS) up towards the S&P price. At this point though, we're just not seeing any indication of any such growth resurgance.

[10] http://www.factset.com/insight/2015/03/earningsinsight_3.20.15#.Vqpq8porJhE

The concensus GDP forecast on Wall Street is currently calling for GDP growth of around 2%. However, as the chart below of our favorite GDP forecasters – the GDPNow series published by the FRB Atlanta – is scrapping along at 0.5% - 1.0%.[11]

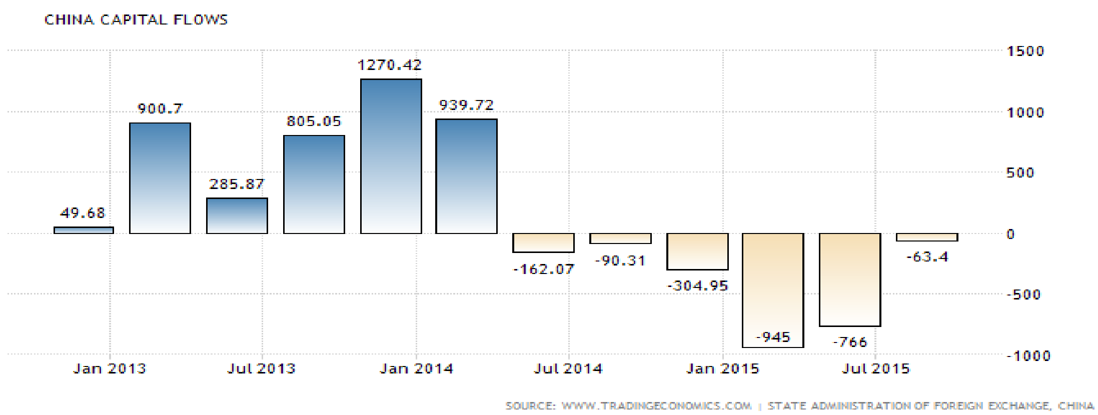


Nor are things looking any more promising globally (in fact they're looking worse, relative to the positive, albeit subdued, levels of growth here in the U.S.). A recent Financial Times (FT) headline states "Grim Year Forecast for Develping Nations", as they report; "Developing economies last year recorded their slowest growth since the immediate aftermath of the 2008 financial crisis and are facing the prospect of an equally grim 2016 , the World Bank has warned".[12] IBD reported "China Growth Hits 25-Yr Low", and in the next headline "IEA: Oil Glut To Last This Year" they report "The International Energy Agency said crude supply could outpace demand by 1 mil barrels a day for the 3rd straight year.[13] Again, all defltionary.

Nowhere is this deflation more evident than in the data showing foreign countries – formerly blessed with large budget surpluses, resulting from their roles in supplying goods and services to the global economy – now being forced to drawdown their financial reserves. Above, we described Saudi Arabia's forced selling of their holdings of US financial assets. And our recent Client Update clearly showed the massive drawdown occurring in China. We stated … a topic we've discussed in virtually every report is the strength of the US Dollar (USD). It represents the unwinding of a good decade worth of Fed-induced

[11] https://www.frbatlanta.org/cqer/research/gdpnow.aspx?panel=1
[12] "Grim Year Forecast for Developing Nations"; FT; Thursday, January 7, 2016; pg. 2.
[13] IBD's Top 10; Investor's Business Daily; January 20, 2016; pg.1.

capital flows leaving the US and pouring primarily into China and the emerging market economies (EM). This fueled an investment boom, but ultimately resulted in major misallocation of capital and speculative excess. Unfettered growth (at least in our universe) is an inherently unstable situation. As China's growth reached unsustainable extremes, the process began to reverse. This is depicted in the chart below from Trading Economics (http://www.tradingeconomics.com/china/capital-flows).



It clearly shows the outflows that began nearly two years ago in Q II 2014. The data only goes up to Q III of 2015, and appears to be improving, but as Barron's reports, "Money is fleeing China on a scale not generally realized" ("A Currency Affair"; Barron's; January 11, 2016; pg. 7). Attempting to stem this flight, The Chinese authorities drew down $108 billion of reserves in December, the largest monthly drop since 2003. The Barron's article cites a JPMorgan economist who "…found that a stunning $930 billion of capital fled China from second-quarter 2014 through third-quarter 2015…." To stabilize their currency (the Yuan [CNY]), the central bank (PBOC) must purchase it in the open market. As the PBOC buys CNY, it shrinks the supply – which is ***deflationary***. Central banks typically have their reserves invested somewhere – very often in the US Treasury bond market. In order to raise the US Dollars to make the CNY purchases, the PBOC must sell off its holdings of US Treasuries which pressures our interest rates, puts upward pressure on the USD, and is essentially ***"exporting" their deflation***.

