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HAGLER VS. LEONARD: A UNANIMOUS DECISION FOR EMERGING MARKETS

By Jordi Visser, President & CIO

As a young kid growing up in New Jersey, I was a huge sports fan. I would watch anything. Some of my greatest childhood memories are of the great sporting events of the 1980s - the U.S. Olympic Gold Medal Hockey team, the Mets 1986 World Series, Georgetown vs. St. John's, Jack Nicklaus winning the masters, Borg vs. McEnroe at Wimbledon and the fight between Marvin Hagler and Sugar Ray Leonard. That fight was the best I can remember watching. Not only did the fight itself leave a lasting memory, but both the decision and the reaction were equally as gripping. You can ask ten people who they think won the fight and you will get passionate arguments on both sides. Seldom do you end up with a sporting event when so many people watch the same event but come up with totally different views on the outcome. Here are two examples of sports writers' analysis of the fight:

"What Ray Leonard pulled off in his split decision over Hagler was an epic illusion. He had said beforehand that the way to beat Hagler was to give him a distorted picture. But this shrewdest of fighters knew it was even more important to distort the picture for the judges. His plan was to "steal" rounds with a few flashy and carefully timed

Jordi Visser
President & CIO
CIO@gweiss.com
+1 212-415-7123

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flurries and to make the rest of each three-minute session as unproductive as possible for Hagler by circling briskly away from the latter's persistent pursuit. When he made his sporadic attacking flourishes, he was happy to exaggerate hand speed at the expense of power, and neither he nor two of the scorers seemed bothered by the fact that many of the punches landed on the champion's gloves and arms."

"It wasn't even close...He didn't just outpoint Hagler, he exposed him. He made him look like a guy chasing a bus. In snowshoes. Leonard repeatedly beat Hagler to the punch. When he did, he hit harder. He hit more often. He made Hagler into what he perceived him to be throughout his career—a brawler, a swarmer, a man who could club you to death only if you stood there and let him. If you moved, he was lost."

The passionate arguments surrounding the decision in this fight have been on my mind a lot since reading the news from Davos a few weeks ago. I have been writing about the growing risk of a recession for over a year now, so the discussion around the possibility of a recession is not the issue. What hit me was how extreme the viewpoints have become in such a short period of time. Many macro managers were calling for a systemic event similar to 2008. There were other annual industry conferences and events in January where the same message was being delivered. Sentiment seems to be growing and spreading in a manner I have not seen before. In just two months, we are now worried about defaults, the European banking system and a large scale China devaluation. Fears have jumped from a much needed equity market correction with some sort of an industrial recession all the way to a repeat of 2008. Some influential people have gone so far as to use the word "depression". All of these outcomes are of course possibilities but black swan events by definition are supposed to be a surprise and right now none of these would be surprising. To connect the dots between what I see and what others are saying is a huge leap. And now, with so many people talking about it, I think it's time to look at the other side. Like the sports writers' differing opinions on the Hagler/Leonard outcome, I would like to give my counter argument to the Davos "decision."

In my 2016 outlook Stop Waiting for Godot!, I made the argument that we believe we're in an economic environment with sharper and shorter business and investment cycles with more algorithmic trading and less liquidity. This would make the inflection points much more violent. In my opinion, all inflection points start simply with a positioning shift due to too many people on the same side of the boat. After that, value investors jump on the trend because of the stabilization and large value dispersion that resulted from the panic and then, finally, the fundamental data begins to support the trend and justifies it. I also mentioned how crowded positioning had become in what is effectively one trade and that when this inflection point occurred, it would be a violent market regime shift. For me, the reason behind this combustible positioning situation is simple. It's a function of a lack of fundamentally justified positioning due to low growth and low inflation and the outsized 18 month move in commodities and the dollar. Effectively, all positions are the same.

