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FREE REPORT

Making sense of it all – Free Report

What a week. The S&P 500 closed down 3.5% — its worst performance in over two years — and 1.6% alone on Friday while the Dow Jones Industrial Average sagged 3.8% for the week and finished with a 1.8% falloff in the steepest weekly setback in three years.

The market is becoming worried that the oil price plunge to sub-$60 per barrel is becoming as much a demand story as supply story — the WTI price is now down 46% from the June peak but almost half of that has occurred in just the past three weeks.

Volatility surged as the VIX broke above 20 for the first time since the market correction in October (though this is the long-run norm) and in a week that saw more than $1.2 trillion vanish from global equity markets.

I have to say that up until Friday, things were still actually making some sense. The areas of the market tied to energy and basic materials were in decline, the other segments were doing fine (for some perspective, S&P 500 Energy stocks are down 15.3% for the year while the entire market is still up 9.5%). But Friday's market action was noteworthy for the fact that all 10 equity sectors were in the loss column, and "leader" was Consumer Discretionary with just a 0.6% drop — eight of the other sectors were down at least 1%.

The Treasury market rallied again (best week in two years) and at 2.08%, the 10-year yield closed below the levels of the day of the October "flash crash" even with another solid economic report (such as consumer sentiment reaching an almost eight-year high).

And this time, there was no rally in the U.S. dollar (though the prior strength in the greenback has already caused a downward reassessment for the 40% of the S&P 500 that are exposed — the FT cites estimates that more than 275 companies have actually provided warnings due to the strong U.S. dollar). And, yet, the CRB commodity price index tanked and the oil price hit its lowest level since May 2009 (copper looks like the next candidate to break down).

At the same time, the only item out there behaving well is gold — quietly hugging its 100-day moving average. Then again, perhaps bullion is hanging in for the same reason why core government bond markets are rallying — investor risk appetite is faltering across a broad front.

To underscore how nutty things are at the current time, yields on two-year government bonds are actually negative in Japan, Germany, France, Switzerland, Sweden, Denmark, Austria and the Netherlands.

SUMMARY

- The market is becoming worried that the oil price plunge to sub-$60 per barrel is becoming as much a demand story as supply story
- This equity market is still not cheap by any stretch and has been trading very heavy on a technical basis for some time now
- What concerns me now is how the markets are reacting in general, not just the energy market
- Markets do have this tendency to shoot first and ask questions later. That has not changed one iota
- So even with the hit to energy investment and production, and the knock-on financial impacts, there are clear winners from the implosion in energy prices
- The process of taking out the sharpened pencils and intensifying the credit search may be starting

Think about that. Investors are so fearful now that they are paying governments to have the pleasure of holding on to their debt for the next two years.

And yet, even with this, the equity markets across the pond cannot muster a rally — this truly is investor risk aversion at an extreme level.

So where do we go from here? Well, near-term it is plain to see that both a third-order Fibonacci retracement level and the 200-day moving average are the same near the 1,940 level — that is actually also the area the consensus had been forecasting this time last year.

The one thing we do know is that even with the S&P 500 trading within its Bollinger valuation bonds, this market is still not cheap by any stretch at a 16x forward price-to-earnings multiple (14x is the norm) and has been trading very heavy on a technical basis for some time now — momentum, breadth and divergence indicators were all pointing in the way of a wobbly backdrop for months. But the fact that we are not seeing a Santa rally may be foreboding given how strong the seasonals are.

This market is still not cheap by any stretch and has been trading very heavy on a technical basis for some time now

Besides the seasonals, the gurus who had been bullish into year-end were citing the fact that some 85% of Large-Cap mutual funds had lagged the market in 2014 and as such would be seeking to put more cash to work.

The CFTC Commitment of Traders data actually do show that this move has already happened and the buying power has now exhausted itself.

Indeed, pages M34 and M35 of Barron's reveals how the short interest on the NYSE dropped 1.1% in the second half of November and by 3.3% in the Nasdaq — this support is now behind us and those that did cover their shorts may now be regretting it and adding back their negative bets at a time when the buyers seem to be spooked and relegated to the sidelines.

As for this sudden turn of events (weren't the major averages hitting new all-time highs just a week ago?), it could be a margin call from the selling taking place in commodities and the High-Yield debt markets. It could be year-end tax-loss related selling. It could be a plain old-fashioned round of profit-taking. Or it could be something a little more nefarious — the markets are sniffing something out.

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As for the U.S. dollar, the signs of a classic quantitative easing program out of the European Central Bank suggest a euro heading lower — perhaps even as low as par. The massive LDP victory in Japan renders additional yen depreciation a further lock — part and parcel of Abe's reflationary plan (only in Japan does one get rewarded politically for having successfully driven one's economy into recession).