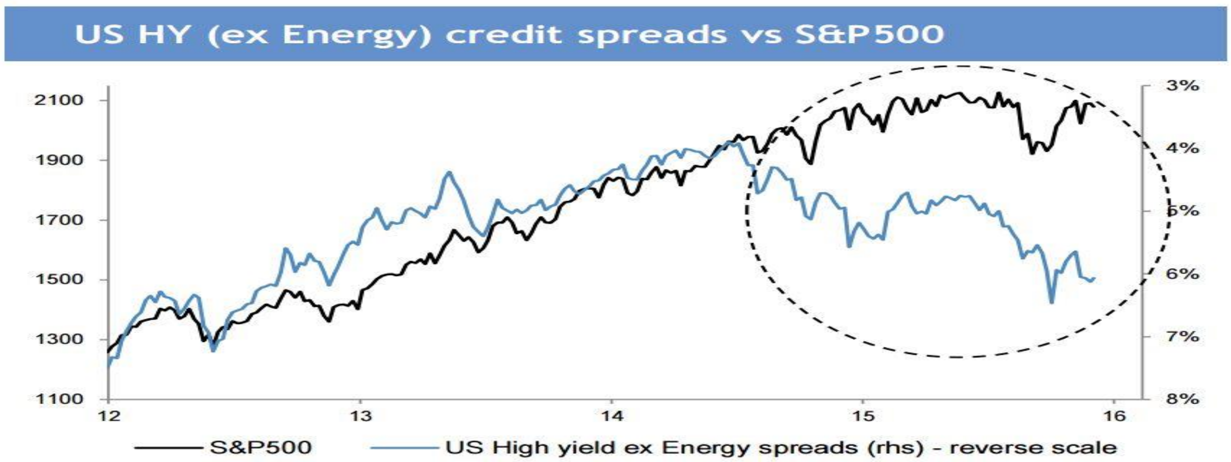
Some pundits claim that the US is relatively isolated from the effects of all this because our exports of goods and services make up less than 14% of our GDP.[14] Barron's recently asked "Will a slowing China really bring down the global economy? HSBC economist Fredric Neumann isn't so sure. He notes that China makes up about 15% of the world's economy in U.S.dollars today, about the same as Japan in the 1980's. Yet Japan's decline registered as 'barely a blip' on the global economy…"[15]

Intuitively, the focus on the economy makes sense. However, "fundamental" analysis is not necessarily any better a predictor of future market behavior than technical analysis. Further, we believe that over-reliant focus on economic fundamentals misses a more significant analysis. In short, (paraphrasing, and with all due respect to, James Carville), it's not "the economy, stupid" but ***it truly is the credit markets, stupid***. One of the bull arguments discussed above was that if you strip out the energy sector, corporate profits are doing fine. We take strong exception to that view. It's very much like saying that if you took out any of the wrong/unprofitable investment decisions that we've made in our portfolios over the years,

[14] https://research.stlouisfed.org/fred2/series/B020RE1Q156NBEA
[15] Barron's Market Week; Barron's; January 18, 2016; pg. M1.

then we'd be the most successful investors on the Street. We'd be happy to take that approach, except for the fact that it's wrong, and clearly irrelevant. Again, borrowing from our recent Client Update;

…The other issue … concerns the "high-yield" bond market, otherwise known as junk bonds. These bonds (and all bonds for that matter) trade at a "spread" above US Treasury bonds yields. When the economy is good, the spreads narrow and vice versa…These companies are extremely sensitive to the health of the economy and the movements in their spreads are often good leading indicators of future economic growth. The next chart from MarketWatch (http://www.marketwatch.com/story/deteriorating-junk-bonds-flash-warning-signs-for-stocks-2015-12-07) paints a pretty frightening picture.