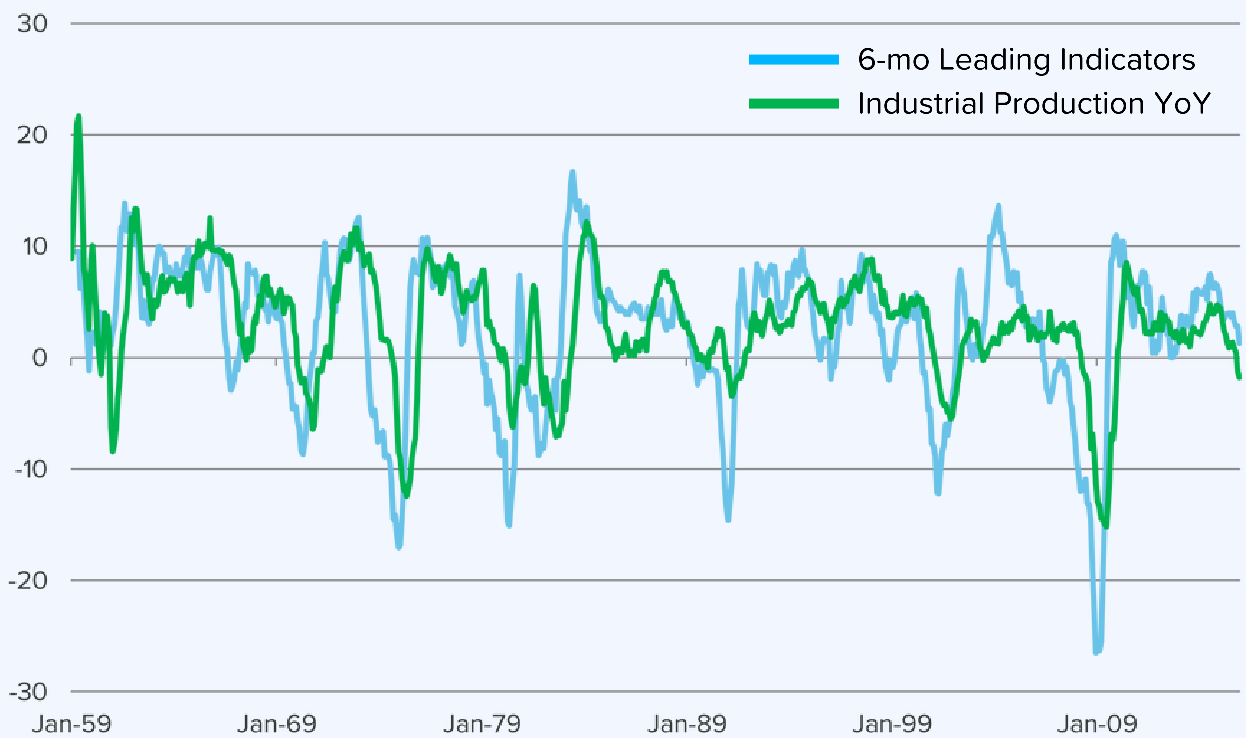
So here's the case for why I believe this will not be another 2008 but rather a typical recession and why everyone should be looking at signals suggesting that we're already priced for it. For what it is worth, I have to say, it's much more fun to write papers suggesting the worst may be over and it could be time to look for opportunities then writing papers about a potential recession. Although, I will add it is more painful to be early when trying to find bottoms than tops. Tops tend to be more rolling in shape, as we have seen for the last 18 months, while bottoms tend to move like "V"s or "W"s. As a disclaimer, in 2008 I started writing about positive times to come in December long before the panic and market bottom was over. I want to reiterate that I strongly believe inflection points will be much more violent than in prior cycles, which means you need to be early. Three things have me on high alert for a potential regime change: 1) sentiment and the market indicators confirming that sentiment, 2) green shoot signs in those areas that led this downturn which suggest that things are changing, and 3) China. In the remainder of this paper, if these three things play out, I discuss what I perceive to be a surprising opportunity that could amount to more than just a bounce.

In terms of sentiment, again, the feedback from Davos really hit me hard. I've been writing about a potential recession for over a year so it shocked me to see how quickly people seemed to get negative. Leading up to the Great Financial Crisis, recessions were getting harder and harder to identify in statistics as more of the economy was driven by the service side. Basically, for a recession to be anything more than mild you really needed to have a serious deflationary event combined with a large scale credit event. In this case, the deflation we are dealing with is commodities. I do think this has caused some sort of a US production recession as well as a corporate profits recession that will weaken the service side of the economy. As I have written in papers dating back over a year, the outstanding debt impacted by the fall in commodities is large, but I don't see this as anything close to the 2008 banking crisis or even the 1998 EM sovereign crisis. For sentiment to get to that level of crisis, I think it's been driven in part by the recency bias of 2008 and part by the Austrian economics belief that the debt supercycle blow up has been delayed by central bankers and now they are left without ammo. I do not believe that either of those scenarios represents our current deflation situation. As much as people want to now view the current commodity situation as bad, the reality is that lower commodity prices are good for almost everyone and bad for a very small part of the world. It's ironic that if you read economic outlooks for 2015, one of the big positives was the notion of lower oil prices for the world. Now, just a year later, it's a driving force behind a debt deflation situation that will take down the banking system! Quick sentiment shifts of this magnitude should be viewed skeptically, particularly when it shows in positioning reports and market movements. Too many people seem to be ready for this outcome. When you hear the voices, see the positioning and see the market movements confirming the sentiment, I think it is time to be careful.

To make the case that this type of commodity led deflation is quite different than prior debt deflation cycles refer to Exhibit 1. This is a chart dating back to 1959 overlaying YoY US industrial production with the 6 month annualized LEI (Leading Economic Indicator Index). Remember the LEI was created to help be predictive of a recession by focusing on the demand side of the economic indicators. If you look back in history you will notice that relationship helped every single time IP went negative as the LEI led production lower. For the most recent plunge, LEI is still positive and lagging. I will argue again that regardless of whether or not this is eventually technically defined as a recession, we have some sort of a recession with negative YoY IP. At the same time, unless we start to see a sizeable fall in stocks and consumer confidence coupled with a sharp rise in jobless claims, it will be difficult to see significant weakness in consumption. Lower gas prices and zero rates continue to be helping the demand side of the US economic engine from weakening too much. It was surprising how well the consumer sentiment numbers held up in January despite the fall in stock prices and front page news stories on the worst start to a year ever.