So the U.S. dollar will continue to rise over time and all currencies (including the beloved loonie) will get caught in the crossfire, especially with the likes of the Reserve Bank of Australia Governor openly forecasting a further ten cent decline in the Aussie dollar — this, sadly enough, will have an impact on the entire resource-currency space and an 80 cent Canadian dollar, if we are talking about relationship-maintenance, can no longer be ruled out. The odds are hardly trivial.

With regards to bonds, the Treasury market is likely to follow the U.K. Gilts market seeing as the U.S. and the U.K. are at the same part of the business, inflation and monetary policy cycle. So the risk is that barring a reversal in the U.K., the yield on the 10-year T-note is likely to retest 1.8% which is nearly 30 basis points away from where we are now — also consider that there is a huge 214,778 net speculative short position on the CBOT (a 4½-year high) that may be forced to cover.

With regards to bonds, the Treasury market is likely to follow the U.K. Gilts market

As a contrarian, I was also quite shocked and disturbed to see the Barron's 2015 forecast survey — not one of the 10 strategists see the stock market lower (the low forecast for the S&P 500 is 2,100 and the high is 2,350). Technology was the favored sector by eight of the 10, while Utilities was the most detested by eight of the 10. The Materials sector was basically ignored altogether as if it does not exist — mentioned twice as the largest underweight, that's it. A brave three souls mentioned Energy as a favoured sector for 2015, only one had it on the avoidance list.

Incredibly, views on real GDP growth for 2015 was in an incredibly tight 2¾% to 3% range — talk about group-think. This makes me nervous.

And as for the bond market, nobody is calling for an extension of this rally — the range on the 10-year T-note is 2¾% to 3½% — so the most bullish view is a 65 basis point surge from where we are now. This is shades of last year when the yield was 3% and the consensus for 2014 was 3½%. Again, this is a contrary positive for the bond bulls as was the case last year.

More than likely, yields will touch bottom when the strategist community turns overwhelmingly bullish — the fact that the forecasters have yet to throw in the towel on this past year's horrible interest rate call is a real commentary on human behavior: the inability or unwillingness to learn from past mistakes.

To be sure, the bull case for bonds won the day in 2014, and here's why: it's because the Fed has continuously shown its reluctance to tighten, and inflation is still surprising to the downside. In fact, market-based inflation expectations at 1.6% for 10-year TIPS break-evens are where they were in the past when the Fed would respond with a dose of quantitative easing.

The bull case for bonds won the day in 2014

Analysts have been over-estimating the terminal rate for some time, but when one throws into the mix the sustained decline in money velocity, the extent of credit creation in a new banking sector regulatory regime, sluggish productivity, and an aging population, the view of the equilibrium rate being lower than has been in past cycles has been prescient, and the drop in yields reflects all these factors.

Tack on the receding fiscal deficit and thirst for income and duration from non-price-sensitive entities like pension funds and sovereign wealth funds as well as central banks with their own agendas (reducing the cost of capital to generate growth), and the move to lower yields reflects all these factors (as a sign of how global central banks are dominating the buying activity, indirect bidding for the long bond auction last week absorbed 49.8% of the offering).

Europe's contribution via its entry into Japanese-style stagnation and deflation is just the icing on the cake.

As for the oil price, we are into a political game of chicken which means nobody really knows what the bottom is. Did the Saudis blow it with a failed bluff? Or is this a long-term plan to recapture market share from the shale producers and a geopolitical strategy to hit Russia, Iran and ISIS as hard as possible? After all, with a $2 trillion reserve fund to keep fiscal finances afloat, the Saudis have staying power and the oil minister just indicated late last week that a production cut is not coming yet.

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At the same time, U.S. oil output continues to rise as the demand conditions globally wane (indeed, U.S. production is growing one million barrels per day annually and the Energy Department just predicted that output will rise 700,000 barrels per day in 2015 and average 9.3 million barrels per day — whatever negative production response there is to be does not happen until the second half of next year).

Something tells me that at some point, the low in the oil price will be turned in when Saudi Arabia announces that "enough is enough" (not yet, obviously, with Al-Naimi asking rhetorically at a Lima conference last week, "*Why should I cut production. This is a market and I'm selling in a market. Why should I cut*?"). This is what happened in 1986, after all — and once it cut production to 2.5 million barrels per day from 10 million barrels per day at the time, the bottom was finally reached, but only after a 60% slide that ended with WTI near $10 per barrel.

The low in the oil price will be turned in when Saudi Arabia announces that "enough is enough"

Many geopolitical experts would tell you this was a concerted attempt by the West, with Saudi assistance, to start the process of weakening the Soviet Union back in the mid-1980s — maybe yes, maybe no but for 15 years, oil prices settled in a new and lower range (not $10, mind you) of $20 to $40 dollars a barrel (far off what the National Energy Plan was calling for, if you remember) and we all moved on.

