Global Strategy Weekly

China set to start another leg in the Ice Age, taking the S&P back below 666

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Investors are coming to terms with what a Chinese renminbi devaluation means for Western markets. It means global deflation and recession. The coming carnage is an indirect result of the failure of the Fed's QE. It may not have done much to boost US growth, but it certainly inflated global asset prices into the stratosphere. The one area though, where US QE did unambiguously boost growth was in emerging markets (EM) as surplus money poured into these supposedly superior investment opportunities, leading to massive EM foreign exchange intervention to hold their currencies down. This turned ineffective US QE into very effective EM QE in terms of boosting EM economic growth. A commodity bubble and the resultant US shale investment boom were all consequences of the Fed's QE. The illusion of prosperity is shattered as boom now turns to bust. But I do hope this time around the Queen won't ask, as she did in November 2008, why nobody saw this coming!

- I have always said that if inflating asset prices via loose monetary policy were the route to economic prosperity, Argentina would be the richest country in the world by now – and it is not! The Fed's pursuit of negligently loose monetary policies since 2009 is a misguided attempt to boost economic growth via asset price inflation and we will now reap the whirlwind (the ECB, Bank of Japan and the Bank of England are all just as bad). One of the main problems has been the overconfidence with which the Fed pursues their objective. Yet in the run-up to the 2008 Global Financial Crisis they demonstrated their lack of understanding of the disastrous impact of excessively low Fed Funds. Even in retrospect they remain in denial - as evidenced by Bernanke's recent book. Why can't these incompetents understand that they are, once again, the midwife to yet another global unfolding economic crisis? But unlike 2007, this time around the US and Europe sit on the precipice of outright deflation. Indeed, it is all around us. But don't expect the central bankers to comprehend the hole they now find themselves in.

Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	30
Bonds	20-50	35	50
Cash	0-30	5	20

Source: SG Cross Asset Research

Source: Hedgeye Risk Management

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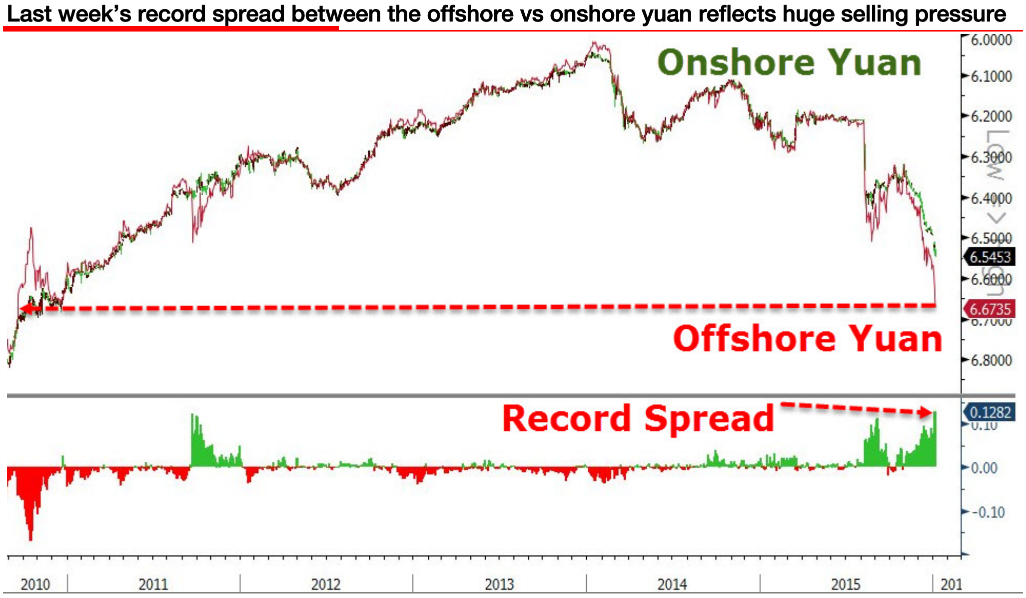
My thanks to Hedgeye Risk Management for their permission to reproduce the cartoon above. They really do have a fine collection that made me laugh, and we need to laugh in these troubled times (see cartoons here. Do contact them though if you wish to reproduce any).

Investors seem genuinely surprised that the Chinese devaluation is accelerating. They should not be. The impossible trilogy of maintaining an independent domestic monetary policy and a semi-fixed exchange rate while loosening capital account restrictions is hitting home. We have always highlighted that in a fixed exchange rate regime, monetary policy is almost entirely dependent on the balance of payments. Something was going to have to give and it was always going to be the currency. We have seen it in the EM space time and time again.