Exhibit 1: Commodity Deflation—This Time is Different

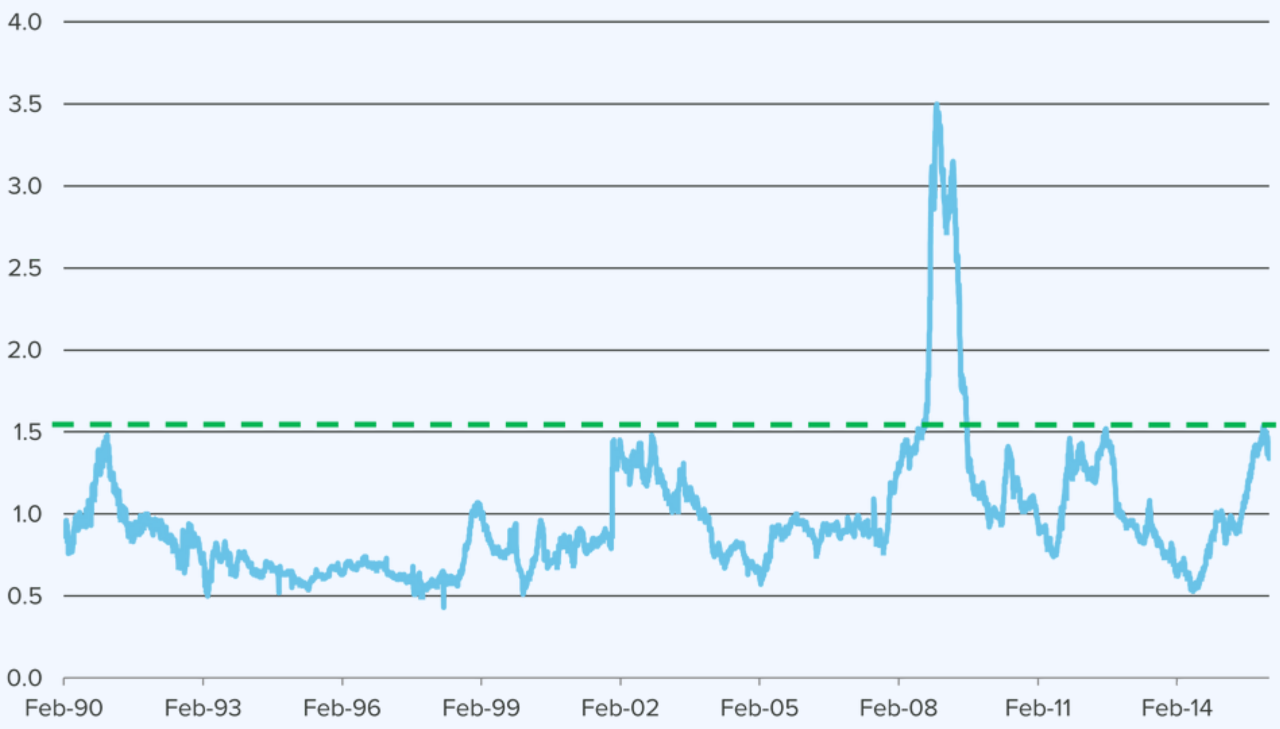
6 Month Leading Indicators vs. YoY Industrial Production