I sense a similar situation this time around but I do have to say that a new consensus has emerged of WTI slumping to $50 per barrel — if you think the consensus call on bond yields this time last year was bad, the forecast for oil was $94.50 per barrel!

If we truly mean revert, we could be in for a retest of $35 per barrel — that is what the chart says, it is not exactly my forecast — and then likely to be in a new range of $50 to $70 dollars thereafter. That $35 level, however, would very much resemble the capitulation lows we had both in 1986 and again in 1998 in real terms (something has to give to bring the market back to balance — the EIA projects that global supply will still outstrip demand by some 400,000 barrels per day in 2015).

That would cause quite a bit of pain in terms production and/or investment cuts, dividend cuts, asset sales, consolidation, defaults in the High-Yield debt space — but this is where capitulation bottoms are turned in historically, regardless of the market whose bubble has burst.

For the time being, the oil market will remain beset by sluggish global growth, excess world supply, and the reluctance of OPEC — or the U.S. for that matter — to curb production.

The oil market will remain beset by sluggish global growth and excess world supply

Imagine going to sleep in 2002 when the oil price was $20 per barrel and waking up today to hear about a collapse to just under $60. We spent several years with a price near or above $100 and as has always been the case in the past, human ingenuity takes over — ways to more efficiently consume oil (forms of conservation) and new innovative ways to produce it.

The “peak oil” theorists were merely food Malthusians in disguise. It was somehow inevitable that lowered pricing was going to become an outcome at some point — the by-product of the technological advancement in fracking and other forms of extraction, along with greater supply. Oh yes, and as if that cheaper alternative (otherwise known as natural gas, where prices sagged with production growth of 40% in the past seven years) didn’t end up having a role in this too.

But what concerns me now is how the markets are reacting in general, not just the energy market. Investors are worried about knock-on effects (especially in the credit markets), the effect this can have on the global financial system, the deflationary impulse on a world economy still beset by an unprecedented debt burden six years after the collapse, and geopolitical implications.

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The action in government bonds is telling us that rightly or wrongly, markets are really concerned about the oil price slide exacerbating deflationary pressures — deflation for debtors is indeed a worrisome development.

Emerging Markets that are oil exporters and who had previously borrowed heavily in U.S. dollars are going to face severe financial strains.

While lower energy costs certainly benefits the U.S. economy (large trade deficit and consumer driven) in broad terms, it has the opposite effect for many of the world’s zero growth economies.

So now analysts and investors, at the margin, are extrapolating that the U.S. may in fact struggle more next year than is commonly believed. Remember, the surprise, by definition, may well not be on the upside in terms of cyclical risks — the consensus is already at 3% for real growth next year.

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As for the "black swan", I am getting asked about this more and more from our clients. I do not know if I should be comforted by this or feel uneasy — at least there isn't anyone out there who is wide-eyed and bushy-tailed.

The general uncertainty of the rapid oil decline, coupled with the fragility and intransigence of many of the governments most impacted, calls into question the "unknowables" (social unrest, terrorism, war, etc.) and markets abhor uncertainty — that much we do know. And that is how Friday's "baby out with the bathwater" felt as a microcosm to that effect.

As I said above, if anyone tells you that have conviction on where oil is going, they are either liars or delusional. That said, I do think that we have set in motion long-term pricing that will be challenged to move materially higher, which should continue to support U.S. — at this point, the fear is almost palpable, but not totally irrational.

And for now, the market is not differentiating between good and bad deflation. The bond market is telling us that deflation globally is becoming more of a serious risk. Full stop.

The economist and the strategist in the room carries the burden of calling the markets, but sometimes you have to step back, take a holistic approach, and assess what the message the markets are actually conveying.

Markets do have this tendency to shoot first and ask questions later. That has not changed one iota.

Markets do have this tendency to shoot first and ask questions later

As for geopolitical risks, I do believe that investors fear Putin will do something desperate, and that in contrast to the accelerating recessionary pressures in Russia curbing his ambitions, the markets are thinking that as he becomes more marginalized, as he realizes he has fewer chips to play, that seeking war will be the way out as it has in the past as a source of economic stimulus. This is very likely an over-reaction, but then again, has anyone ever seen what a Siberian tiger does when it's backed into a corner?

Or maybe if it is not further military incursions into former Soviet satellites, maybe will be economic warfare — like a default. It was just 15 years ago that Russia pulled this stunt, and that was when, for a brief period, the U.S. was no longer that "oasis of prosperity" as LTCM almost brought down JPMorgan until the New York Fed (led by Bill McDonough) rode to the rescue. The question then becomes — who exactly are the world's creditors who are on the hook for the $750 billion of Russian externally-held debt?