I have always thought that in order to revive a spluttering Chinese economy, the authorities would have to devalue, but not just because an overvalued exchange rate was squeezing their manufacturing sector (e.g. sector nominal GDP growth of zero in Q3 2015). Instead I felt that an overvalued exchange rate had steadily undermined competitiveness to the point that it had undermined the balance of payments. This was compounded last year by an accelerated capital outflow as anti-corruption measures intensified, and an unprecedented unwinding of dollar-denominated borrowings by Chinese corporates. **All these factors have combined to take the Chinese balance of payments into deep deficit.**

Most crucial of all, any serious attempt to fight the downward pressure on the currency would lead to a shrinkage of Chinese FX reserves. This represents a de facto Quantitative Tightening (QT) for China's domestic economy as the central bank's balance sheet shrinks. Cuts in domestic interest rates and the Reserve Requirement Ratio (RRR) to offset the FX QT only accelerate the currency outflow, further increasing downward pressure on the renminbi. Indeed it is apparent from last week's weakness of the more freely traded offshore yuan that without intervention, downward pressure on the yuan remains extreme (see chart below).

Last week's record spread between the offshore vs onshore yuan reflects huge selling pressure



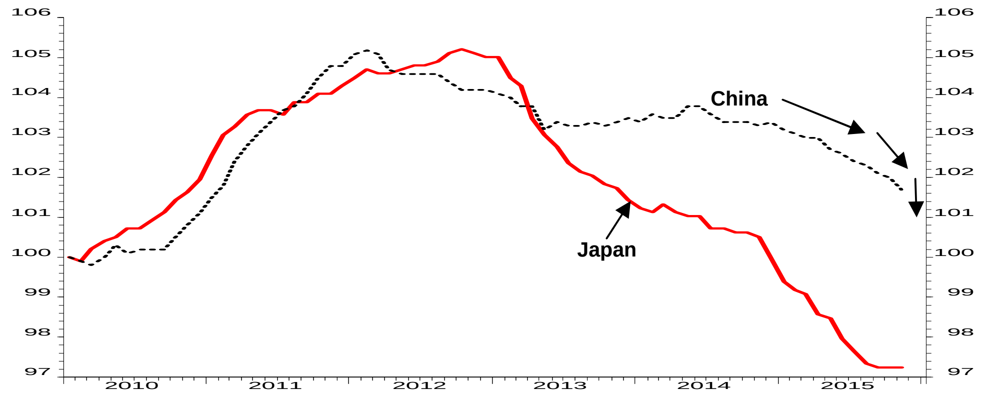
Source: Zerohedge

One of the reasons cited for the decline in Chinese equities last week was disappointment that monetary policy had not been loosened at the turn of the year. But the increasing inability of policymakers to both loosen domestic monetary policy and prevent the renminbi falling at the same time was made clear last week. On Dec 30 Bloomberg reported that *"the central bank's chief economist damped speculation lenders' reserve-requirement ratios will be eased by saying any adjustments should avoid causing too much volatility to short-term rates. In deciding on changes, maintaining stable money rates should be considered a priority as inappropriate timing and scale can lead to unwanted policy transmissions into the real economy, Ma Jun, chief economist of the People's Bank of China's research bureau, wrote in a commentary.* ***Excessive cuts may also worsen capital outflows."***

The BIS and IMF have both shown that rapid growth of EM dollar-denominated debt over the past few years was mainly concentrated in the Chinese corporate sector (unsurprising after years of steady, carry-trade inducing, renminbi appreciation). Hence despite the Chinese economy being sucked into a deflationary quagmire – best illustrated by a declining GDP deflator – many dismissed the possibility of devaluation because of the likelihood that this dollar debt would cause substantial corporate bankruptcies.

That risk to the Chinese corporate sector was substantially reduced by the end of last year. The Institute of International Finance (IIF) recently reported a huge unwind of this debt, which was sufficiently large **to take the entire EM capital account into deficit in 2015 for the first time on record** (including, surprisingly, the 2008 GFC and 1997 Asian crisis). This prescient action means that many Chinese corporates have taken the signal from the initial August devaluation seriously and readied themselves for further renminbi fall. **Hence China is now in a better position to transmit a massive deflationary shock to the West without damaging its own corporate sector.** Indeed we can already see US import price deflation intensifying as the decline in the dollar prices of goods from China accelerates (see chart below).