Source: Bloomberg

Exhibit 2: Markets Already Discounting a Recession

Baa Yield Spread to AAA



Source: Bloomberg

Exhibit 3: Commodity Sentiment Sharply Negative

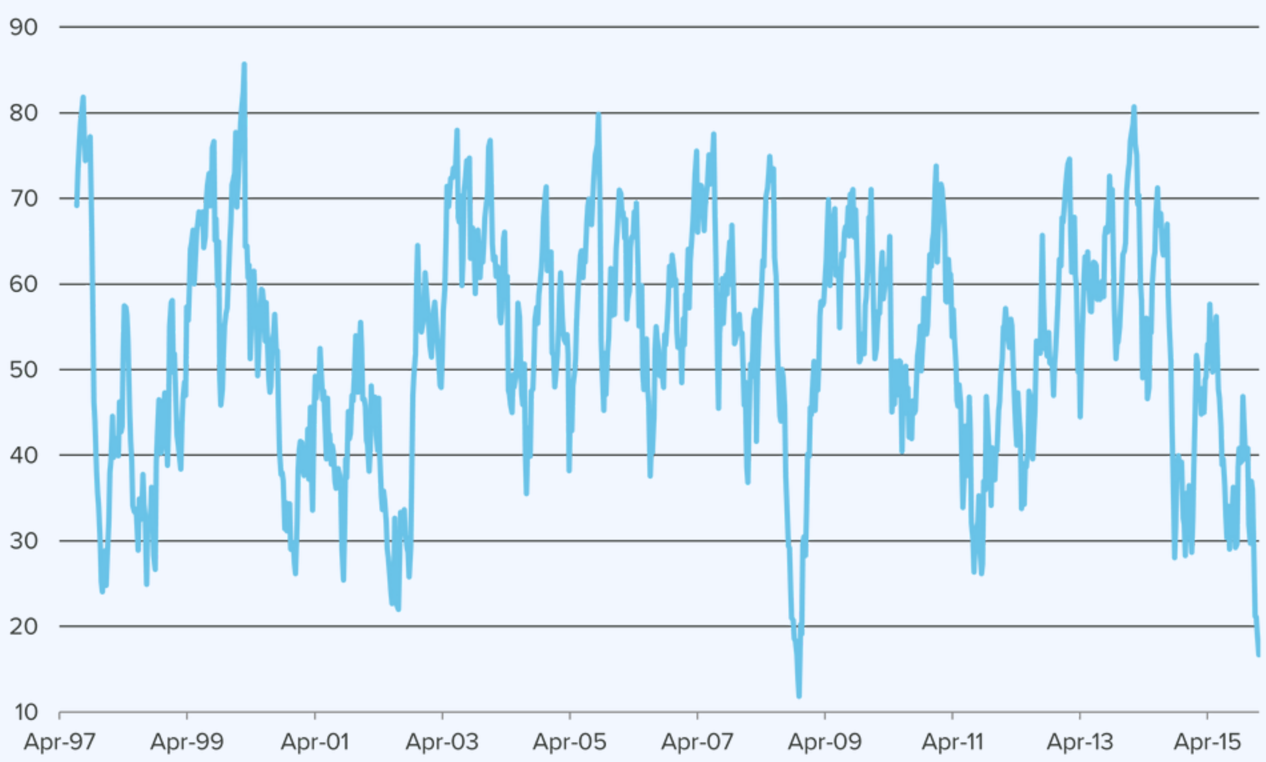
FCX Bond Price

Source: Bloomberg

On top of credit, equity markets have also done enough to discount a recession with most activity occurring in January. Equity markets around the world have fallen sharply off their highs with many of them down more than 20% at the lows in January, including the broad based New York Stock Exchange composite, Russell 2000 and Value Line Arithmetic indices. On a sector basis, one of my favorite panic gauges is the utility sector vs. the financial sector. In January, utilities outperformed financials by 14.5%. In the last 20 years, there are only five months when outperformance exceeded 14%. Four were during June 2008 to January 2009 with three of them after Lehman and the other was after the Russian default in August 1998. Also, the telecom sector outperformed the S&P 1500 by 11% in January. The only three months when outperformance was greater in last 20 years occurred in November 2008, October 2002 and September 2001. Then from a factor level, Exhibit 4 shows the 14 week RSI of low quality ranked S&P index vs. high quality over the last 20 years. The only time it was lower was in the period after Lehman. There has been a stampede into safer balance sheet cash flow safe stocks and sectors which typically happens in recessions. Finally, in Europe, believe it or not, the Eurostoxx Banks underperformed the Eurostoxx by more in January than any month during the 2011-2012 crisis when the fear was over the breakup of the EU. Not only are we hearing the negative sentiment, but the market is also reflecting the panic in asset prices.