There is another element, which is the demand part of the oil backdrop which received a lot of attention as last week drew to a close. It's one thing for the IEA to cut its demand outlook for the fourth time in the past five months (by 230,000 barrels per day to 93.3 million) but for OPEC do so publicly (that the call on its oil will hit a 12-year low in 2015 of 29.12 million barrels per day, down 300,000 from the most recent estimate — but what was the motive to announce that?) also merely exacerbated the downward price movement late last week.

One culprit on the demand side is likely China — this is one canary in the coal mine. The official data say China is running at 7% on GDP growth but Bloomberg's tracking has it below this target each of the past four months.

China's PMIs are flashing stagnation in industrial activity (the overall production numbers themselves have weakened to growth levels not posted since 1990!) and both electricity output and steel production are basically flat from year-ago levels. The excess capacity riddled property sector has seen residential sales tumble 7.9% YoY and the inventory backlog has soared 28% (November data).

China's PMIs are flashing stagnation in industrial activity

I have heard from two credible sources now — one of them a client of ours who does a lot of business in China — that things had been slow already, but in the past two months have hit stall-speed completely. Something is going on there; maybe the most crucial number was the 6.7% YoY slide in Chinese imports in November — that is ugly.

Meanwhile, we have intensifying political risk in Greece, the oddity of seeing German five-year breakeven levels slipping below zero which means the bond market is making it official on its deflation call despite massive policy stimulus (the market's way of giving the ECB — other central banks too — a big fat "F" on the report card).

While many look at dollar-euro slipping to the low-1.20s and wondering aloud how that does not stem deflation risks, consider that a huge offset from that reflationary effect is coming from the plunge in the Russian ruble which is creating huge corporate strains within the euro area (ask anyone who works Carlsberg how things are going these days).

The ballyhooed second tranche of the TLTRO last week was hugely disappointing with only half the €400 billion capacity actually taken up (in the process, emboldening the cries for classic QE early next year).

I am hearing in some circles that the bursting of the energy bubble is hauntingly similar to the bursting of the Tech bubble of the late 1990s — as my friend and author of the excellent *The Credit Strategist*, Michael Lewitt, put it to me this weekend, "*it's too facile a comparison. A lot of the internet stuff 15 years ago was nonsense. Any assets that go bust here I think will be bought up — 15 years ago the stuff just vaporized*".

I am hearing that the bursting of the energy bubble is hauntingly similar to the bursting of the Tech bubble of the late 1990s

I totally agree. Many of those dotcoms had no business plans and today's Small-Cap energy companies actually do have real assets that will get bought up by the major players, albeit at much cheaper prices.

So even with the hit to energy investment and production, and the knock-on financial impacts, there are clear winners from the implosion in energy prices.

All the talk is how the shale oil revolution was financed with junk bonds that will now default and take the investment banks down for a wild ride.

That may well be the case, but many of these bonds do not face the refinancing calendar until 2017 (nearly $14 billion comes due, according to Fitch), so I would not be too hasty and for all the disaster talk, the rating agency still sees an Energy sector default rate of no higher than 1% for 2015 (see page 13 of the weekend FT) and no higher than 2% for the entire junk bond market which is still less than half the norm of just over 4% — did I already say the markets have this pattern of shooting first and asking questions second?

The process of taking out the sharpened pencils and intensifying the credit search may be starting.

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Average yields on High-Yield corporate debt in the Energy sector is fast approaching distressed levels of 10% (now at 9%; in fact, it is estimated that nearly 20% of Energy debt is now considered to be trading at distressed levels) — and the broad junk market is back to nearly 7% for the first time since mid-2013 as contagion risks get priced into this space. The total return year-to-date is now -5.3% in the High-Yield Energy segment versus +3.1% for the overall High-Yield market.

Capitulation is coming to the fore as Lipper data show a doubling in net outflows from mutual funds and ETF's over the past week to $1.9 billion. Liquidity issues are likely to crop up if this continues, and the big banks and dealers no longer have the inventory to help make markets and serve as an effective intermediary as they have in the past. Even in the Investment-Grade corporate debt market, yield spreads have widened since July from 97 basis points to 130 basis points.

Liquidity issues are likely to crop up if this continues

As Michael Lewitt told me, when the dust settles, "*I will be owning a boatload of junk bonds trading at huge discounts. These are the times I wait for and they seem to happen about every seven years like we learned in the Bible*".

And within equities, our Executive Vice President & Chief Investment Officer Bill Webb sent me a line that went:

> *It still feels a bit early to me, but we're seeing the right early "corrective" signals of lower drilling permits, capex cuts, dividend cuts — it will take time but sets the stage for the next cycle.*
>
> *Our shopping list will include low-cost producers with strong balance sheets who can weather the storm and hopefully pick off assets or companies during the storm.*

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