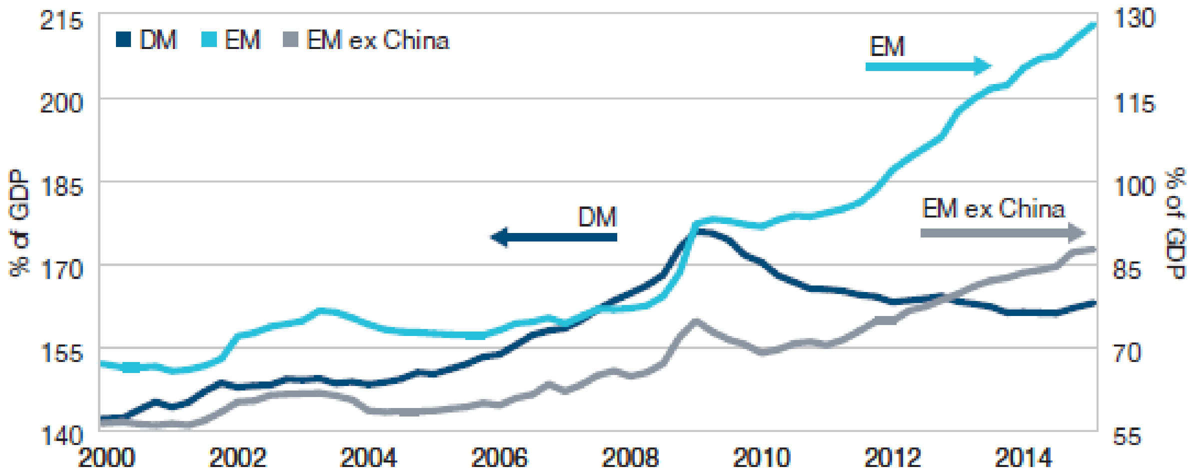


The blue line is inverted, so a falling line actually means that the yields and spreads are rising – a sign of stress in that market. The chart is all the more concerning because **it excludes the junk bonds of energy companies!** The black line is the S&P 500, and typically these two series will converge again at some point – either the economy improves and the blue line trends up again, or the economy slides towards weaker growth/recession and the S&P sells off. At this point, we remain partial to this latter scenario and continue to invest accordingly…

The bulls will argue further that the high-yield, "junk bond" market is only a small percentage of the corporate bond market, and an even smaller percentage of the total bond market (shades of the head-in-the-sand views on the subprime portion of the mortgage market back in 2007-2008). But this misses a larger point that feeds back to the fundamental economic growth outlook. Namely, the corporations issuing this debt are all contributing to economic growth – even if not to financial profits! They hire employees, buy goods and services from other busisnesses, pay rent, and so on. Many of these companies should have gone into bankruptcy after the 2008 financial crisis. As a result of central bank zero interest rates policy, they were able to issue even more debt and/or refinance existing debt in the hopes that economic growth would pick up and they'd be able to generate enough revenue to service and pay down the debt. This never really occurrd. As discussed above, the prognosis for global growth is bleak. In the meanwhile, corporate debt growth has increased dramatically and, as seen in the chart below, as a percentage of GDP, it now far exceeds the total amounts existing prior to 2008.[16]

