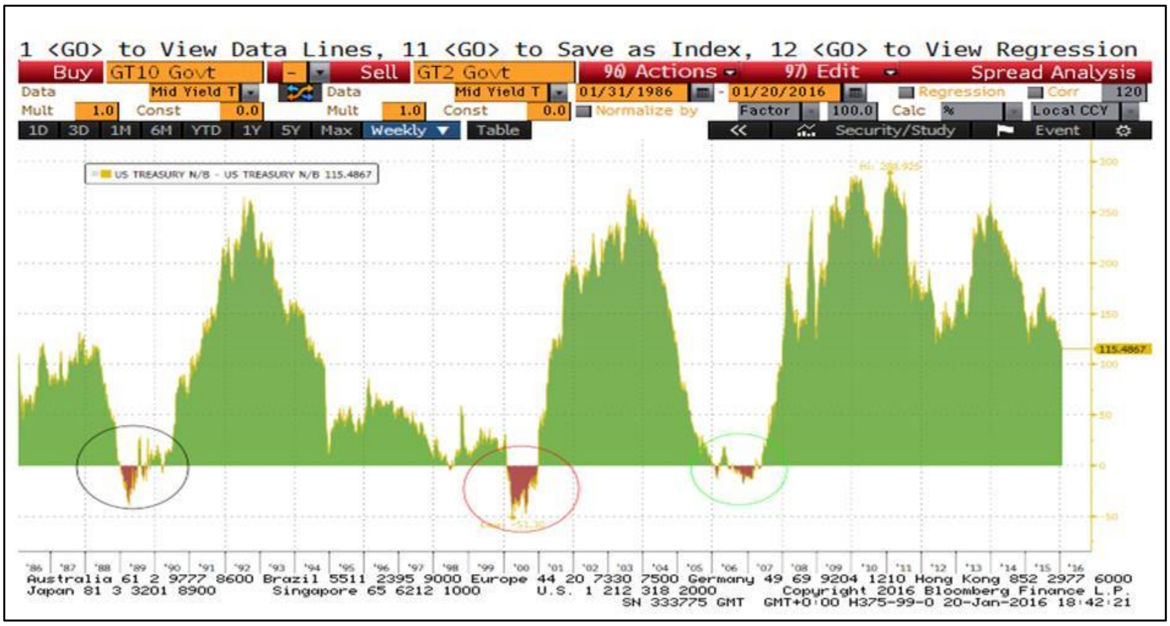
EFG Investment Communication
Market Update – 21 January 2016

by Moz Afzal, CIO

As we wrote in our note last week ***“Tis the Season to be…nervous?”***, we believe that the heightened financial market distress of the past few weeks reflects overly fearful sentiment. In the points below, we outline our key thoughts as to our positioning in the context of our views at the beginning of the year and, more importantly, what our strategy is in the short and long-term.

Let’s start with the assertion that we are entering into a developed economy recession. As we show in Chart 1, recessions are typically preceded by a flat to inverted yield curve. As the chart shows, this is not the case in the US today with the yield curve mid-cycle in terms of its positioning. Although it has flattened since the peaks in 2013, the yield curve remains nonetheless reasonably steep. This view is further reinforced by observing that employment conditions in the developed world remaining robust, interest rates remain very low or negative and energy and gasoline prices are at multi-year lows. As you may have read recently, the IMF (International Monetary Fund) cut its global growth forecast to 3.4% yesterday from 3.6%, but it still currently predicts that global growth will be higher this year than it was in 2015.

Chart 1: US Yield Curve (10Yr-2Yr)



Source: EFGAM, Bloomberg

There is a fear that China will collapse, with a very large RMB devaluation which will wreak havoc on the rest of the world. As we discussed in our last note[1], we do not foresee this happening. What is happening is that the Chinese economy continues to shift from one led by industry and capex to a service and consumer-led economy. Recent data reinforces this view. The IMF currently has a growth forecast for China of 6.3% for 2016 and 6.0% for 2017. We believe many economists have a far dimmer view of the outlook for China, so growth at 6% or more will represent a positive surprise for markets. We should be wary, however, that Chinese policy makers are inexperienced in managing a more market led economy and they will continue to "learn by doing" which means that we will have these bouts of volatility from time to time until they improve.