Exhibit 4: Investors Moving into 'Quality' Stocks

Relative Strength Low Quality S&P 500 vs. High Quality S&P 500 Index

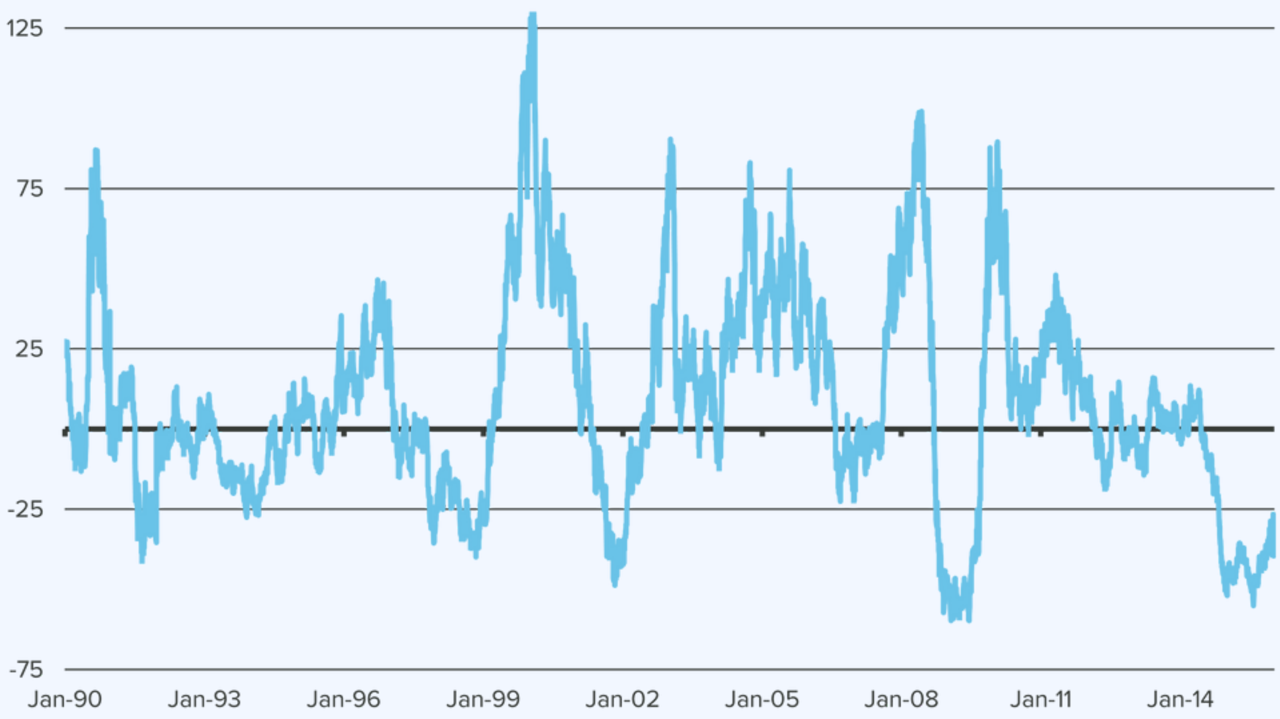


Source: Bloomberg

So if we accept that we are likely in some sort of a recession, and that the market is clearly seeing it and discounting it, it is time to go back to the concept behind our recession model and look at rate of change. In 2009 Ben Bernanke started using the phrase "green shoots" which is just another way of saying rate of change or second derivative. Basically, before things get better, they get less worse. This may sound simple but because people believe asset prices should only improve when the data is good, it pays to focus on the second derivative in looking for bottoms particularly if bottoms are sharp. Given these problems have been caused primarily by commodities and the dollar, let's focus on these for green shoots. The most interesting change I can see today suggesting that the worst is over is in the CRB raw spot index, which is a component of our recession model. From May 2014 to November 2015 this index was down 17 of 19 months with the two positive months less than 60 bps. In December, it was up 1.19% and then January was up 3.01%, which was the single largest month since 2012.So far in February it is up over 1% again. The 10 day moving average in the index crossed the 100 day moving average for the first time since November 2013. This index does not use futures so it may be a better indication of true demand than futures indices which can bounce around on speculative positioning. Iron ore, one of the more important and recently weak indicators for China, made its low in December and has rallied nicely so far in February. Finally, for energy, using the S&P GSCI energy index, Exhibit 5 shows that the 1 year rate of change is at the highest level since 2014.

Exhibit 5: A Turning Point in Energy Markets?

1 Year Rate of Change S&P GSCI Energy



Source: Bloomberg

A similar rate of change argument can be made for most currencies vs. the dollar as well. In the last three months, the dollar has been weaker against the euro, yen, aussie and kiwi. The DXY as of today is less than 1% from the 200 day moving average. At the peak in March 2015, it was more than 12% above the 200 day moving average. The final strength of the dollar over the last six months was driven by a combination of Asian currencies and the emerging market commodity countries. This move was helped by the final fall in crude from the low 60s in June and from the surprise China devaluation in August. For me these were the trigger events that got people as bearish as they are today.

Outside of sentiment, the market indications of panic and the green shoots showing up, China is what makes me feel most strongly that the Davos negativity is wrong. Consensus views on China are based around a hard landing and a large scale devaluation of the yuan. Although I continue to believe that China will slow for years to come, like all developed markets with growing demographic issues, and that their currency is likely to continue to weaken in the near term, I do not agree that China is going to have a hard landing or do anything that could cause unexpected consequences in their own country like a large scale devaluation. It is this view that makes me feel like I am reliving the day after Hagler/Leonard, only watching a different fight. I just don't understand how people have gotten to this outcome with such unanimity. In terms of the currency, the last 18 months has been a dollar strengthening trade. With the yuan pegged to the dollar, the yuan was strengthening against global exchange rates. China let the currency adjust in August, part of the requirement for the IMF SDR inclusion and then announced they will be monitoring the currency against a basket in December. Why does a devaluation need to be against the dollar and not against other exchange rates? The 12 month yuan dollar forward has already weakened to the lowest level since 2009. At the end of January, Premier Li Keqiang reinforced this by telling the IMF chief they have "no intention to boost exports by devaluing the renminbi, not to mention waging a trade war." In addition he said, "The fact is that the renminbi exchange rate has remained basically stable against a basket of currencies and there is no basis for continuous depreciation of the renminbi." If a senior US official said something like this about the dollar, it would be big news. When it is said by a senior China official, it is treated as no big deal.