Private Credit Growth in Developed and Emerging Markets (EM), 2000–2015

As of September 2015



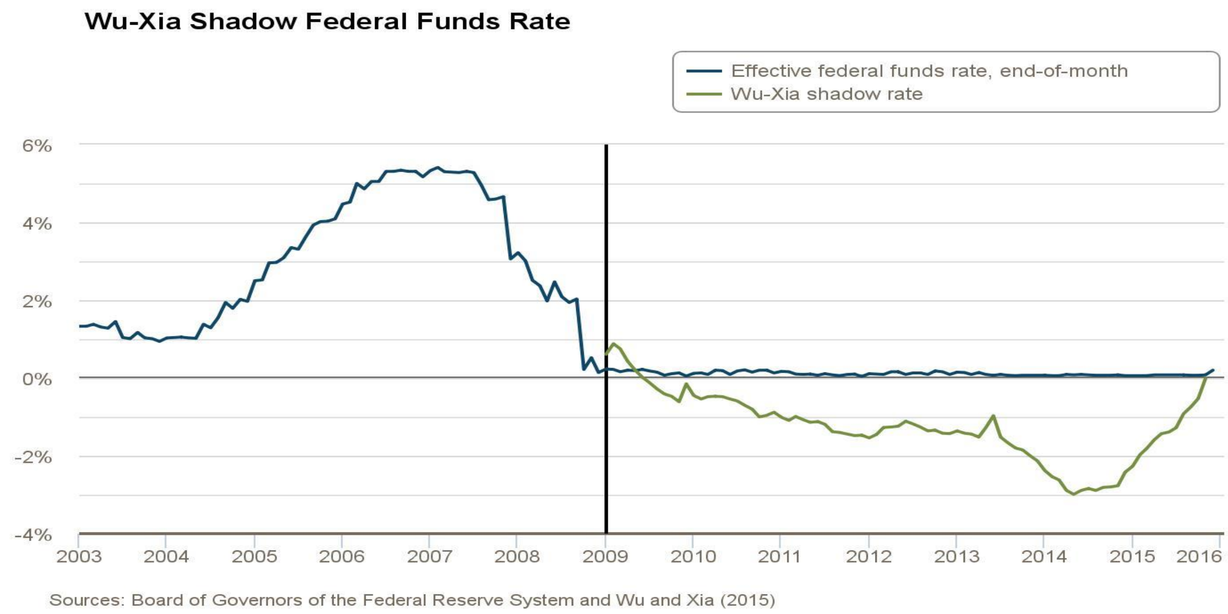
The chart shows that private credit as a percentage of GDP grew significantly in the EM countries and decreased in the developing world (DM). The glaring standout though, is total EM debt, including – and in particular – China. The capital outflows from China detailed above are the equivalent of monetary ***tightening***! The combination of tightening monetary conditions after a period of surging credit growth is ultimately a toxic combination. In an article entitled "Corporate Credit Shock Looms for China", the FT reports that "Standard & Poors estimates that the number of bond defaults will rise to double digits this year, a record, from nine last year, as credit quality falls in the world's second-largest economy. The rating agency has put 15 per cent of its rated portfolio of 240 Chinese companies on watch – the most since 2008 and nearly double the 8 per cent of a year ago…Beijing knows that with $15tn in corporate debts, equal to about 145% of gross domestic product, a wave of defaults would trigger a financial crisis."[17] Note that this is only corporate debt. Total debt as a percentage of China's GDP is estimated to be well over 240%![18]

Further, some economists have argued that monetary conditions in the US have been restrictive for several years now. As the effective Fed funds rate has been between the zero and ¼ pecent range targeted by the Federal Open Market Committee since '08 – '09, researchers have tried to develop a

[16] https://www4.troweprice.com/gis/fai/us/en/insights/articles/2015/q4/global-economics.html

[17] "Corporate Credit Shock Looms for China"; FT, Wednesday, January 27, 2016; pg. 20.
[18] http://www.economist.com/news/finance-and-economics/21676837-credit-growth-still-outstripping-economic-growth-deleveraging-delayed

"shadow" rate model showing the real, inflation adjusted level of interest rates. One such series was developed by Cynthia Wu and Fan Dora Xia, two economists at the Federal Reserve Bank of Atlanta. Called the Wu-Xia Shadow Federal Funds Rate, the series is presented on FRB Atlanta's website and is shown below.[19]



What this chart shows is that since the end of QE in 2014, the (shadow) Fed funds rate has increased by 3%, or 300 basis points (bps). Given the Feds proclivity towards small incremental rate increases of typically .25 bps at a time, ***this is equivalent to perhaps 12 Fed rate hikes***! And, given that there's usually a 6-12 month lag before the effects of rate changes show up in the real economy, this would go a long way towards corroborating the weak GDP readings from FRB Atlanta's GDPNow series.

Finally, regarding the impending unwinding of debt in China, the economist George Magnus explains;

> The growth in Chinese non-financial debt has been analysed since the 2008-09 bank lending stimulus programme. It has risen from about 100 per cent to about 250 per cent of gross domestic product but, far from slowing down with the economy, the pace of debt accumulation has picked up in the past one to two years. Total social financing, a broad measure of monthly credit creation, is growing at nearly three times the rate of officially recorded money GDP growth, or more if you don't believe the official GDP data. Curiously, many private companies face tight credit conditions, so rapid credit creation may be largely for the benefit of the cash-flows of the highly indebted real-estate sector, local governments and state enterprise sectors.
>
> …Although government officials speak occasionally of the need to allow corporate defaults and restructuring, and recognise bad debts in the banking system, political and institutional bolckages to such outcomes are formidible.