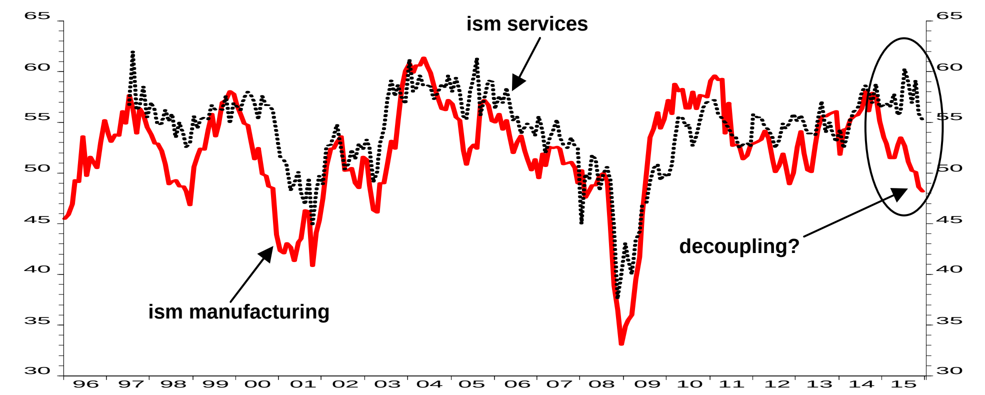
US deflationary import price baton being passed from Japan to China (level Jan 2010=100)



Source: Datastream

The western manufacturing sector will choke under this imported deflationary tourniquet. Indeed US manufacturing seems to be suffering particularly badly already (see chart below). Clients often say to me that *"despite the manufacturing gloom, aren't indicators of services activity holding up quite well? And since the service sector is a much larger part of the economy than in the past, why should a weak manufacturing sector drag the overall economy into recession?"* If only I had been given £1 every time I heard someone say that to me in the last 30 years - usually just ahead of a recession - I would be a rich man indeed. When an economy is hurtling towards recession it is *almost always* the manufacturing sector that takes the less volatile services sector by the hand and leads it into a recessionary underworld.

Decoupling – the most dangerous word in finance and economics



Source: Datastream

Where will this all end? I believe the Fed and its promiscuous fraternity of central banks have created the conditions for another debacle every bit as large as the 2008 Global Financial Crisis. I believe the events we now see unfolding will drive us back into global recession. I have long believed that 30y US bond yields would converge with Japan, just as Germany has now done. **But a key part of my Ice Age thesis is that the US equity market remains in a valuation bear market that did not fully play itself out in March 2009, when the S&P touched the 666 level, and we will see new lows.**

The chart below from Pring Turner is somewhat out of date but illustrates my point nicely (apologies as I have not recreated and updated it myself but I promise to do so). The top part of the slide shows the real S&P back to 1900 while the bottom panel shows the Shiller PE (cyclically adjusted PE, CAPE). Valuation booms are followed inevitably by busts. But the key point is that these valuation bear markets take the Shiller PE back down to 7x or below. Valuation bear markets can occur in either a high or low inflation environment but **what is true for all of them is that they take many economic cycles to play out.** The three previous valuation bear markets have taken between 4 to 6 recessions to fully play out (the red part of the top line are recessions). We *also* know from Japan's lost decade (and a half) that the process takes many economic cycles and we also know that each gut-wrenching episode of additional stock market de-rating typically occurs during recessions.

It has previously taken between 4 to 6 recessions for US equity valuation bear markets to fully play out

Source: Pring Turner

Since valuations peaked at the most obscene level ever in 2000, we have only seen two recessions and at the nadir of the last one, in March 2009, the Shiller PE bottomed at 13.3x, way above the typical sub-7x bottom. **In valuation terms the bear market was not completed in 2009 and indeed after only two recessions there was no reason to expect it to have been completed** (since this chart ends, the real S&P has enjoyed a strong rally and the Shiller PE has now moved back above 26x in the fourth quarter of last year).

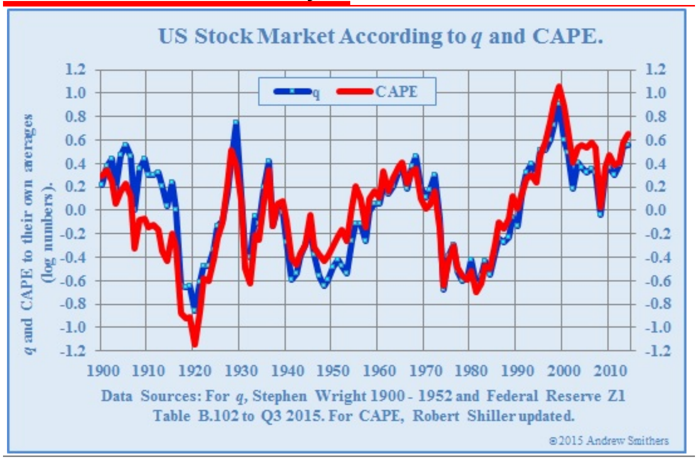
If I am right and we have just seen a cyclical bull market within a secular bear market, then the next recession will spell real trouble for investors ill-prepared for equity valuations to fall to new lows. To bottom on a Shiller PE of 7x would see the S&P falling to around 550. **I will repeat that: If I am right, the S&P would fall to 550, a 75% decline from the recent 2100 peak**. That obviously will be a catastrophe for the economy via the wealth effect and all the Fed's QE hard work will turn dust. That is why I believe the Fed will fight the next bear market with every weapon available including deeply negative Fed Funds rates in addition to more QE. Indeed, negative policy rates will become ubiquitous.