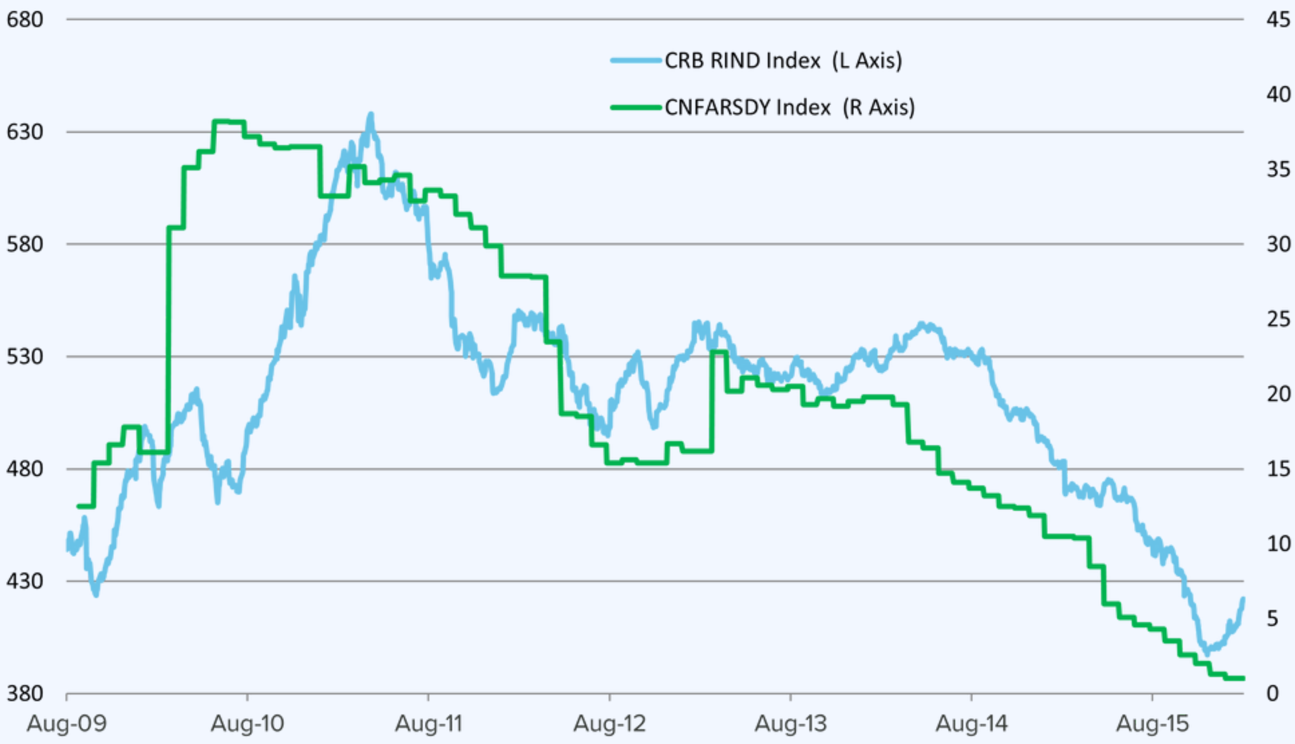
As for the argument of China's weakness in the industrial economy, I do agree that their fixed asset investment has slowed rapidly and there is likely hundreds of billions of dollars of non-performing loans related to it. However, none of this is new news to the market or Chinese officials. In addition, I also agree in the short term that there is still likely to be pressure on the currency leading to more reserve losses. However, these two likelihoods do not, in my opinion, make a hard landing inevitable. China clearly has an industrial recession and in that sector, a corporate profits recession. At the same time, it created 13 million jobs last year. An industrial and profits recession while creating a lot of jobs sounds a lot like the U.S. but of course in China it's a hard landing. For any argument on bad debt, I will continue to remind people that the debt is in zombie SOEs and local governments. This is just like zombie auto companies, Freddie and Fannie and banks in the US and the periphery countries in the EU. The only difference is China doesn't need to vote on TARP or convince the Germans to agree to bailouts. On top of that, they can do QE without a Fed, BOJ or ECB announcement. On top of that, it's also difficult for me to believe that picking a fight with the largest bully at the school will work. This is not Thailand or Malaysia in 1998. This is the largest economy in the world in PPP terms with an M2 almost twice as big as the United States.