Another concern is that problems in the energy sector will lead to contagion in credit markets. There is some truth to this, in that contagion fear is high given the illiquidity that exists these days in fixed income markets. However, Table 1 and Chart 2 show that there is as yet very little contagion into the other sectors of high yield (HY). We find both investment grade (IG) and HY corporates attractive at this point. Eventually the energy sector itself will find a floor (as we wrote in our 2016 Outlook) and will consolidate. This will create a significant performance opportunity.

Table 1: US High Yield Distress* By Sector

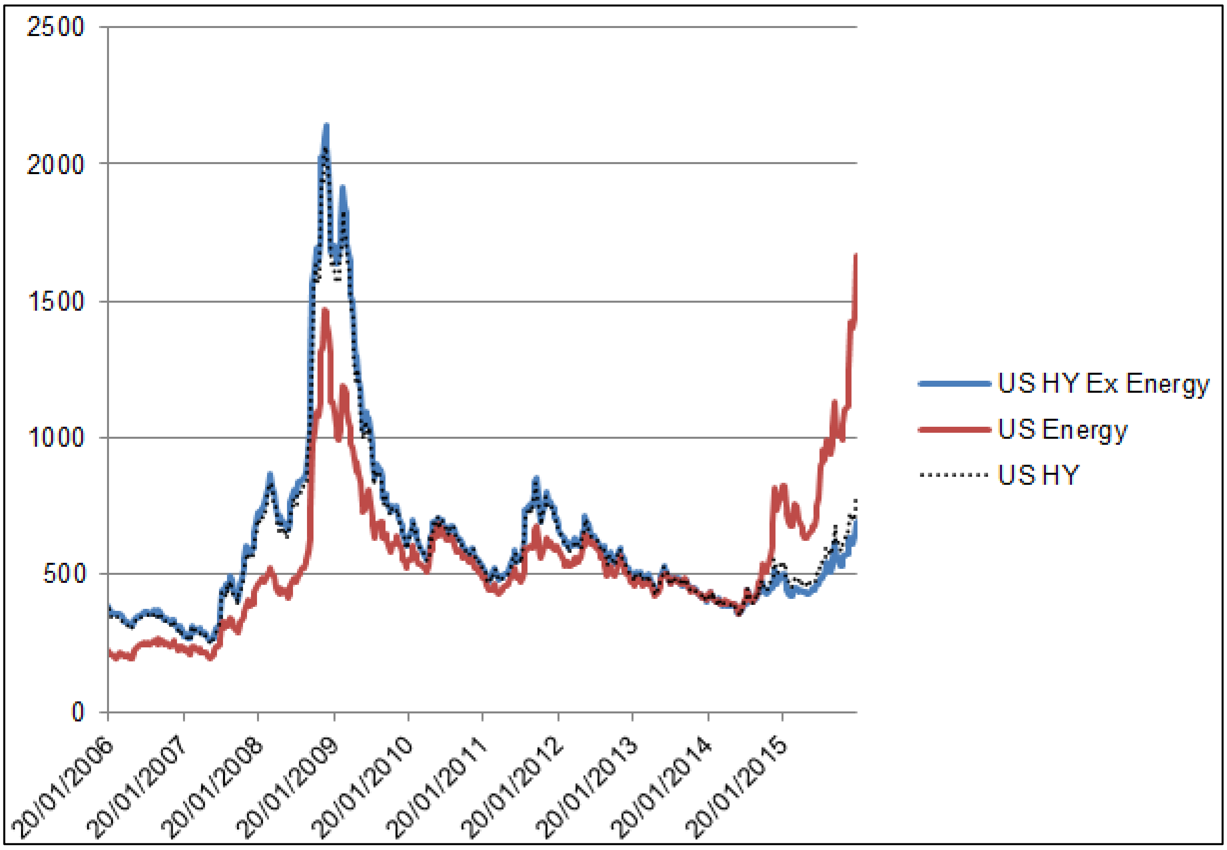
	Jan-16		Jan-09	
Sector	% in distress	Weight in the Index	% in distress	Weight in the Index
Automotive	3%	2%	46%	8%
Banking	0%	5%	38%	1%
Basic Industry	8%	11%	25%	13%
Capital Goods	1%	6%	7%	5%
CASH	0%	0%	0%	1%
Consumer Goods	0%	3%	13%	4%
Energy	32%	10%	12%	11%
Financial Services	3%	5%	53%	2%
Healthcare	0%	10%	9%	8%
Insurance	0%	1%	0%	1%
Leisure	0%	4%	19%	5%
Media	4%	11%	41%	8%
Real Estate	0%	1%	47%	1%
Retail	11%	5%	24%	5%
Services	6%	5%	17%	4%
Technology & Electronics	4%	5%	26%	4%
Telecommunications	0%	10%	5%	10%
Transportation	4%	1%	13%	1%
Utility	5%	3%	3%	9%