Most believe a 75% equity bear market to be impossible. But those same people said something similar prior to the 2008 Global Financial Crisis. They, including the Fed, failed to predict the vulnerability of the US economy that would fall into deep recession, well before Lehman's went bust in September 2008.

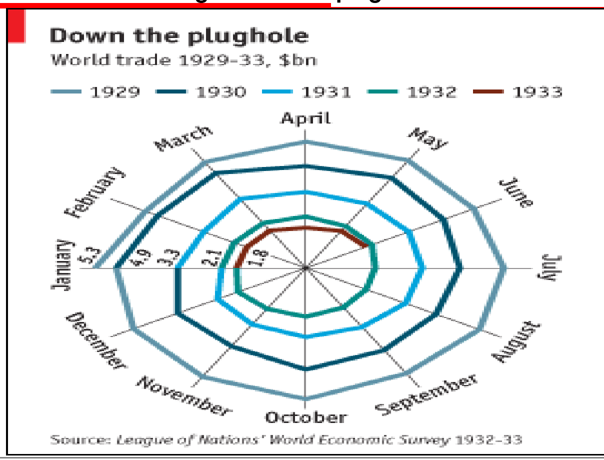
Many of the bulls attempt to undermine the validity of the Shiller PE - for example, saying that using the 10y moving average of reported earnings as the divisor includes the huge collapse in reported earnings in 2009 due to write-offs, and that it does not reflect the recent strong underlying trend of earnings. Now I think this is an invalid criticism as the whole point of using a 10y moving average is to smooth the cycle and get a 'cyclically-adjusted' measure of earnings – in which case you should include the write-offs suffered during a recession! But if I do use a shorter 5y moving average there is good news – to complete the valuation bear market, the S&P would 'only' have to fall by two-thirds to around 650 (a fraction below the March 2009 low of 666), instead of falling by three-quarters to 550.

Now I realise most people think I am talking utter garbage but I'm used to that. And maybe I am! But the truth will come out in the next recession which may be pretty close now. The excellent Advisor Perspectives website has an update of various long-term measures of US equity valuation, which all show current valuations close to historical peaks, bar the madness of 2000, see link. The excess of valuation from the average ranges from just below 90% to 45% (note I think we are heading back to extreme cheapness, *not* merely average or fair value). Because of my economics background I like Tobin's Q (the ratio of market value of the corporate capital stock divided by its replacement value). Tobin's Q is also one of the favourite long-term valuation tools of well known strategist, Andrew Smithers. And it also shows a very similar overvaluation as the Shiller CAPE, despite using a totally different methodology for its calculation (see left-hand chart below and link). That is why I think the message from the Shiller CAPE is the right one and that 550 rather than 660 will be the market's ultimate nadir. And amid the financial carnage that is why I believe we will be witness to the shocking spectacle of *minus* 5% Fed Funds at the bottom of the next recession.

Tobin's Q tells the same story as Shiller CAPE



Where are we heading – down the plughole



Source: Andrew Smithers, League of Nations,

Can things get even worse? Yes! We will probably see a trade war not unlike that in the 1930's (see top right-hand chart). Indeed there are already signs of stresses and strains. World trade growth actually declined for most of last year as measured by the Netherlands Bureau for Economic Policy (the keeper of the monthly World Trade Monitor) – the weakest outturn since 2009 - link. The latest data shows growth in the three months to October of only 0.5% yoy. There might be more weakness to come! Many of you might have missed amid the Christmas festivities that on Dec 23, the US imposed punitive sanctions on Chinese steel imports of 256% - link. Hence as renminbi devaluation accelerates and a new more deadly phase of the global currency war unfolds and we slide into another global recession, do investors really believe that policymakers won't repeat the mistakes of the 1930s, and that the ultimate outcome of the Ice Age will not be an outright deflationary bust accompanied by a trade war?