In terms of the math behind the drop off in China's GDP, let's use an example of a simple algebraic formula. X+Y=Z where Z is the real GDP growth rate. X is the Fixed Asset Investment ("FAI") contribution and Y is the consumption contribution. Let's assume in 2010, X is 7%, Y is 3% and Z is 10%. Now let's assume that for 2016, X is 1.5%, Y is 4.5% and Z is 6%. This is approximately my belief on what has happened since 2010. Everyone who is saying GDP is closer to 3% is correct if they talk about FAI. Exhibit 6 shows China YoY fixed asset real estate investment relative to the CRB raw spot industrial commodity index which I mentioned above as a green shoot. Looking at this chart you can see that YoY FAI real estate growth has declined from 20+% to 2.8%. That kind of a massive drop in growth rate is a hard landing. Since most people view China as the 70% fixed asset investment country, it makes sense that they would think a hard landing is coming. However, at the same time, retail sales for 2015 rose 10.7% and despite softness in real estate prices in the commodity sensitive parts of the country and inventory problems in Tier 3 and Tier 4 cities, Shanghai, Beijing and Shenzhen secondary real estate prices were up

11.7%, 20.8% and 42.6% respectively in 2015. To support these statistics, Exhibit 7 shows the relative chart of the Shanghai Property index to the Shanghai composite. In addition, car sales were up 18% and movie box office, airline passengers, 4G subscriptions all continue to show strong YoY growth. FAI is weak but to have a hard landing the second derivative of these consumption stats should at least be pointed down and for many of these and for the monthly real estate data, the second derivatives are pointed up. In addition, just this past week they lowered the down payment on mortgages. In 2013, I wrote a paper titled, Adapt or Die Part II: The Signal or the Noise. This paper focused on how looking at the industrial revolution side of the economy was noise and the real story for China is the rapidly growing digital economy. In the US, for indications in the market of that story, we look at the Nasdaq relative to the SPX. In China that is seen in the Shenzhen Composite relative to the Shanghai seen in Exhibit 8. I continue to believe the Shenzhen Composite is the best investment story few people follow and it remains the signal while the SOE filled Shanghai Composite is the noise. Aside from the already known weakness in the industrial side of the economy, I just don't see any signs of a hard landing. My gut tells me fighting the Chinese government will be as painful as shorting JGBs and the China consumer will be as difficult to bet against as the baby boomers were during the 1990s.