Source: EFGAM, Bloomberg, Merrill Lynch Bank of America

*Distress defined as number of issuers trading below 40c in the dollar

[1] EFG Market Update: 'Tis the season to be…nervous?
(Published 11 January)

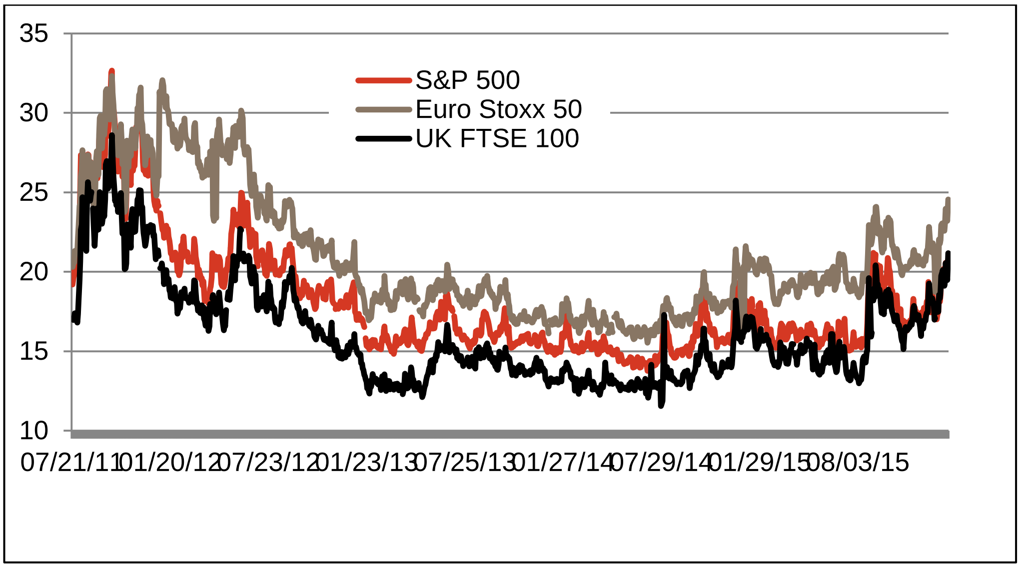
Chart 2: US High Yield Energy vs. Non Energy



Source: Merrill Lynch Bank of America

When do we reach a bottom? We believe an interim low for the markets is approaching, as conditions are over-sold and fear is high, per the implied volatilities (more accurate than the VIX index) which are at highs we have not seen since 2011 (Chart 3). In addition, valuation spreads (shown in Chart 4) are at extremes and consistent with previous recession type periods, which as we have established above, we do not believe in. In the rally, stocks that have been overly beaten up relative to fundamentals, value stocks and small-caps, offer the most up-side relative to ETFs (exchange-traded funds). We note for example, that on 20th January the Russell 2000 Index was up 0.5% and is down by 20% from its peak versus the S&P that was down 1.2% (on 20th January).