[19] https://www.frbatlanta.org/cqer/research/shadow_rate.aspx?panel=1

> Instead, all we are likely to see is more credit easing, in the wake of the six initiatives since late 2014 to cut interest rates and banks' reserve requirements, albeit to no economic effect. The credit binge, then, will go on until it can't.
>
> Decisive factors will be the compromised debt-servicing capacity of borrowers, and the banks under the weight of rising non-performing and bad loans and emerging funding difficulties as loan-to-deposit ratios increase further.
>
> It is in this context that we might reflect on the announcement of a $512bn fall in currency reserves in 2015. Since China has a current account and net direct investment surplus of about $600bn, implied capital outflows must have been close to $1tn. Some of this was capital flight. Given the interplay between capital flight, a more uncertain "managed" currency depreciation and a private credit binge that's going in the wrong direction, China's credit crisis may be approaching just that little bit faster."[20]

Of course, adversity and crisis create opportunity. Such opportunity, in our estimates, are developing in the high-yield market in particular. However, we're not convinced that we're out of the disinflationary, deleveraging woods yet. At this point, we continue to overweight cash, underweight equities, and are increasing our short-equity positions in our models that allow shorting. We continue to feel that this is an environment to presereve capital rather than trying to enhance returns, as the risk reward scenarios remain unfavorable.

Sincerely,

Jason Waxler

[20] "Credit Binge is the Real Concern as Crisis Shows Little Sign of Abating"; FT Tuesday, January 12, 2016; pg.20

U.S. Equity

	QTD (%)	YTD (%)	1 Year (%)
NASDAQ Composite Index℠	8.4	5.7	5.7
Standard & Poor's 500 Index	7.04	1.38	1.38
Dow Jones Industrial Average	7.7	0.2	0.2
Russell 2000 (Small Cap) Index℠	3.6	-4.4	-4.4

Non-U.S. Equity

	USD (%)			Local Currency (%)		
	QTD	YTD	1-Year	QTD	YTD	1 Year
MSCI AC World ex U.S.	3.24	-5.66	-5.66	4.81	1.86	1.86
MSCI EAFE	4.71	-0.81	-0.81	6.34	5.33	5.33
MSCI Europe	2.49	-2.84	-2.84	5.17	4.91	4.91
MSCI Pacific	9.00	2.96	2.96	8.55	5.95	5.95
MSCI Japan	9.34	9.57	9.57	9.83	9.93	9.93
MSCI EM (Emerging Markets)	0.66	-14.92	-14.92	1.49	-5.76	-5.76

U.S. Fixed Income

	QTD (%)	YTD (%)	1 Year (%)
Barclays U.S. Aggregate	-0.57	0.55	0.55
Barclays U.S. Corporate High Yield	-2.07	-4.47	-4.47

Non-U.S. Fixed Income

	QTD (%)	YTD (%)	1 Year (%)
Barclays Global Aggregate	-0.92	-3.15	-3.15
Barclays Global Aggregate (Hedged)	0.10	1.02	1.02
Barclays Global EM Local Currency Government Universal	0.87	-3.62	-3.62
Barclays Global EM Local Currency Gov't Universe (Hedged)	0.72	1.64	1.64
Citigroup World Government Bond Index ex-U.S.	-1.38	-5.54	-5.54
Citigroup World Government Bond Index ex-U.S. (Hedged)	0.58	1.55	1.55

Real Estate/Commodity

	QTD (%)	YTD (%)	1 Year (%)
Wilshire U.S. RESI℠	7.64	4.81	4.81
Wilshire Global ex U.S. RESI℠	0.63	-3.43	-3.43
Wilshire Global RESI℠	4.96	1.65	1.65
Dow Jones UBS Commodity Index	-10.52	-24.66	-24.66
S&P GSCI Commodity	-16.63	-32.86	-32.86
Alerian MLP Index	-2.76	-32.59	-32.59

[21], [22]

[21] http://advisor.wilshire.com/KnowledgeCenter/Fourth-Quarter-2015-Market-Commentary.aspx
[22] https://finance.yahoo.com/q/hp?s=%5EDJI+Historical+Prices