Exhibit 6: Green Shoots in China

China Fixed Asset Real Estate Investment vs. CRB RIND Index



Source: Bloomberg

Exhibit 7: Chinese Secondary Real Estate on the Rise

Shanghai Property Index/Shanghai Composite Index

Source: Bloomberg

Exhibit 8: The Chinese Information Age

Shenzhen Composite Index/Shanghai Composite

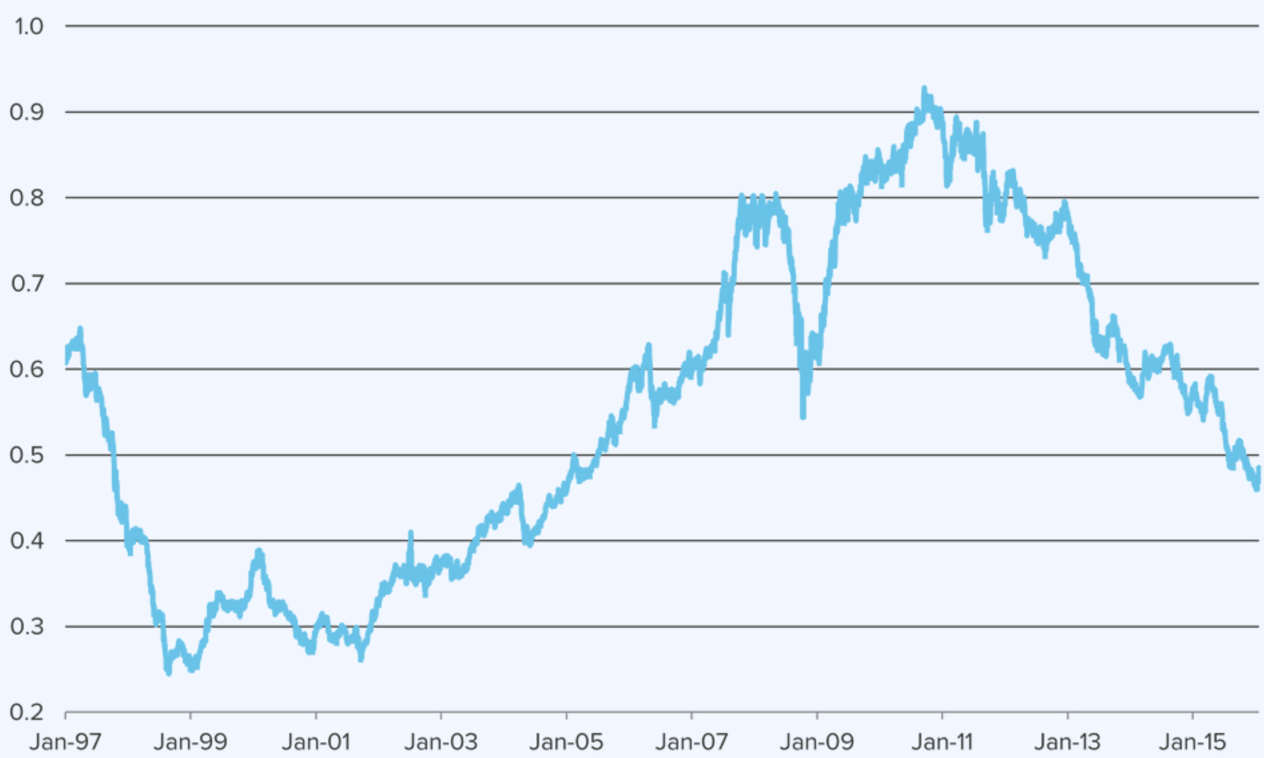
Source: Bloomberg

Overall, sentiment is now extremely negative, with positioning to reflect that view and many market indicators showing recession type fear movements. We have seen some green shoots in commodities and a weaker dollar signaling that the worst of those moves may be over. At the same time I do not think China will have a hard landing or force a large scale devaluation. Using those as a backdrop, I think it is time to talk about an opportunity that would benefit from this scenario. Despite the bounce in the CRB raw spot index, I want to be clear that I do not think buying commodities is the opportunity. Whatever bounce that occurs to me will be a positioning bounce. I continue to believe innovation is leading us into a post scarcity world where commodities will continue to remain low. The opportunity to me lies with emerging markets. I mentioned in the 2016 outlook paper that I believed this year emerging markets would outperform global developed markets. This to me is not a bounce trade. I know there are a lot of people that think the EM world is doomed but I see it differently and believe although it may end up being a little early, longer term investors should be buying emerging markets now.

If you look at MSCI emerging markets vs. MSCI world, you will see that so far this year despite the negative start, EM has outperformed. Exhibit 9 shows the long term chart of the pair. Starting in early 2011, EM has gone through five years of pain. This has been driven by three major forces. The first two can be seen back in Exhibit 6. China's fixed asset investment into real estate was growing rapidly with China in a three year period laying more concrete and cement than the US did during the entire 20th century. This obviously led to extrapolation that it would continue but, as the chart shows, the growth rate slowed along with GDP. Starting in early 2014, we saw the final rapid slowdown along with the commodities and a stronger dollar. In the same way that investors were extrapolating the growth of China back in early 2011, now they are extrapolating the trends in China's growth drop, commodities fall and the dollar strength. At a minimum, I expect stabilization in all of these trends to be a relatively good thing for EM.

Exhibit 9: Emerging Markets Ready for a Bounce

MSCI EM/MSCI World



Source: Bloomberg

From an entry point perspective, I believe EM is cheap but I don't really want to use value as a spark; I could have said that for a long time. Rather, I am going to use my experiences with EM in the 1990s and thoughts on innovation as to why I think the time is not only now for a trade but also why I think EM will outperform for some time. I traded emerging markets throughout the 1990s beginning two months before the Tequila Crisis began in 1994. I was in Brazil during the Asian crisis and left after the devaluation in Brazil. During those times, I realized that no matter how dedicated the western world says it is to EM, when it gets bad, it looks for the exit door. Bottoms are typically made when you have investment banks closing offices in EM, which we are seeing now, and fund outflows of the magnitude we have recently seen. In addition, bottoms typically occur when we see panic reach the developed markets. If you look at Exhibit 9, you will see the last three important relative inflection points for EM took place in September 1998, September 2001 and November 2008. All of these dates were mentioned in the paragraph above regarding the recent strength in telecom and utilities coupled with the weakness in the banks.

In addition to the bottoming signs, I think the pressure EM governments are facing currently can only be viewed as a positive. Having lived in Brazil for over two years, I can tell you that the government and corruption are two of the problems keeping the country from making necessary progress. Everyone is asking for structural reform. Structural reform means structural problems and I can't think of a better bottom signal then what we are seeing in Brazil. High level arrests, smartphone led organized protests and impeachment talk are all good, not bad. Finally, from an innovation perspective, I mentioned in my 2016 outlook that I expect the next innovation boom to be in healthcare. It will be disruptive in the way that the energy sector was disrupted. I see the benefits of innovation in healthcare driving prices lower, helping to balance out the lack of good hospitals and doctors. Life expectancy in the BRICs is at the bottom of life expectancy tables. They will benefit the most by what's to come in healthcare. I see a similar story happening with education over the next five years as online education and virtual reality allow for countries that need these services to benefit dramatically. Over the next five years, the biggest beneficiaries to the technology boom will be the bottom end of the distribution of wealth problem. Cheaper energy, education and healthcare all mean big improvements for emerging markets. Lower commodity prices and technology are speeding up structural reform.

It is ironic that at Davos, people were saying the world is going to fall apart from a deflation scenario. Also at Davos was talk about the problem of the distribution of wealth. I think the next part of the innovation boom will be the deflation in three areas the majority of the EM world needs. All of this gets back to the Davos "decision." I may be watching the same battle over a recession, but like in the case with the Hagler/Leonard fight almost 30 years ago, I see a controversial outcome. Also, for what it is worth, I still think Hagler won that fight.