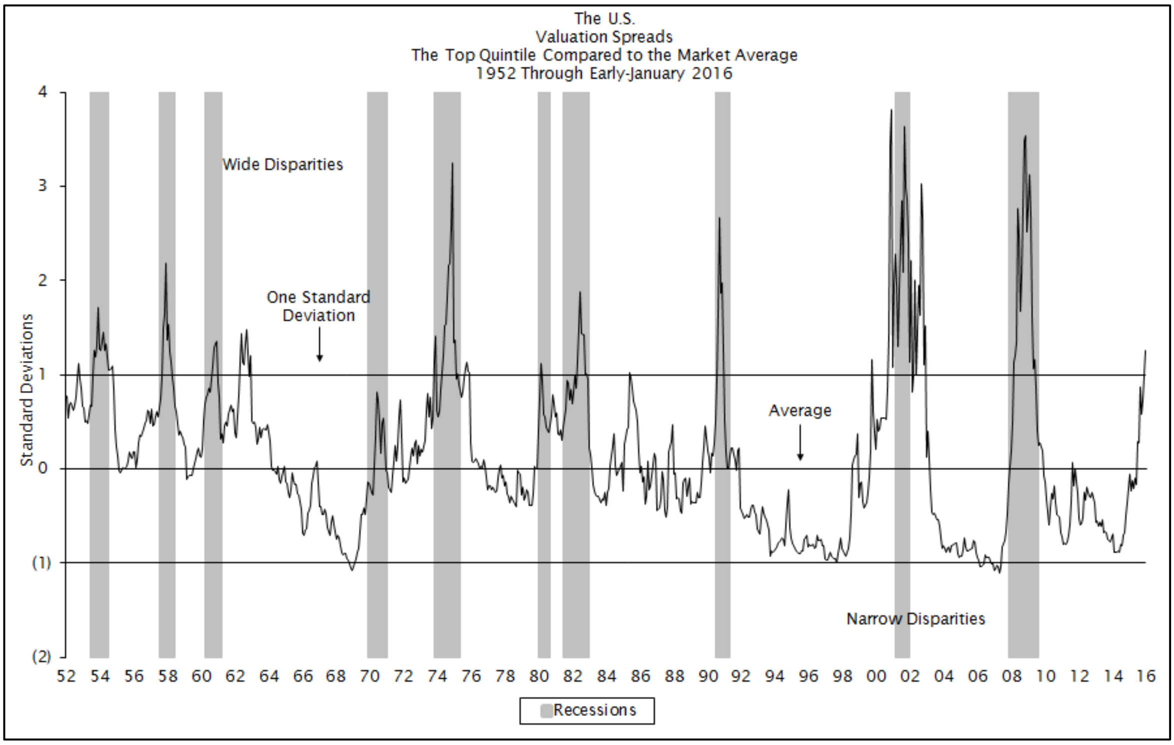
Chart 3: A Measure of Protection Demand*



*The implied volatilities of At-The-Money 12-month put options

Source: EFGAM, Bloomberg

Chart 4: US Valuation Spreads and Recessions



Source: National Bureau of Economic Research, Empirical Research Partners Analysis

From a contrarian perspective, we find it interesting that the major banks are all calling for a bear market. It is often the case that when all market participants share the same view at the same time, this is the point at which it is most attractive to adopt the opposite view.

As Birinyi Associates recently noted, *"sentiment maybe [sic] at an all-time low. We have never seen so many, so extreme forecasts. Granted there are more forecasts from diverse sources but for major firms to go to the edge of the limb is without precedent*". Major banks' recent strategist commentary includes:

- JP Morgan: Sell Stocks on Any Rally
- Guggenheim Sees Equity Bear Market
- UBS Full Size Bear Market This Year
- Citi Cuts US Equities to Underweight
- RBS Warns: "Sell Everything"
- Merrill: The S&P Could Go to 1,600 Bear Market is Here – Expect Another 15% Plunge
- SocGen - S&P Could Plunge 75%

Source: Birinyi Associates

What do we do next? Just like a doctor, we need to assess the "market" patient. What we are looking for are signs that any rally is sustainable and is in line with our non-recessionary and non-contagious view. The rally has got to have breadth (5 stocks up vs. 1 stock down), volume skewed to the upside and fear from the investing community that they are missing out. As we noted above, most large bank strategists have a negative view. We would also like to see a rally be accompanied by "good news"; this could come from confirmation that the Federal Reserve will not be reckless in rate increases or more dovish commentary from the European Central Bank (ECB), Bank of Japan (BoJ) and other central banks. In addition, a mildly depreciating US dollar which may accompany these more dovish comments will ease the pressure on commodities, emerging market currencies and credit spreads. If these rally conditions are not met, we will need to reassess our views in light of market action and volatility and look to cut our risk exposure and wait for a better re-entry point. This re-entry point may coincide with the Federal Reserve moving to re-engage quantitative easing (no. 4) to stabilise market conditions. This year may well be one of tactical awareness and we will need to keep an open and flexible mind if indeed additional actions are necessary.

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